

**COMMONWEALTH OF PUERTO RICO**  
**Financial Information and Operating Data Report**  
**May 1, 2010**

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**INTRODUCTION**

**General**

The financial and operating information about the Commonwealth of Puerto Rico (the “Commonwealth” or “Puerto Rico”) included in this Report has been updated as of May 1, 2010, except as otherwise provided herein. The Commonwealth’s fiscal year runs from July 1 through June 30 of the following year. References in this Report to a particular fiscal year are to the year in which such fiscal year ends.

**Forward-Looking Statements**

The information included in this Report contains certain “forward-looking” statements. These forward-looking statements may relate to the Commonwealth’s fiscal and economic condition, economic performance, plans, and objectives. All statements contained herein that are not clearly historical in nature are forward-looking, and the words “anticipates,” “believes,” “continues,” “expects,” “estimates,” “intends,” “aims,” “projects,” and similar expressions, and future or conditional verbs such as “will,” “would,” “should,” “could,” “might,” “can,” “may,” or similar expressions, are generally intended to identify forward-looking statements.

These statements are not guarantees of future performance and involve certain risks, uncertainties, estimates, and assumptions by the Commonwealth that are difficult to predict. The economic and financial condition of the Commonwealth is affected by various financial, social, economic, environmental, and political factors. These factors can be very complex, may vary from one fiscal year to the next, and are frequently the result of actions taken or not taken, not only by the Commonwealth and its agencies and instrumentalities, but also by entities such as the U.S. government or other nations that are not under the control of the Commonwealth. Because of the uncertainty and unpredictability of these factors, their impact cannot, as a practical matter, be included in the assumptions underlying the Commonwealth’s projections.

**Overview of Economic and Fiscal Condition**

*Economic Condition*

Puerto Rico’s economy is currently in a recession that began in the fourth quarter of fiscal year 2006. Although Puerto Rico’s economy is closely linked to the United States economy, for fiscal years 2007, 2008 and 2009, Puerto Rico’s real gross national product decreased by 1.2%, 2.8%, and 3.7%, respectively, while the United States economy grew at a rate of 1.8% and 2.8%, respectively, and contracted during fiscal year 2009 at a rate of 2.5%. According to the Puerto Rico Planning Board’s (the “Planning Board”) latest projections, which take into account the preliminary results for fiscal year 2009, the economic impact of a delay in the disbursement of funds from the American Recovery and Reinvestment Act of 2009 (“ARRA”), and other economic factors, the gross national product for fiscal year 2010 is

forecasted to contract by 3.6%. The gross national product for fiscal year 2011, however, is forecasted to grow by 0.4%.

### *Fiscal Condition*

*Structural Budget Imbalance.* Since 2000, the Commonwealth has experienced a structural imbalance between recurring government revenues and expenditures. The structural imbalance was exacerbated during fiscal years 2008 and 2009, with recurring government expenditures significantly exceeding recurring revenues.

Prior to fiscal year 2009, the government bridged the deficit resulting from the structural imbalance through the use of non-recurring measures, such as borrowing from Government Development Bank for Puerto Rico (“GDB”) or in the bond market, postponing the payment of various government expenses, such as payments to suppliers and utilities providers, and other one time measures such as the use of derivatives and borrowings collateralized with government owned real estate. Since March 2009, the government has taken multiple steps to address and resolve this structural imbalance. These steps are discussed below under “The Economy—Fiscal Stabilization and Economic Reconstruction.”

For fiscal year 2009, the estimated deficit was approximately \$3.490 billion, consisting of the difference between preliminary revenues (without taking into account a one time accounting adjustment related to the sales and use tax) and estimated expenses for such fiscal year. The estimated deficit is projected to be less than \$2.5 billion for fiscal year 2010 and approximately \$1.0 billion for fiscal year 2011, as discussed below. The administration projects it will eliminate the deficit by fiscal year 2013.

*Results for Fiscal Year 2009.* Total preliminary General Fund revenues for fiscal year 2009 were \$7.673 billion, representing a decrease of \$686 million, or 8.2%, from fiscal year 2008 revenues and an increase of \$73 million, or 1.0%, over the \$7.6 billion revised estimate presented by the administration in February 2009. Total expenses for fiscal year 2009 were approximately \$11.250 billion, consisting of budgeted General Fund expenditures of \$9.484 billion and approximately \$1.766 billion of additional non-budgeted expenses. The difference between preliminary General Fund revenues and total expenses for fiscal year 2009 was principally paid from proceeds of Puerto Rico Sales Tax Financing Corporation (“COFINA” by its Spanish-language acronym) bond issues pursuant to the fiscal stabilization plan described below.

*Preliminary Results for Fiscal Year 2010 (First Eight Months).* Preliminary General Fund revenues for the first eight months of fiscal year 2010 (from July 2009 through February 2010) were \$4.47 billion, a decline of \$318 million, or 6.6%, from the \$4.79 billion of revenues for the same period in the prior fiscal year and on target with the budgeted revenues for the first eight months of fiscal year 2010. As budgeted, the decline in General Fund revenues reflects the reduction in General Fund revenues from the sales and use tax as a result of the allocation of a larger portion of such tax to COFINA (amounting to \$365 million for the first eight months of fiscal year 2010), and the continuing impact of the ongoing economic recession, partly offset by the effect of the temporary and permanent revenue raising measures implemented as part of the fiscal stabilization plan described below (including \$128 million in additional property taxes for

the first eight months of fiscal year 2010). If the additional allocation to COFINA and additional property taxes are not taken into account, the reduction in General Fund revenues would have been \$81 million, or 1.9%. The estimated General Fund revenues for fiscal year 2010 remain, as budgeted, at \$7.670 billion.

Budgeted expenditures for fiscal year 2010 amount to \$10.170 billion, consisting of \$7.670 billion of budgeted General Fund expenditures and approximately \$2.5 billion of additional expenditures to be covered from COFINA bond issues, as part of a multi-year fiscal stabilization plan to achieve fiscal balance (see “Fiscal Stabilization Plan” below).

*Fiscal Stabilization Plan.* In January 2009, the administration, which controls the Executive and Legislative branches of government, began to implement a multi-year plan designed to achieve fiscal balance, restore sustainable economic growth and safeguard the investment-grade ratings of the Commonwealth. The fiscal stabilization plan, which was generally contained in Act No. 7 of March 9, 2009, as amended (“Act No. 7”), seeks to achieve budgetary balance on or before fiscal year 2013, while addressing expected fiscal deficits in the intervening years through the implementation of a number of initiatives, including: (i) a gradual \$2 billion operating expense-reduction plan through reduction of operating expenses, including payroll, which is the main component of government expenditures, and the reorganization of the Executive Branch; (ii) a combination of temporary and permanent revenue raising measures, coupled with additional tax enforcement measures; and (iii) a bond issuance program through COFINA. The proceeds from the COFINA bond issuance program were and will be used to repay existing government debt (including debts with GDB), finance operating expenses for fiscal years 2009 through 2011 (and for fiscal year 2012, to the extent included in the government’s annual budget for such fiscal year), including costs related to the implementation of a workforce reduction plan, and fund an economic stimulus plan, as described below. During fiscal year 2010, the administration began to design and intends to adopt during fiscal year 2011 a comprehensive reform of the tax system and commence to implement a long-term economic development plan, both of which are designed to complement the short-term economic reconstruction and supplemental stimulus initiatives described below.

As of April 30, 2010, the administration had implemented measures that are expected to result in annual savings of approximately \$900 million.

*Government Reorganization Plan.* The administration has also taken the first steps to reorganize and modernize the Executive Branch. On December 11, 2009, the Governor signed Act No. 182 that seeks to reduce the number of government agencies and operational expenditures. On April 13, 2010, the administration submitted to the Legislative Assembly a bill proposing a referendum to amend the Constitution in order to restructure the Legislative Assembly by reducing the number of legislators. If the bill is approved, the referendum would be held on or prior to May 1, 2011 and any amendments to the Constitution approved in such referendum would take effect with respect to the Legislative Assembly to be installed on January 2, 2013.

*Unfunded Pension Benefit Obligations and Cash Flow Deficits of the Retirement Systems.* One of the challenges every administration has faced during the past 20 years is how to address the growing unfunded pension benefit obligations and cash flow deficits of the three government

retirement systems that are funded principally with government appropriations. As of June 30, 2009, the total unfunded accrued actuarial liability for the three retirement systems was \$23.9 billion and the expected aggregate cash flow deficit for fiscal year 2010 was \$640 million. In order to address the growing unfunded pension benefit obligations and cash flow deficits of the three government retirement systems, the administration has adopted or will adopt the measures described in “Retirement Systems—Efforts to Address Cash Flow Shortfall and Improve Funding Ratio.” See “Retirement Systems.”

In February 2010, the Governor of Puerto Rico established a special commission to make recommendations for improving the financial solvency of the retirement systems. The Commission is expected to submit a report to the Governor by the end of the first quarter of fiscal year 2011.

### *Economic Reconstruction Plan*

In fiscal year 2009, the administration began to implement a short-term economic reconstruction plan. The cornerstone of this plan was the implementation of federal and local economic stimulus programs. Puerto Rico has been awarded approximately \$6.5 billion in stimulus funds under the ARRA program, which was enacted by the U.S. government to stimulate the U.S. economy in the wake of the global economic downturn. Approximately \$3.3 billion of the ARRA funds is allocated for consumer and taxpayer relief and the remainder will be used to expand unemployment and other social welfare benefits, and spending in education, healthcare and infrastructure, among others. As of April 23, 2010, Puerto Rico has disbursed \$2.8 billion in ARRA funds, or 43% of awarded funds.

The administration has complemented the federal stimulus package with additional short and medium-term supplemental stimulus measures that seek to address local economic challenges and provide investment in strategic areas. These measures included a local \$500 million economic stimulus plan to supplement the federal plan.

### *Economic Development Plan*

The administration has also developed the *Strategic Model for a New Economy*, which is a comprehensive long-term economic development plan aimed at improving Puerto Rico’s overall competitiveness and business environment and increasing private-sector participation in the Puerto Rico economy. As part of this plan, the administration enacted Act No. 161 of December 1, 2009, which overhauled the permitting and licensing process in Puerto Rico in order to provide for a leaner and more efficient process that fosters economic development. The administration also proposes to (i) strengthen the labor market and encourage greater labor-force participation by bringing out-of-date labor laws and regulations in line with U.S. and international standards, (ii) adopt a new energy policy that seeks to lower energy costs and reduce energy-price volatility by reducing Puerto Rico’s dependence on fuel oil and the promotion of diverse, renewable-energy technologies, and (iii) adopt a comprehensive tax reform that takes into account the Commonwealth’s current financial situation. In February 2010, the Governor named a committee to review the Commonwealth’s tax system and propose a tax reform. The committee’s report is due by September 2010 and the administration plans to file tax reform legislation during the immediately following legislative session.

In addition, to further stimulate economic development and cope with the fiscal crisis, on June 8, 2009, the Legislative Assembly approved Act No. 29 establishing a clear public policy and legal framework for public-private partnerships to finance and develop infrastructure projects and operate and manage certain public assets. The administration is currently evaluating and expects to commence procurement for eight public-private partnership priority projects during fiscal year 2011.

The administration has also identified strategic initiatives to promote economic growth in various sectors of the economy where the Commonwealth has competitive advantages and several strategic/regional projects aimed at fostering balanced economic development throughout the Island. These projects, some of which are ongoing, include the development of a trans-shipment port and tourism and urban redevelopment projects.

The fiscal stabilization plan, the economic reconstruction plan, and the long term economic development plan are described in further detail below under “The Economy—Fiscal Stabilization and Economic Reconstruction.”

#### *Recalibration of Ratings of Commonwealth General Obligation Bonds*

On April 19, 2010, Moody’s Investors Service (“Moody’s”) announced the results of the recalibration of certain U.S. municipal bond issues and issuers in order to enhance the comparability of credit ratings across its portfolio of rated securities. As a result of this recalibration, the Commonwealth’s general obligation debt is now rated “A3” with a stable outlook by Moody’s, which is three categories above the previous “Baa3” rating. The administration expects that this recalibration will increase the number of potential investors for the Commonwealth’s general obligation bonds and have a positive impact on the Commonwealth’s financing costs.

#### *Proposed Fiscal Year 2011 Budget*

On April 26, 2010, the Governor submitted to the Legislative Assembly a proposed budget for fiscal year 2011. The proposed budget provides for total General Fund revenues of \$8.195 billion, compared to estimated General Fund revenues of \$7.670 billion for fiscal year 2010. The proposed General Fund revenues of \$8.195 billion include base revenues of \$7.645 billion, \$241 million from tax enforcement and compliance measures, \$220 million from license fees of video lottery machines and \$89 million of property taxes from the self-appraisal of real property. The proposed fiscal year 2011 budget provides for total expenditures of \$9.195 billion, consisting of General Fund expenditures of \$8.195 billion and additional expenditures of \$1.0 billion that are expected to be covered from proceeds of COFINA bond issues, including a \$500 million proposed bond issue during fiscal year 2011. The proposed total expenditures for fiscal year 2011 are \$975 million, or 9.6%, lower than budgeted total expenditures of \$10.170 billion for fiscal year 2010, and \$2.055 billion, or 18.3%, lower than estimated total expenditures of \$11.250 billion for fiscal year 2009.

#### **Geographic Location and Demographic Trends**

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



According to the United States Census Bureau, the population of Puerto Rico was 3,808,610 in 2000 (3,967,179 as of July 1, 2009 according to the most recent U.S. Census Bureau estimate), compared to 3,522,000 in 1990. As of 2000, the population of San Juan, the island's capital and largest city, was 434,374 (420,326 as of July 1, 2009 according to the most recent U.S. Census Bureau estimate).

## **Relationship with the United States**

Puerto Rico's constitutional status is that of a territory of the United States, and, pursuant to the territorial clause of the U.S. Constitution, the ultimate source of power over Puerto Rico is the U.S. Congress.

Puerto Rico came under United States sovereignty pursuant to the Treaty of Paris, signed on December 10, 1898, which ended the Spanish-American War. Puerto Ricans have been citizens of the United States since 1917. In 1950, after a long evolution toward greater self-government, Congress enacted Public Law 600, which provided that the existing political, economic and fiscal relationship between Puerto Rico and the United States would remain the same, but Puerto Rico would be authorized to draft and approve its own Constitution, guaranteeing a republican form of government. The Constitution was drafted by a popularly elected constitutional convention, approved in a special referendum by the people of Puerto Rico, amended and ratified by the U.S. Congress, and subsequently approved by the President of the United States.

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

The official languages of Puerto Rico are Spanish and English.

## **Governmental Structure**

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

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

### **Principal Officers Responsible for Fiscal Matters**

**Luis G. Fortuño** was sworn in as Governor of Puerto Rico on January 2, 2009. From 2005 until becoming Governor, Mr. Fortuño was Puerto Rico's elected Resident Commissioner in the U.S. House of Representatives. Mr. Fortuño was an attorney in private practice from 1985 to 1993, and again from 1997 to 2003. Mr. Fortuño was the Executive Director of the Tourism Company from 1993 to 1996. From 1994 to 1996, Mr. Fortuño served as the first Secretary of the Department of Economic Development and Commerce. Mr. Fortuño holds a Bachelor's Degree from the Edmund A. Walsh School of Foreign Service at Georgetown University and a Juris Doctor from the University of Virginia School of Law.

**Juan Carlos Puig Morales** was designated as Secretary of the Department of the Treasury (the "Treasury Department") on January 4, 2009 and unanimously confirmed by the Senate of Puerto Rico on March 6, 2009. From 1998 to 2008, Mr. Puig Morales served as a Director in the Taxpayer Advocate Service, an independent office within the U.S. Internal Revenue Service, in Puerto Rico and South Florida. From 1994 to 1998, Mr. Puig Morales served in various positions in the Treasury Department, including Assistant Undersecretary of Internal Revenue, Project Manager of the Master Tax Archive, and Director of Administrative Reform. From 1990 to 1994, Mr. Puig Morales served as a Senior Tax Administration Advisor with the U.S. Internal Revenue Service. Mr. Puig Morales holds a Bachelor of Arts Degree from the University of Turabo, where he majored in Economics.

**María Sánchez Brás** was appointed Executive Director of the Office of Management and Budget ("OMG") on January 2, 2009. From 2004 to 2008, Ms. Sánchez Brás worked as the principal financial officer of several companies in the insurance and pharmaceuticals sectors in Puerto Rico. From 1998 to 2004, Ms. Sánchez Brás served as Controller for McDonald's Caribbean region. From 1990 to 1998, Ms. Sánchez Brás worked with various manufacturing companies in different managerial and financial roles. Prior to 1990, Ms. Sánchez Brás worked with KPMG Peat Marwick. Ms. Sánchez Brás holds a Bachelor's Degree from the University of Puerto Rico – Río Piedras Campus, where she majored in Accounting. Ms. Sánchez Brás has been a Certified Public Accountant (CPA) since 1991 and a Certified Internal Auditor (CIA) since 1992 and is a member of the Association of Certified Fraud Examiners (ACFE).

**Carlos M. García** was ratified as President and Chairman of the Board of GDB on January 7, 2009. Mr. García served as President of Banco Santander Puerto Rico from August 2008 to January 2009 and Senior Executive Vice President and Chief Operating Officer of Santander BanCorp and Banco Santander Puerto Rico from January 2004 to January 2009. Mr. García served as a member of the Board of Directors of Santander BanCorp and several of Santander BanCorp's subsidiaries and affiliates. Mr. García serves as Director of Make-a-Wish Foundation of Puerto Rico. Mr. García served as President and Chief Executive Officer of Santander Securities Corporation from August 2001 to January 2006. Mr. García joined Santander Securities Corporation in 1997 as Director of its Investment Banking Department, and

Banco Santander Puerto Rico in October 2003 as Executive Vice President of Wholesale Banking. From 1993 to 1995, Mr. García worked at Credit Suisse First Boston Puerto Rico, Inc., which later was acquired by Popular Securities, Inc., for which he worked from 1995 to 1997. Mr. García holds a dual degree in Business from the Wharton School and in Comparative Literature from the College of Arts and Sciences of the University of Pennsylvania.

## Political Trends

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

	<b>1992</b>	<b>1996</b>	<b>2000</b>	<b>2004</b>	<b>2008</b>
New Progressive Party	49.9%	51.1%	45.7%	48.2%	52.8%
Popular Democratic Party	45.9%	44.5%	48.6%	48.4%	41.3%
Puerto Rico Independence Party	4.2%	3.8%	5.2%	2.7%	2.0%
Others, Blank or Void	-	0.5%	0.5%	0.6%	3.9%

With the results of the 2008 election, control of the legislative branch continued under the New Progressive Party, while the Executive Branch is now also controlled by the New Progressive Party. The current membership of the Senate and House of Representatives by political party is as follows:

	<b>Senate</b>	<b>House</b>
New Progressive Party	21	37
Popular Democratic Party	8	17
Total	29	54

The next general election (gubernatorial, municipal, and legislative) in Puerto Rico will be held in November 2012.

## THE ECONOMY

### General

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

Puerto Rico's economy experienced a considerable transformation during the past sixty-five years, from an agriculture economy to an industrial economy. Virtually every sector of the economy participated in this expansion. Factors contributing to this expansion include government-sponsored economic development programs, increases in the level of federal transfer payments, and the relatively low cost of borrowing. In some years, these factors were aided by a significant rise in construction investment driven by infrastructure projects, private investment, primarily in housing, and relatively low oil prices. Nevertheless, the significant oil price increases experienced from January 2002 to June 2008, the continuous contraction of the manufacturing sector, and the budgetary pressures on government finances triggered a general contraction in the economy.

Puerto Rico's economy is currently in a recession that began in the fourth quarter of fiscal year 2006, a fiscal year in which the real gross national product grew by only 0.5%. For fiscal years 2007 and 2008, the real gross national product contracted by 1.2% and 2.8%, respectively. For fiscal year 2009, preliminary reports indicate that the real gross national product contracted by 3.7%. In March 2010, the Planning Board announced that it was projecting a contraction of 3.6% in real gross national product from fiscal year 2009 to fiscal year 2010. The Planning Board projects an increase in real gross national product of 0.4% for fiscal year 2011.

Nominal personal income, both aggregate and per capita, has increased consistently from 1947 to 2009. In fiscal year 2009, aggregate personal income was \$59 billion (\$49.9 billion at 2005 prices) and personal income per capita was \$14,905 (\$12,589 in 2005 prices). Personal income includes transfer payments to individuals in Puerto Rico under various social programs. Total U.S. federal transfer payments to individuals amounted to \$13.1 billion in fiscal year 2009 (\$12.2 billion in fiscal year 2008). Entitlements for previously performed services or resulting from contributions to programs such as Social Security, Veterans' Benefits, Medicare, and U.S. Civil Service retirement pensions were \$10 billion, or 76% of the transfer payments to individuals in fiscal year 2009 (\$9.3 billion, or 73.9%, in fiscal year 2008). The remainder of the federal transfers to individuals is represented by grants, mostly concentrated in the Nutritional Assistance Program (Food Stamps) and Pell Grant scholarships (higher education).

Total average annual employment (as measured by the Puerto Rico Department of Labor and Human Resources Household Employment Survey, known as the "Household Survey") also increased during the first seven years of the last decade. From fiscal year 2000 to fiscal year

2009, total employment has increased at an average annual growth rate of 0.2% to 1,168,200. Since fiscal year 2007, however, there has been a decrease in employment. These recent decreases in total employment have been caused by the current economic recession.

The dominant sectors of the Puerto Rico economy in terms of production and income are manufacturing and services. The manufacturing sector has undergone fundamental changes over the years as a result of increased emphasis on higher-wage, high-technology industries, such as pharmaceuticals, biotechnology, computers, microprocessors, professional and scientific instruments, and certain high technology machinery and equipment. The service sector, which includes finance, insurance, real estate, wholesale and retail trade, transportation, communications and public utilities, and other services, plays a major role in the economy. It ranks second to manufacturing in contribution to gross domestic product and leads all sectors in providing employment.

The following table shows the gross national product for the five fiscal years ended June 30, 2009.

**Commonwealth of Puerto Rico**  
**Gross National Product**  
**Fiscal Years Ended June 30, 2005, 2006, 2007, 2008, and 2009**

	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009<sup>(1)</sup></b>
Gross national product – \$ millions <sup>(2)</sup>	\$53,752	\$56,732	\$59,521	\$61,527	\$62,759
Real gross national product – \$ millions (2005 prices)	53,752	54,027	53,400	51,889	49,951
Annual percentage increase (decrease) in real gross national product (2005 prices)	1.9%	0.5%	(1.2)%	(2.8)%	(3.7)%
U.S. annual percentage increase in real gross national product (2005 prices)	3.1%	2.8%	1.8%	2.8%	(2.5)%

<sup>(1)</sup> Preliminary.

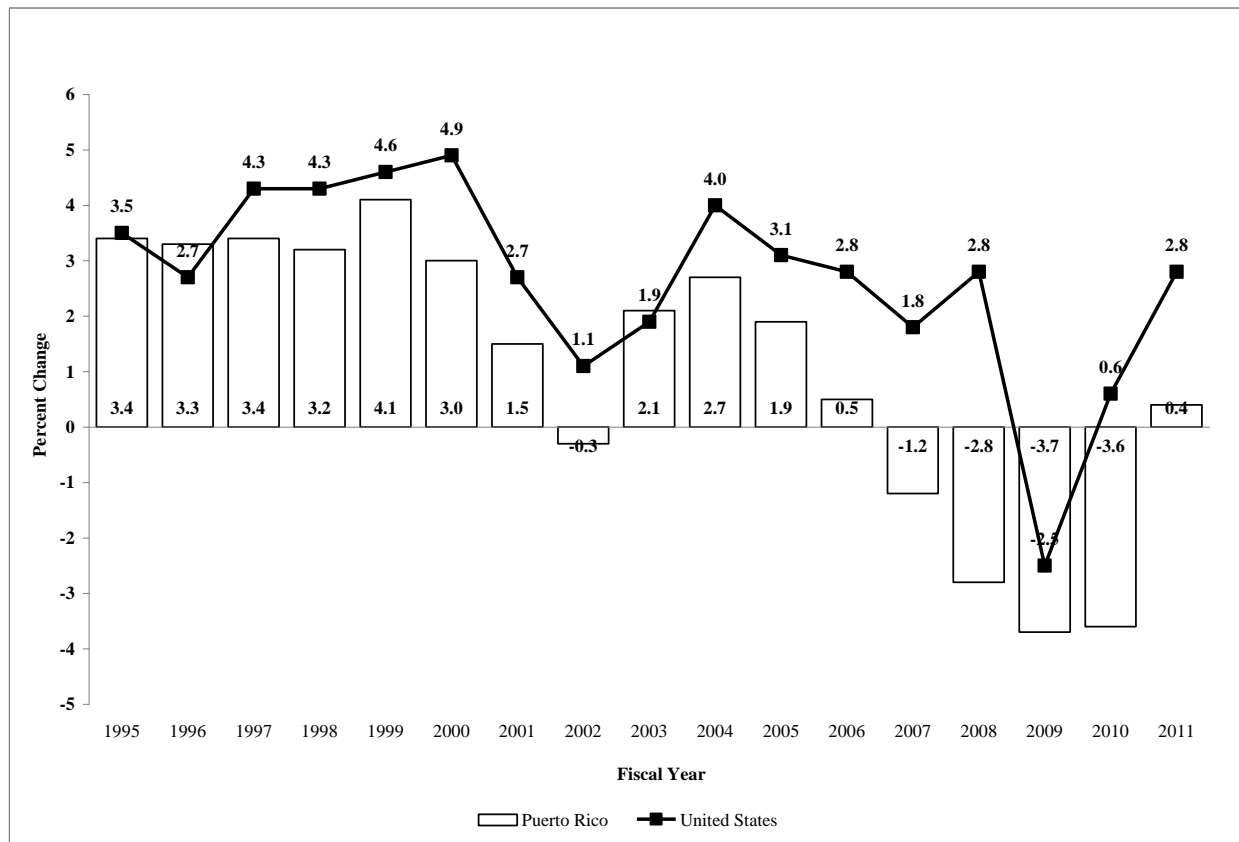
<sup>(2)</sup> In current dollars.

*Sources:* Puerto Rico Planning Board and Global Insight Inc.

The economy of Puerto Rico is closely linked to the United States economy, as most of the external factors that affect the Puerto Rico economy (other than oil prices) are determined by the policies and performance of the mainland economy. These external factors include exports, direct investment, the amount of federal transfer payments, the level of interest rates, the rate of inflation, and tourist expenditures. During fiscal year 2009, approximately 71.6% of Puerto Rico's exports went to the United States mainland, which was also the source of approximately 46.9% of Puerto Rico's imports. In fiscal year 2009, Puerto Rico experienced a positive merchandise trade balance of \$24.5 billion.

The following graph compares the growth rate of real gross national product for the Puerto Rico and U.S. economies since fiscal year 1990, and the forecast of the growth rate for fiscal year 2010.

## REAL GNP GROWTH RATE (Percent)



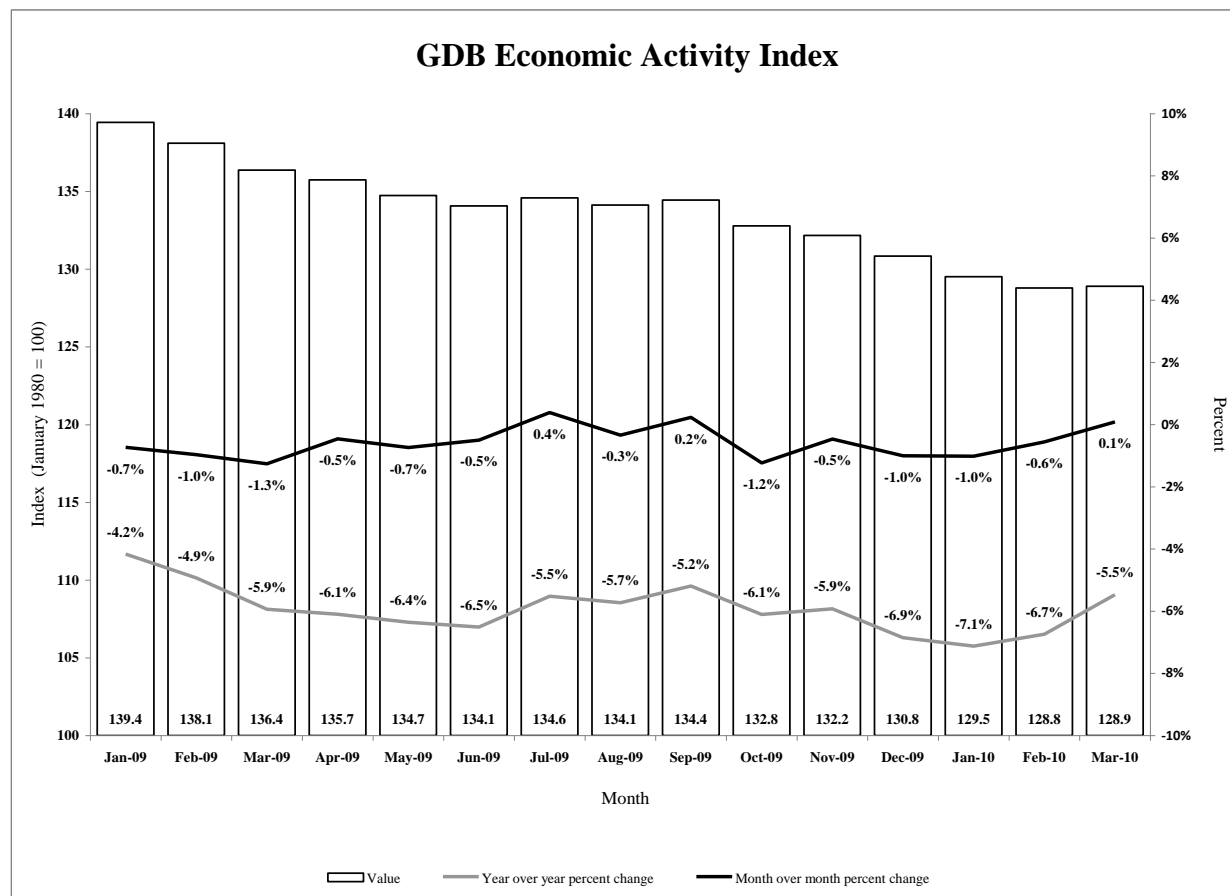
Sources: Puerto Rico Planning Board & IHS-Global Insight.

\* Estimate for Puerto Rico from the Puerto Rico Planning Board (Mar-2010).

\*\* Estimate for U.S. from IHS Global Insight (Mar-2010).

Since the 1950s, the Planning Board has prepared a complete set of macroeconomic measures like those prepared for the United States by the Bureau of Economic Analysis (“BEA”) of the Department of Commerce, as part of the National Income and Product Accounts (“NIPA”). In contrast with BEA, which computes the economic accounts on a quarterly basis, the Planning Board computes Puerto Rico’s NIPA on an annual basis. Like BEA, the Planning Board revises its statistics on a regular basis. The Planning Board classifies its statistics as preliminary until they are revised and made final in conjunction with the release of new data each year. Thus, all macroeconomic accounts for fiscal year 2009 shown in this Appendix are preliminary until the revised figures are released and the forecast for fiscal year 2010 is revised. Certain information regarding current economic activity is, however, available in the form of the Government Development Bank – Economic Activity Index, a coincident indicator of ongoing economic activity. This index, shown in the table below and published by GDB since October 2009, is composed of several variables (total payroll employment based on the Establishment Survey, total electric power consumption, cement sales and consumption of gasoline) that highly correlate to Puerto Rico’s real gross national product.

As the following graph shows, the month to month reduction in the Government Development Bank Economic Activity Index has begun to stabilize.



### *Economic Forecast for Fiscal Years 2010 and 2011*

On March 10, 2010, the Planning Board released its revised gross national product forecast for fiscal year 2010 and its gross national product forecast for fiscal year 2011. The Planning Board revised its gross national product forecast for fiscal year 2010 from a projected growth of 0.7% to a contraction of 3.6%, both in constant dollars. The Planning Board's revised forecast for fiscal year 2010 took into account the estimated effects on the Puerto Rico economy of the Government's fiscal stabilization plan and the activity expected to be generated from the Government's local stimulus package. The revised forecast also considered the effect on the Puerto Rico economy of general and global economic conditions, the U.S. economy, the volatility of oil prices, interest rates and the behavior of local exports, including expenditures by visitors. The Planning Board's forecast for fiscal year 2011 projects an increase in gross national product of 0.4% in constant dollars. The forecast, however, did not take into account the activity expected to be generated from funds received or expected to be received by ARRA. The Planning Board's forecast for fiscal year 2011 took into account the estimated effect of the projected growth of the U.S. economy, tourism activity, personal consumption expenditures, federal transfers to individuals and the acceleration of investment in construction due to the Government's local stimulus package and the establishment of public-private partnerships.

### *Fiscal Year 2009*

The Planning Board's preliminary reports on the performance of the Puerto Rico economy for fiscal year 2009 indicate that real gross national product decreased 3.7% (an increase of 2.0% in current dollars) over fiscal year 2008. Nominal gross national product was \$62.8 billion in fiscal year 2009 (\$50 billion in 2005 prices), compared to \$61.5 billion in fiscal year 2008 (\$51.9 billion in 2005 prices). Aggregate personal income increased from \$55.6 billion in fiscal year 2008 (\$49 billion in 2005 prices) to \$59 billion in fiscal year 2009 (\$49.9 billion in 2005 prices), and personal income per capita increased from \$14,080 in fiscal year 2008 (\$12,410 in 2005 prices) to \$14,905 in fiscal year 2009 (\$12,589 in 2005 prices).

According to the Household Survey, total employment for fiscal year 2009 averaged 1,168,200, a decrease of 4.1% from the previous fiscal year. The unemployment rate for fiscal year 2009 was 13.4%, an increase from 11% for fiscal year 2008.

Among the variables contributing to the decrease in gross national product was the continuous contraction of the manufacturing and construction sectors. Due to the Commonwealth's dependence on oil for power generation and gasoline (in spite of its recent improvements in power-production diversification), the high level of oil prices accounted for an increased outflow of local income in fiscal year 2008. Although the situation improved significantly during fiscal year 2009, oil prices remained at relatively high levels and the impact of the increases of previous years were still felt in fiscal year 2009. The current difficulties associated with the financial crisis resulted in lower short-term interest rates, but this did not translate into a significant improvement in the construction sector due to the high level of inventory of residential housing units.

### *Fiscal Year 2008*

The Planning Board's reports on the performance of the Puerto Rico economy for fiscal year 2008 indicate that real gross national product decreased 2.8% (an increase of 3.4% in current dollars) over fiscal year 2007. Nominal gross national product was \$61.5 billion in fiscal year 2008 (\$51.9 billion in 2005 prices), compared to \$59.5 billion in fiscal year 2007 (\$53.4 billion in 2005 prices). Aggregate personal income increased from \$52.1 billion in fiscal year 2007 (\$48.5 billion in 2005 prices) to \$55.6 billion in fiscal year 2008 (\$49 billion in 2005 prices), and personal income per capita increased from \$13,244 in fiscal year 2007 (\$12,319 in 2005 prices) to \$14,080 in fiscal year 2008 (\$12,410 in 2005 prices). The significant increase in personal income in fiscal year 2008 is due in part to the tax rebate program implemented by the Bush Administration during that fiscal year.

According to the Household Survey, total employment for fiscal year 2008 averaged 1,217,500, a decrease of 3.6% compared to 1,262,900 for fiscal year 2007. At the same time, the unemployment rate for fiscal year 2008 was 11.0%, an increase from 10.4% for fiscal year 2007.

Among the variables contributing to the decrease in gross national product were the continuous contraction of the manufacturing and construction sectors, as well as the current contraction of U.S. economic activity. Furthermore, the decline in Puerto Rico's gross national product was not offset by the federal tax rebates due to the high levels of oil prices during fiscal



year 2008. The dramatic increase to record levels in the price of oil and its derivatives (such as gasoline) during that period served to reduce the income available for other purchases and, thereby, negatively affected domestic demand. Due to the Commonwealth's dependence on oil for power generation and gasoline (in spite of its recent improvements in power-production diversification), the high level of oil prices accounted for an increased outflow of local income in fiscal year 2008. The current difficulties associated with the financial crisis resulted in lower short-term interest rates, but this did not translate into a significant improvement in the construction sector.

### *Fiscal Year 2007*

The Planning Board's reports on the performance of the Puerto Rico economy during fiscal year 2007 indicate that the real gross national product fell by 1.2%. Nominal gross national product was \$59.5 billion (\$53.4 billion in 2005 prices), compared to \$56.7 billion in fiscal year 2006 (\$54.0 billion in 2005 prices). This represents an increase in nominal gross national product of 4.9%. Aggregate personal income was \$52.1 billion in fiscal year 2007 (\$48.5 billion in 2005 prices), as compared to \$50.8 billion in fiscal year 2006 (\$48.5 billion in 2000 prices), and personal income per capita was \$13,244 in fiscal year 2007 (\$12,319 in 2005 prices), as compared to \$12,970 in fiscal year 2006 (\$12,382 in 2005 prices).

According to the Household Survey, total employment for fiscal year 2007 averaged 1,262,900, a decrease of 0.3% compared to 1,266,300 for fiscal year 2006. The unemployment rate for fiscal year 2007 was 10.4%, a decrease from 11.7% for fiscal year 2006.

### **Fiscal Stabilization and Economic Reconstruction**

In January 2009, the administration began to implement a multi-year Fiscal Stabilization Plan (the "Fiscal Plan") and Economic Reconstruction Plan (the "Economic Plan") that seeks to achieve fiscal balance and restore economic growth. The Fiscal Plan is central to safeguarding the Commonwealth's investment-grade credit rating and restoring Puerto Rico's economic growth and development. In March 2009, the Legislative Assembly enacted three bills providing for the implementation of the Fiscal Plan and the Economic Plan.

In addition, the administration designed and began to implement the *Strategic Model for a New Economy*, a series of economic development initiatives which aim to enhance Puerto Rico's competitiveness and strengthen specific industry sectors. These economic development initiatives were intended to support the prospects of long-term and sustainable growth.

### *Fiscal Stabilization Plan*

The Fiscal Plan has three main objectives: (i) stabilize the short-term fiscal situation, (ii) safeguard and strengthen the Commonwealth's investment-grade credit rating, and (iii) achieve budgetary balance by fiscal year 2013. The Fiscal Plan, which was generally contained in Act No. 7, included operating expense-reduction measures, tax revenue enforcement measures, temporary and permanent revenue raising measures, and financial measures, as discussed below.

*Expense Reduction Measures.* A significant portion of Puerto Rico's budget deficit is attributable to the accumulated effect of high operating expenses in the government. The Fiscal Plan seeks to reduce the government's recurring expense base to make it consistent with the level of government revenues. The Fiscal Plan established a government-wide operating expense-reduction program aimed at reducing operating expenses, including payroll, by \$2 billion.

Payroll expense is the most significant component of the government's recurring expense base. The reduction in payroll expenses contemplated by the Fiscal Plan was implemented in three phases and included certain benefits conferred to participating employees, as follows:

- *Phase I: Incentivized Voluntary Resignation and Voluntary Permanent Workday Reduction Programs:* The Incentivized Voluntary Resignation Program offered public employees a compensation incentive based on the time of service in the government. The Voluntary Permanent Workday Reduction Program was available to public employees with 20 or more years of service. The Workday Reduction Program consisted of a voluntary reduction of one regular workday every fifteen calendar days, which is equivalent to approximately a 10% reduction in annual workdays. Phase I commenced in March 2009 and public employees had until April 27, 2009 to submit the required information to participate in the voluntary programs available under Phase I and be eligible for the Public Employees Alternatives Program. Under Phase I, 2,553 employees resigned under the Incentivized Voluntary Resignation Program and 27 employees took advantage of the Voluntary Permanent Workday Reduction Program. Based on the number of employees who agreed to participate in these programs, the administration estimates that expenses for fiscal year 2010 will be reduced by \$90.9 million.
- *Phase II: Involuntary Layoff Plan:* As provided in Act No. 7, Phase II went into effect because the objective of reducing \$2 billion in expenses was not achieved after implementation of Phase I and Phase III (see below). Under Phase II, subject to certain exceptions, employees with transitory or non-permanent positions were terminated. As a result, 2,237 positions were eliminated, representing an estimated savings of \$48.9 million annually. In addition, Phase II provided for one or more rounds of involuntary layoffs and applied to most central government public employees unless excluded pursuant to Act No. 7, strictly according to seniority in public service, starting with employees with the least seniority. The plan excluded certain employees providing "essential" services, certain employees paid by federal funds, those on military leave, and political appointees and their trust employees (political appointees and their trust employees, who do not hold a permanent or career position in the government, are referred to herein as "non-career" employees). Employees in Phase II received a severance package that included health coverage payment for up to a maximum of six months or until the former public employee became eligible for health insurance coverage at another job. As of April 30, 2010, total government employees dismissed under Phase II (excluding the 2,237 transitory or non-permanent positions eliminated) was approximately 11,354, representing an estimated savings of \$259.4 million annually. The administration expects to

complete promptly the termination process with respect to an additional 2,785 previously notified employees, representing additional estimated savings of \$74.8 million annually, and thereby completing Phase II.

The full implementation of Phase II was delayed as a result of the seniority certification and termination notification process followed by certain central government agencies. Total government employees expected to be affected during fiscal year 2010 as part of the implementation of Phase I and II of Act No. 7 is approximately 18,929 (2,553 from Phase I, 2,237 from the elimination of employees with transitory or non-permanent positions under Phase II and 14,139 from the involuntary layoffs under Phase II), of which approximately 1,945 are expected to return to the Department of Education pursuant to an agreement between the Department of Education and the corresponding union. This agreement, which provides for certain salary workday reductions and certain additional service requirements, among other things, allowed the administration to achieve annual savings of \$52 million (increasing by \$27 million the amount that would have been saved through the termination of such employees). An additional 500 employees are expected to be recruited and retrained by the Treasury Department to perform tax auditing and collection functions and by private collection firms to assist the Treasury Department in those functions.

- Phase III: Temporary Suspension of Certain Provisions of Laws, Collective Bargaining Agreements, and Other Agreements: Phase III went into effect on March 9, 2009 and imposed a temporary freeze on salary increases and other economic benefits included in laws, collective bargaining agreements, and any other agreements. Phase III will remain in effect for a period of two years, but this term may be shortened by the Governor by means of an executive order should OMB certify that the savings resulting from the implementation of Act No. 7's expense-reduction measures are sufficient to cover the law's objectives. The administration expects that savings from the implementation of these measures will be approximately \$187 million for fiscal year 2010.
- Public Employees Alternatives Program: The employees that elected to participate in the Incentivized Voluntary Resignation Program under Phase I or that were subject to involuntary layoffs under Phase II, were eligible to participate in the Public Employees Alternatives Program. This program assists public employees in their transition to other productive alternatives, and offers vouchers for college education, technical education, and professional training, as well as for establishing a business and for relocation.

Act No. 7 extends the term of collective bargaining agreements with public employees that had expired at the time of its enactment or that expire while it is in effect for a period of two years (until March 9, 2011) and provides that during this period such collective bargaining agreements may not be renegotiated or renewed.

The following table summarizes the amount of employees affected by the workforce and labor related expense reduction measures included in Act No. 7 and the expected annual savings in operational expenses from the implementation of Phases I through III of the Fiscal Plan.

<b>Phase</b>	<b>Affected Employees</b>	<b>Savings (in millions)</b>
Phase I: Voluntary Resignation	2,553	\$90.9
Phase II: Involuntary Layoffs		
Termination of transitory and non-permanent employees	2,237	48.9
Layoffs (as of April 30, 2010)	11,354	259.4
Pending Layoffs	2,785	74.8
Phase III: Suspension of Certain Benefits	-	186.9
<b>Total</b>	<b>18,929</b>	<b>\$660.9</b>

During October and November 2009, various government employees terminated as a result of the implementation of Act No. 7 filed a complaint in the Puerto Rico Court of First Instance against the Governor and several agency heads. In their complaints, which were later consolidated into a single legal proceeding, the plaintiffs seek, among other relief, an injunction to stop the Government of Puerto Rico from implementing Act No. 7 and requested that Act No. 7 be declared unconstitutional, thereby nullifying the termination of their employment. On February 2, 2010, the Puerto Rico Supreme Court declared that Act No. 7 is constitutional with respect to the plaintiff's argument and denied the request for an injunction.

On April 13, 2009, a group of government employees and labor organizations filed a complaint in the U.S. District Court for the District of Puerto Rico challenging the constitutionality of Act No. 7 and seeking to enjoin the enforcement of Act No. 7. The Governor of Puerto Rico and several agency heads are defendants in the action. The complaint alleges that Act No. 7 violates the United States and Puerto Rico constitutions because, among other reasons, the statute substantially impairs certain statutory and contractual rights of government employees including those contained in their collective bargaining agreements with Commonwealth agencies. On August 5, 2009, the United States District Court for the District of Puerto Rico denied the preliminary injunction. The District Court's decision allowed the Government to continue with the implementation of Act No. 7. The Government has moved to dismiss the complaint and plans to vigorously defend the constitutionality of Act No. 7. See "Litigation."

The second element of the expense-reduction measures, which pertains to other operating expenses, was conducted through an austerity program in combination with other expense reduction measures. The austerity program mandated a 10% reduction in other operational expenses, including cellular phone use, credit cards, and official vehicles.

In September 2009, the Governor issued an executive order requiring all agencies and public corporations to reduce, modify or cancel service contracts to achieve a cost reduction of at least 15%. The executive order covers advertising, consulting, information technology, accounting, legal and other services (except for direct services to the public), and grants the Fiscal Restructuring and Stabilization Board created under Act No. 7 (the "Fiscal Board") the power to monitor agencies and public corporations in order to ensure the required 15% minimum cost reduction. Each agency or public corporation had 30 days to report the following to the Fiscal Board: (i) all service contracts currently in effect, (ii) all canceled and/or modified

contracts and the corresponding savings, (iii) justification for any remaining contracts in light of the mission of the agency or public corporation, and (iv) the reasonableness of the fees or compensation terms for each remaining contract. The administration expects to achieve annual savings of approximately \$20 million from these reductions.

In September 2009, the Governor issued another executive order requiring all agencies and public corporations to report the following to the Fiscal Board within 30 days: (i) all lease contracts currently in effect, (ii) the uses of leased premises, (iii) the needs for such premises, (iv) the terms and conditions of each lease, and (v) budgeted amounts for rent and other related expenses. The administration expects to achieve annual savings of at least 15% of rent and related expenses or approximately \$22 million by among, other things, consolidating operations of one or more agencies or public corporations and renegotiating leases to obtain more favorable terms.

As of April 30, 2010, the administration had already reduced operating expenses through expense reduction measures other than Phase I through III of the Fiscal Plan by \$150 million, professional service contracts and lease agreements by \$42 million through the implementation of the executive orders referred to above, and the workforce through attrition for additional savings of \$45 million.

*Tax Revenue Enforcement Measures.* The Fiscal Plan also seeks to increase tax revenues by implementing a more rigorous and ongoing tax enforcement and compliance strategy. Specific tax enforcement initiatives included: (i) enhancements to the administration of federal grants and fund receipts, (ii) stronger collections and auditing efforts on Puerto Rico's sales and use tax, and (iii) a voluntary tax compliance program.

*Revenue Raising Measures.* The goal of achieving fiscal and budgetary balance required a combination of measures that included the introduction of permanent and temporary tax increases. The Fiscal Plan included six temporary and four permanent revenue increasing measures. With respect to temporary revenue increasing measures, the administration implemented: (i) a 5% surtax on income of certain individuals that is expected to generate \$58 million in additional revenues, (ii) a 5% surtax on income of certain corporations that is expected to generate \$41 million in additional revenues, (iii) a 5% income tax on credit unions (commonly known as "cooperativas" in Puerto Rico) that is expected to produce \$5 million in additional revenues, (iv) a 5% income tax on Puerto Rico international banking entities that is expected to produce \$20 million in additional revenues, (v) a special property tax on residential real estate that is expected to produce \$230 million in additional revenues, and (vi) a moratorium on certain tax credits. The temporary measures will be in effect for up to three fiscal years beginning in fiscal year 2010. The permanent measures include (i) modifications to the alternative minimum tax for individuals and corporations each of which is expected to generate \$10 million annually, (ii) an increase in the excise taxes on cigarettes, (iii) new excise taxes on motorcycles, and (iv) an increase in the excise taxes on alcoholic beverages. The permanent increases to excise taxes on cigarette, motorcycles and alcoholic beverages are expected to generate \$48 million, \$1 million and \$5 million, respectively, in additional revenues. The total estimated revenues from these temporary and permanent measures for fiscal year 2010 is \$428 million.

*Financial Measures.* The administration has also carried out several financial measures designed to achieve fiscal stability throughout the Fiscal Plan implementation period. These measures included, among others, (i) a financing or bond issuance program, the proceeds of which were used to bridge the structural budgetary imbalance during the Fiscal Plan implementation period and fund some of the Economic Plan initiatives, (ii) the restructuring of the securities held in the Corpus Account of the Infrastructure Development Fund (the “Corpus Account”), which is under the custody and control of the Puerto Rico Infrastructure Financing Authority (“PRIFA”), and (iii) the restructuring of a portion of the Commonwealth’s debt service.

These financial measures were anchored on the bond-issuance program of COFINA. Act No. 7, in conjunction with Act No. 91 of May 13, 2006, as amended (“Act 91”), and Act No. 1 of January 14, 2009 (“Act 1”), allocated to COFINA, commencing on July 1, 2009, 2.75% (one-half of the tax rate of 5.5%) of the sales and use tax imposed by the central government, thus increasing COFINA’s financing capacity and allowing the Commonwealth to achieve fiscal stability throughout the implementation period of the Fiscal Plan.

During fiscal years 2009 and 2010, COFINA issued approximately \$5.6 billion and \$2.0 billion, respectively, of revenue bonds payable from sales and use tax collections transferred to COFINA. The proceeds from these bond issues have been or are expected to be used for, among other uses, paying approximately \$1.9 billion of Commonwealth obligations that did not have a designated source of repayment, paying or financing approximately \$4.8 billion of operational expenses constituting a portion of the Commonwealth’s deficit, and fund the Local Stimulus Fund (described below) with approximately \$500 million.

Act No. 3, approved by the Legislative Assembly of the Commonwealth on January 14, 2009 (“Act 3”), authorized the sale of the securities held in the Corpus Account. PRIFA sold the securities in January 2009 and used the proceeds to, among other things, make a deposit to the General Fund of approximately \$319 million, which was applied to cover a portion of the Commonwealth’s budget deficit and make a transfer to GDB of approximately \$159 million as a capital contribution. The gross proceeds resulting from the sale were approximately \$884 million.

The Fiscal Plan has provided more fiscal stability, thereby safeguarding and strengthening Puerto Rico’s credit. The fiscal structure resulting from the full implementation of the plan will be sustainable and conducive to economic growth and development.

### *Economic Reconstruction Plan*

To balance the impact of the Fiscal Plan, the administration developed and is implementing an economic reconstruction program designed to stimulate growth in the short term and lay the foundation for long-term economic development. The Economic Plan consists of two main components: (i) two economic stimulus programs, and (ii) a supplemental stimulus plan.

*Economic Stimulus Programs.* The cornerstone of Puerto Rico’s short-term economic reconstruction plan was the implementation of two economic stimulus programs aimed at

reigniting growth and counterbalancing any adverse effects associated with the Fiscal Plan. The economic stimulus programs consisted of Puerto Rico's participation in ARRA (also referred to herein as the "Federal Stimulus") and a local plan (the "Local Stimulus") designed to complement the Federal Stimulus.

- ***Federal Stimulus Program:*** Puerto Rico has been awarded \$6.5 billion in stimulus funds from ARRA. The funds are distributed in four main categories: relief to individuals, budgetary and fiscal relief, taxpayers' relief, and capital improvements. In terms of government programs, the Federal Stimulus allocates funds to education, agriculture and food assistance, health, housing and urban development, labor, and transportation, among others. As of April 2010, PRIFA, which is responsible for the administration of ARRA in Puerto Rico, reported that approximately \$2.16 billion in ARRA funds had been disbursed.
- ***Local Stimulus Program:*** The administration formulated the Local Stimulus to supplement the Federal Stimulus and address specific local challenges associated with the local mortgage market, the availability of credit, and the infrastructure and construction sectors. Despite the fact that the Local Stimulus amounted to a \$500 million investment by the government, it is estimated that its effect would be greater due to certain lending programs, which are being coordinated in collaboration with commercial banks in Puerto Rico. The administration has been disbursing funds under the \$500 million local stimulus program. Most municipalities have received disbursements earmarked to pay outstanding debts and fund local projects. The administration has also disbursed funds allocated towards job training programs, a strategic water distribution project in a southern municipality and the revamping of the Puerto Rico permits system. In addition, \$190 million of Local Stimulus funds will be used mainly to promote infrastructure projects.

*Supplemental Stimulus Plan.* The Supplemental Stimulus Plan is designed to provide investment in strategic areas with the objective of laying the foundations for long-term growth in Puerto Rico. The coordinated implementation of the Supplemental Stimulus Plan is expected to reinforce continuity in reigniting economic growth while making key investments for long-term development.

The Supplemental Stimulus Plan is being conducted through a combination of direct investments and guaranteed lending. Specifically, the Supplemental Stimulus Plan targets critical areas such as key infrastructure projects, public capital improvement programs, private-sector lending to specific industries, and the export and research-and-development knowledge industries. The Supplemental Stimulus Plan takes into account the strategic needs that Puerto Rico must fulfill in order to become a more competitive player in its region and in the global economy.

#### *Economic Development Program*

The Department of Economic Development and Commerce ("DEDC"), in coordination with other government agencies, is in the process of implementing the *Strategic Model for a New*

*Economy*, which consists of a comprehensive, long-term, economic development program aimed at improving Puerto Rico's overall global relevance, competitiveness, and business environment, and increasing private-sector capital formation and participation in the economy. These initiatives are centered on the dual mission of fostering multi-sector growth while reducing costs and barriers to business and investment, and are a medium-to-long-term counterpart to the Economic Plan and the Supplemental Stimulus Plan described above.

The administration is emphasizing the following initiatives to enhance Puerto Rico's competitive position: (i) overhauling the permitting process, (ii) reforming the labor market, (iii) reducing energy costs, (iv) reforming the tax system, (v) promoting the development of various projects through public-private partnerships, (vi) implementing strategic initiatives targeted at specific economic sectors, and (vii) promoting the development of certain strategic/regional projects.

*Permitting Process.* The first initiative, the reengineering of Puerto Rico's permitting and licensing process, has already been achieved. On December 1, 2009, the Governor signed Act No. 161, which overhauls the existing permitting and licensing process in Puerto Rico in order to provide for a leaner and more efficient process that fosters economic development. In the short term, this restructuring is focused on eliminating the significant backlog of unprocessed permits that are currently in the pipeline of various government agencies. Longer term, this law seeks to significantly reduce the number of inter-agency processes and transactions currently required by creating a centralized, client-focused system that simplifies and shortens the permitting process for applicants.

*Labor Law Reform.* Initiatives will also be undertaken to strengthen Puerto Rico's labor market. The administration seeks to encourage greater labor-force participation by providing the private sector with more flexibility in establishing feasible labor arrangements. One focus of the labor-market reform will be the modernization of Puerto Rico's regulatory framework. Legislative changes to be introduced will focus on bringing out-of-date labor laws and regulations in line with U.S. and international standards with respect to such matters as flex-time arrangements, overtime rules, workers' compensation, and benefit requirements, among others. This labor reform is expected to provide a significant improvement in Puerto Rico's competitiveness in the global marketplace.

*Energy Policy.* The administration also considers the adoption of a new energy policy to be critical for Puerto Rico's competitiveness. Presently, fluctuations in oil prices have a significant effect on Puerto Rico's overall economic performance. The administration expects to focus on reducing Puerto Rico's dependence on fossil fuels, particularly oil, through the promotion of diverse, renewable-energy technologies. By implementing a new energy policy, the administration will seek to lower energy costs, reduce energy-price volatility, and establish environmentally sustainable energy production through a reduction in ecologically harmful emissions. The administration is facilitating the development of several initiatives, including the wheeling of energy, conservation efforts, and the installation of new renewable generation capacity, among others. These initiatives are expected to address energy prices in Puerto Rico and provide a means of attracting investment in the energy sector. On April 20, 2010, the administration submitted to the Legislative Assembly two bills in order to implement these



initiatives and commenced a green energy incentives program to promote the development of renewable energy projects.

*Tax Reform.* The administration is also focused on reforming the Commonwealth's tax system in order to improve its competitiveness by simplifying the tax code and optimizing the use of industrial incentives. In February 2010, the Governor named a committee to review the current tax system and propose a comprehensive reform in light of the Commonwealth's current financial situation. The committee is expected to introduce changes that will level taxes across income, consumption, property and other categories, as well as adjust corporate tax rates. The committee's report is due by September 2010 and the administration plans to file tax reform legislation during the immediately following legislative session.

*Public-Private Partnerships.* The administration believes that Public-Private Partnerships ("PPPs") represent an important tool for economic development, particularly in times of fiscal imbalance. PPPs are collaborations between government and non-governmental entities—such as private-sector, non-profit organizations, credit unions, and township corporations (*corporaciones municipales*)—to develop infrastructure projects, manage government assets or provide services. The non-governmental partner takes on certain responsibilities and risks related to the development of the project in exchange for receiving the benefits of operating it.

PPPs provide the opportunity for lower project development costs, reduction of financial risk, creation of additional revenue sources, establishment of service quality metrics, and re-direction of government resources to focus on the implementation of public policy. Puerto Rico has opportunities for the establishment of PPPs in the areas of highways, ports, transportation, solid waste, potable water, and renewable energy, among others.

On June 8, 2009, the Legislative Assembly approved Act No. 29, establishing a clear public policy and legal framework for public-private partnerships in Puerto Rico to further the development and maintenance of infrastructure facilities, improve the services rendered by the Government and foster the creation of jobs. On September 1, 2009, the Governor constituted the Board of Directors of the Public-Private Partnerships Authority (the "PPP Authority"), the entity tasked with implementing the Commonwealth's public policy regarding public-private partnerships. On December 19, 2009, the PPP Authority approved regulations establishing the administrative framework for the procurement, evaluation, selection, negotiation and award process for public-private partnerships in Puerto Rico. As of April 2010, the PPP Authority had engaged various financial advisors to assist it in the evaluation of various projects in the energy, transportation, water and education sectors. The PPP Authority is in the process of evaluating these projects and expects to issue a request for proposal with respect to five projects during the first semester of fiscal year 2011.

*Sector Initiatives.* The administration will complement the previously mentioned initiatives with specific strategic initiatives with the objective of creating jobs and increasing economic activity across various sectors of the Puerto Rico economy. The Commonwealth has natural or structural competitive advantages in several areas, such as pharmaceutical and biotechnology manufacturing. These advantages provide opportunities for the development of regional clusters in high-tech manufacturing, research and development, tourism, renewable

energy, international trade and professional services. The specific initiatives will be designed to promote sustainable economic growth while accelerating to a knowledge-based and innovation driven economy, focused mainly in the development of human capital and intellectual property, thus diversifying Puerto Rico's economic base.

*Strategic/Regional Projects.* The administration has also targeted six strategic/regional projects that will generate investments in all the regions of the Island in order to foster balanced economic development. One of the strategic projects for the northern region is called the Golden Triangle, an urban redevelopment project that incorporates the areas of Old San Juan, Puerta de Tierra, Isla Grande, including the Puerto Rico Convention Center District (the "District"), and Condado, as well as other communities in the vicinity of historic San Juan Bay. The aim of the Golden Triangle project is to develop San Juan Bay into a major tourism, recreation, commercial and residential sector which serves the local community and becomes a major attraction for leisure and business travelers, both local and external. Also in the northern region, Science City represents a critical part of the administration's efforts to move Puerto Rico to the forefront of the science, technology and research and development. It seeks to leverage the significant competitive advantages in the knowledge-based sectors that put Puerto Rico in an ideal position to undertake this type of development.

In the eastern region, the Caribbean Riviera entails the redevelopment of the old Roosevelt Roads navy facility in Ceiba and is a key element in the administration's strategy to create jobs and reignite the economy of Puerto Rico's eastern region, including Ceiba, Naguabo, Vieques, and Culebra. This tourist complex will include hotels, casinos, eco-tourist attractions, international airport, retail, yacht marina, and cruise ship ports.

In the southern region, the administration is developing the Port of the Americas, an international trans-shipment Post Panamax port of global caliber with value-added zones in the southern region of Puerto Rico.

In the western region, the administration focused on developing the required infrastructure to host the XXI Central American and Caribbean Games to be held in Mayagüez during the summer of 2010, and the redevelopment of the Aguadilla airport to serve as the second international airport of Puerto Rico and as a regional logistics hub.

## Employment and Unemployment

The number of persons employed in Puerto Rico during fiscal year 2008 averaged 1,217,500, a 3.6% decrease from 1,262,900 in fiscal year 2007. For fiscal year 2009, the number of persons employed averaged 1,168,200, a decrease of 4.1% compared to previous fiscal year. During the first nine months of fiscal year 2010, total employment averaged 1,108,600, a decline of 6.0% with respect to the same period of the prior year; and the unemployment rate averaged 15.8%.

The following table presents annual statistics of employment and unemployment for fiscal year 2005 through fiscal year 2009, and the average figures for the first nine months of fiscal year 2010. These employment figures are based on the Household Survey, which includes self-employed individuals and agriculture employment, instead of the non-farm, payroll employment survey (the "Payroll Survey"), which does not. The number of self-employed individuals represents around 15% of civilian employment in Puerto Rico, more than double the level in the United States. On the other hand, agriculture employment in Puerto Rico represented 1.2% of total employment in fiscal year 2009.

**Commonwealth of Puerto Rico**  
**Employment and Unemployment<sup>(1)</sup>**  
**(persons age 16 and over)**  
**(in thousands)**

<b>Fiscal Years Ended June 30,</b>	<b>Labor Force</b>	<b>Employed</b>	<b>Unemployed</b>	<b>Unemployment Rate<sup>(2)</sup></b>
		<b><u>(Annual Average)</u></b>		
2005	1,385	1,238	147	10.6
2006	1,422	1,266	156	11.0
2007	1,410	1,263	147	10.4
2008	1,368	1,218	151	11.0
2009	1,349	1,168	181	13.4
2010 <sup>(3)</sup>	1,316	1,109	208	15.8

<sup>(1)</sup> Totals may not add due to rounding.

<sup>(2)</sup> Unemployed as percentage of labor force.

<sup>(3)</sup> Average figures for the first nine months of fiscal year 2010 (July through March 2010).

*Source:* Department of Labor and Human Resources – Household Survey

## Economic Performance by Sector

From fiscal year 2005 to fiscal year 2009, the manufacturing and service sectors generated the largest portion of gross domestic product. The manufacturing, service, and government sectors were the three sectors of the economy that provided the most employment in Puerto Rico.

The following table presents annual statistics of gross domestic product by sector and gross national product for fiscal years 2007 to 2009.

### Commonwealth of Puerto Rico Gross Domestic Product by Sector and Gross National Product<sup>(1)</sup> (in millions at current prices)

	Fiscal Years Ended June 30,		
	2007	2008	2009 <sup>(2)</sup>
Manufacturing	\$37,637	\$40,548	\$43,541
Service <sup>(3)</sup>	40,190	41,227	41,028
Government <sup>(4)</sup>	8,585	8,762	9,254
Agriculture	430	613	633
Construction <sup>(5)</sup>	2,027	1,991	1,782
Statistical discrepancy	(464)	(215)	(538)
Total gross domestic product <sup>(6)</sup>	\$88,405	\$92,926	\$95,708
Less: net payment abroad	(28,884)	(31,399)	(32,949)
Total gross national product <sup>(6)</sup>	\$59,521	\$61,527	\$62,759

<sup>(1)</sup> For fiscal year 2009, the Planning Board published all macroeconomic account data for fiscal years 2007, 2008 and 2009 using the North American Industry Classification System ("NAICS") rather than the Standard Industrial Codes ("SIC") used in prior years. As a result, macroeconomic data for fiscal years prior to 2007 are not comparable and have not been included in this table.

<sup>(2)</sup> Preliminary.

<sup>(3)</sup> Includes wholesale and retail trade, utilities, transportation and warehousing, information, finance and insurance, real estate and rental, and other services.

<sup>(4)</sup> Includes the Commonwealth, its municipalities and certain public corporations, and the federal government. Excludes certain public corporations, such as the Electric Power Authority and the Aqueduct and Sewer Authority, whose activities are included under "Service" in the table.

<sup>(5)</sup> Includes mining.

<sup>(6)</sup> Totals may not add due to rounding.

Source: Planning Board

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

The following table presents annual statistics of average employment based on NAICS for fiscal years 2005 to 2009.

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

	<b>Fiscal Years Ended June 30,</b>				
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009<sup>(2)</sup></b>
Natural resources and construction	68,233	65,492	64,700	59,675	49,083
Manufacturing					
Durable goods	48,067	46,350	45,417	43,100	39,217
Non-durable goods	69,250	66,233	62,442	60,950	57,492
Sub-total	117,317	112,583	107,858	104,050	96,708
Trade, transportation, warehouse, and Utilities					
Wholesale trade	33,717	33,992	33,267	33,717	33,250
Retail trade	136,192	137,358	133,750	130,883	127,475
Transportation, warehouse, and utilities	17,617	17,433	16,992	16,742	15,683
Sub-total	187,525	188,783	184,008	181,342	176,408
Information	22,608	22,675	22,642	21,442	20,217
Finance	48,633	49,767	49,108	48,483	48,417
Professional and business	103,767	106,517	108,800	108,150	103,300
Educational and health	99,967	103,650	105,225	108,550	109,967
Leisure and hospitality	72,592	74,767	73,567	73,408	70,892
Other services	21,258	20,567	18,242	17,367	16,775
Government <sup>(3)</sup>	307,825	302,492	298,125	297,742	300,683
Total non-farm	1,049,725	1,047,742	1,032,275	1,020,208	992,450

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

<sup>(2)</sup> Preliminary.

<sup>(3)</sup> Includes state, local, and federal government employees.

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

## *Manufacturing*

Manufacturing is the largest sector of the Puerto Rico economy in terms of gross domestic product. The Planning Board figures show that in fiscal year 2009 manufacturing generated \$43.5 billion, or 45.5%, of gross domestic product. During fiscal year 2009, payroll employment for the manufacturing sector was 96,708, a decrease of 7.1% compared with fiscal year 2008. Most of Puerto Rico's manufacturing output is shipped to the U.S. mainland, which is also the principal source of semi-finished manufactured articles on which further manufacturing operations are performed in Puerto Rico. Federal minimum wage laws are applicable in Puerto Rico. For fiscal year 2009, the average hourly manufacturing wage rate in Puerto Rico was approximately 53.8% of the average mainland U.S. rate.

Although the manufacturing sector is less prone to business cycles than the agricultural sector, that does not guarantee the avoidance of the effects of a general downturn of manufacturing on the rest of the economy. In the last three decades, industrial development has tended to be more capital intensive and more dependent on skilled labor. This gradual shift in emphasis is best exemplified by large investments over the last decade in the pharmaceutical and medical-equipment industries in Puerto Rico. One of the factors encouraging the development of the manufacturing sector had been the tax incentives offered by the federal and Puerto Rico governments. Federal legislation enacted in 1996, however, which amended Section 936 of the U.S. Internal Revenue Code of 1986, as amended (the "U.S. Code"), phased out these federal tax incentives during a ten-year period that ended in 2006. This change has had a long-term impact on local manufacturing activity. See "Tax Incentives—Incentives under the U.S. Code" under "The Economy."

The following table sets forth gross domestic product by manufacturing sector for fiscal years 2007 to 2009.

**Commonwealth of Puerto Rico**  
**Gross Domestic Product by Manufacturing Sector<sup>(1)</sup>**  
**(in thousands at current prices)**

	<b>Fiscal Years Ended June 30,</b>		
	<b>2007</b>	<b>2008</b>	<b>2009<sup>(2)</sup></b>
Food	\$1,103,133	\$ 831,351	\$ 864,364
Beverage and Tobacco Products	932,301	1,405,111	1,554,799
Textile Mills	2,310	1,378	1,055
Textile Product Mills	13,944	13,876	12,221
Apparel	211,110	236,186	260,107
Leather and Allied Products	18,256	21,530	23,895
Wood Products	24,193	22,668	23,830
Paper	73,908	71,304	71,704
Printing and Related Support Activities	129,716	131,217	117,720
Petroleum and Coal Products	374,137	86,317	360,041
Chemical	26,891,695	27,966,500	29,806,137
Plastics and Rubber Products	126,642	127,091	122,338
Nonmetallic Mineral Products	295,265	273,670	236,869
Primary Metals	103,960	109,287	104,321
Fabricated Metal Products	248,929	247,804	250,066
Machinery	223,441	232,868	225,734
Computer and Electronic Products	4,222,014	5,957,553	6,266,460
Magnetic and Optica	-	-	-
Electrical Equipment, Appliances and Components	518,471	677,088	747,903
Transportation Equipment	81,906	85,913	78,249
Furniture and Related Products	66,039	62,985	54,217
Miscellaneous	1,975,250	1,986,317	2,359,370
Total gross domestic product of manufacturing sector <sup>(3)</sup>	<u>\$37,636,619</u>	<u>\$40,548,014</u>	<u>\$43,541,398</u>

<sup>(1)</sup> For fiscal year 2009, the Planning Board published all macroeconomic account data for fiscal years 2007, 2008 and 2009 using NAICS rather than SIC, which was used in prior years. As a result, macroeconomic data for fiscal years prior to 2007 are not comparable and have not been included in this table.

<sup>(2)</sup> Preliminary.

<sup>(3)</sup> Totals may not add due to rounding.

Source: Planning Board

The following table presents annual statistics of average manufacturing employment by industry based on NAICS for fiscal years 2005 to 2009.

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

Industry group	Fiscal Years Ended June 30,				
	2005	2006	2007	2008	2009 <sup>(1)</sup>
<b><u>Durable goods</u></b>					
Nonmetallic mineral products manufacturing	4,467	4,100	3,825	3,758	3,058
Cement and concrete products manufacturing	3,750	3,533	3,300	3,367	2,833
Fabricated metal products	6,442	5,775	5,675	5,375	4,908
Computer and electronic	10,667	10,808	10,092	8,600	7,033
Electrical equipment	7,650	6,842	6,617	6,658	5,867
Electrical equipment manufacturing	4,975	4,700	4,508	4,383	3,917
Miscellaneous manufacturing	11,158	11,258	12,292	11,967	11,975
Medical equipment and supplies manufacturing	10,467	10,533	11,575	11,342	11,442
Other durable goods manufacturing	7,683	7,567	6,917	6,742	6,375
Total – durable goods	48,067	46,350	45,417	43,100	39,217
<b><u>Non-durable goods</u></b>					
Food manufacturing	13,050	12,650	12,183	11,725	11,392
Beverage and tobacco products manufacturing	3,175	3,392	3,258	3,267	3,125
Apparel manufacturing	8,875	8,258	7,708	9,633	9,825
Cut and sew apparel manufacturing	8,850	8,017	7,075	8,617	8,975
Chemical manufacturing	32,883	32,317	30,467	27,900	25,042
Pharmaceutical and medicine manufacturing	28,567	28,017	26,375	24,033	21,500
Plastics and rubber products	2,750	2,325	2,200	1,983	1,967
Plastics product manufacturing	2,258	2,133	2,025	1,850	1,825
Other non-durable goods manufacturing	8,517	7,292	6,625	6,442	6,142
Total – non-durable goods	69,250	66,233	62,442	60,950	57,492
Total manufacturing employment	117,317	112,583	107,858	104,050	96,708

\* Totals may not add due to rounding.

<sup>(1)</sup> Preliminary.

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



Total employment in the manufacturing sector decreased by 20,609 from fiscal year 2005 to fiscal year 2009. Manufacturing employment had been declining during the past decade, but the decline accelerated during fiscal years 2002 and 2003, falling 10.6% and 4.8%, respectively. Thereafter, manufacturing employment stabilized around 118,000 jobs, but the acceleration in job losses reappeared in fiscal year 2006 with the sector experiencing another drop of 4.0%. For fiscal years 2007, 2008 and 2009, manufacturing employment decreased by 4.2%, 3.5% and 7.1%, respectively. For the first nine months of fiscal year 2010, the sector lost an average of 8,000 jobs, or 8.1% compared to the same period of the previous year. Given that this sector used to pay the highest wages, on average, in Puerto Rico, its general downturn has represented a major difficulty for restoring growth for the whole economy. There are several reasons that explain this sector's job shrinkage: the end of the phase-out of the tax benefits afforded by Section 936 of the U.S. Code, the net loss of patents on certain pharmaceutical products, the escalation of manufacturing production costs (particularly labor and electricity), the increased use of job outsourcing, and, currently, the effects of the global economic decline. Puerto Rico's manufacturing sector is facing increased international competition.

### *Service Sector*

Puerto Rico has experienced mixed results in the service sector, which, for purposes of the data set forth below, includes wholesale and retail trade, utilities, transportation and warehousing, information, finance and insurance, real estate and rental, and other services. This sector has expanded in terms of income over the past decade, following the general trend of other industrialized economies, but with differences on the magnitudes of those changes. During the period between fiscal years 2007 and 2009, the gross domestic product in this sector, in nominal terms, increased at an average annual rate of 1.1%, while payroll employment in this sector decreased at an average annual rate of 1.2%. In the Puerto Rico labor market, self-employment, which is not accounted for in the Payroll Survey, represents approximately 15% of total employment according to the Household Survey. Most of the self-employment is concentrated in the service and construction sectors. The development of the service sector has been positively affected by demand generated by other sectors of the economy, such as manufacturing and construction.

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

The service sector ranks second to manufacturing in its contribution to gross domestic product, and it is the sector with the greatest employment. In fiscal year 2009, the service sector generated \$41.0 billion of gross domestic product, or 42.9% of the total. Wholesale and retail trade, information services, education and health services, professional and business services and real estate and rentals experienced growth in fiscal years 2007 to 2009, as measured by gross domestic product at current prices. Finance and insurance, transportation and warehousing, utilities, and leisure and hospitality experienced contractions in fiscal years 2007 to 2009, as measured by gross domestic product at current prices. From fiscal year 2007 to 2009, gross domestic product increased in the trade sector from \$7.2 billion to \$7.5 billion and in real estate and rentals from \$11.7 billion to \$13.3 billion, and decreased in finance and insurance from \$6.7 billion to \$5 billion.

Service-sector employment decreased from 556,350 in fiscal year 2005 to 545,975 in fiscal year 2009 (representing 55% of total, non-farm, payroll employment). The average service-sector employment for fiscal year 2009 represents a decrease of 2.3% compared to the prior fiscal year. For the first nine months of fiscal year 2010, average service-sector employment was 532,644, a decrease of 2.9% with respect to the same period for the prior fiscal year.

Puerto Rico has a developed banking and financial system. As of December 31, 2009, there were thirteen commercial banks operating in Puerto Rico. Commercial banks in Puerto Rico are generally regulated by the Federal Deposit Insurance Corporation (the “FDIC”) or the Board of Governors of the Federal Reserve System and by the Office of the Commissioner of Financial Institutions of Puerto Rico (the “OCFI”). The OCFI reports that total assets of these institutions (excluding assets of units operating as international banking entities) as of December 31, 2009 were \$83.1 billion, as compared to \$87.3 billion as of December 31, 2008. On April 30, 2010, the OCFI closed three of the thirteen commercial banks named above and the FDIC was named receiver. On the same date, the FDIC entered into loss share purchase and assumption agreements with three of the other commercial banks with operations in Puerto Rico, providing for the acquisition of most of the assets and liabilities of the closed banks including the assumption of all of the deposits. The administration expects that this consolidation will strengthen the Puerto Rico banking sector.

Broker-dealers in Puerto Rico are regulated by the Financial Industry Regulatory Authority (“FINRA”) and the OCFI and are mainly dedicated to serve investors that are residents of Puerto Rico. According to the OCFI, assets under management by broker-dealers in Puerto Rico totaled \$3.3 billion as of December 31, 2009, up from \$2.6 billion on December 31, 2008. Another relevant component of the financial sector in Puerto Rico is the mutual-fund industry. Local mutual funds are organized as investment companies and recorded assets under management of \$13.875 billion as of December 31, 2009, down slightly from \$13.903 billion as of December 31, 2008 according to the OCFI.

Other components of the financial sector in Puerto Rico include international banking entities (“IBEs”) and credit unions (locally known as *cooperativas*). IBEs are licensed financial businesses that conduct offshore banking transactions. As of December 31, 2009, there were 33 international banking entities (including units of commercial banks) operating in Puerto Rico licensed to conduct offshore banking transactions, with total assets of \$42.2 billion, a decrease from \$63.8 billion in total assets as of December 31, 2008. Meanwhile, credit unions, which tend to provide basic consumer financial services, reached \$7.2 billion in assets as of December 31, 2009, a slight increase from \$6.7 billion as of December 31, 2008.

In addition, there are specialized players in the local financial industry that include mortgage-origination companies and auto and personal finance companies.

The following tables set forth gross domestic product and employment for the service sector for fiscal years 2007 to 2009.

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

	<b>Fiscal Years ended June 30</b>		
	<b>2007</b>	<b>2008</b>	<b>2009<sup>(1)</sup></b>
Wholesale trade	\$ 2,751.6	\$ 2,834.6	\$ 2,885.5
Retail trade	4,471.4	4,508.7	4,583.7
Transportation and warehousing	968.3	998.5	978.0
Utilities	2,214.4	2,114.6	2,123.1
Information	2,466.5	2,477.4	2,552.8
Finance and insurance	6,694.3	6,693.4	4,951.8
Real Estate and rental	11,685.7	12,152.0	13,253.5
Professional and business	3,112.5	3,223.7	3,305.0
Education and health	3,592.5	3,932.1	4,131.4
Leisure and hospitality	1,861.5	1,919.1	1,895.6
Other services	371.6	372.8	367.9
<b>Total</b>	<b>\$40,190.3</b>	<b>\$41,226.9</b>	<b>\$41,028.3</b>

<sup>(1)</sup> Preliminary.

Source: Planning Board.

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

	<b>Fiscal Years Ended June 30,</b>				
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009<sup>(1)</sup></b>
Wholesale trade	33,717	33,992	33,267	33,717	33,250
Retail trade	136,192	137,358	133,750	130,883	127,475
Transportation, warehouse and utilities	17,617	17,433	16,992	16,742	15,683
Information	22,608	22,675	22,642	21,442	20,217
Finance	48,633	49,767	49,108	48,483	48,417
Professional and business	103,767	106,517	108,800	108,150	103,300
Educational and health	99,967	103,650	105,225	108,550	109,967
Leisure and hospitality	72,592	74,767	73,567	73,408	70,892
Other services	21,258	20,567	18,242	17,367	16,775
<b>Total</b>	<b>556,350</b>	<b>566,725</b>	<b>561,592</b>	<b>558,742</b>	<b>545,975</b>

\* Totals may not add due to rounding.

<sup>(1)</sup> Preliminary.

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

### *Hotels and Related Services—Tourism*

During fiscal year 2007, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists, was 1,792,300, a decrease of 6.8% over the number of persons registered during fiscal year 2006. The average occupancy rate in tourist hotels during fiscal year 2007 was 71.7%, compared to 70.8% in fiscal year 2006. The average number of rooms available in tourist hotels decreased by 6.5% to 10,044 rooms from fiscal year 2006 to fiscal year 2007 as the completion of regular maintenance and rehabilitation of rooms (that normally results in a certain number of rooms being unavailable at any time) took longer to complete than in the past.

For fiscal year 2008, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists, was 1,744,200, a further decline of 2.7% over the number of persons registered during fiscal year 2007. The average occupancy rate in tourist hotels during fiscal year 2008 was 70.4%, compared to 71.7% in fiscal year 2007. The average number of rooms available in tourist hotels increased by 2.1% to 10,250 rooms from fiscal year 2007 to fiscal year 2008.

During fiscal year 2009, the number of persons registered in tourist hotels, including residents of Puerto Rico and tourists, was 1,708,500, a decrease of 2% over the number of persons registered during the same period of fiscal year 2008. The average occupancy rate in tourist hotels during fiscal year 2009 was 66.2%, a decrease of 5.9% from the prior fiscal year. During fiscal year 2009, the average number of rooms available in tourist hotels increased by 2.1% to 10,467 rooms compared to fiscal year 2008.

In terms of employment figures, this sector has shown a behavior consistent with the local business cycle, accentuated by the contraction of U.S. economic activity. For fiscal year 2009, employment in hotels and other lodging facilities was reduced by 6.7% to 13,300 jobs. For the first nine months of fiscal year 2010, the average decrease was 4.6% with respect to the same period for the prior fiscal year.

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

The following table presents data relating to visitors to Puerto Rico and tourist expenditures for the five fiscal years ended June 30, 2009.

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

**Number of Visitors**

<b>Fiscal Years Ended June 30,</b>	<b>Tourist Hotels<sup>(2)</sup></b>	<b>Excursionists<sup>(3)</sup></b>	<b>Other<sup>(4)</sup></b>	<b>Total</b>
2005 .....	1,361,643	1,386,925	2,324,274	5,072,842
2006 .....	1,424,166	1,300,115	2,297,839	5,022,120
2007 .....	1,353,376	1,375,433	2,333,597	5,062,406
2008 .....	1,342,810	1,496,853	2,373,436	5,213,099
2009 .....	1,277,749	1,232,010	2,272,778	4,782,537

**Total Visitors' Expenditures  
(in millions)**

<b>Fiscal Years Ended June 30,</b>	<b>Tourist Hotels<sup>(2)</sup></b>	<b>Excursionists<sup>(3)</sup></b>	<b>Other<sup>(4)</sup></b>	<b>Total</b>
2005 .....	1,428.4	167.1	1,643.1	3,238.6
2006 .....	1,537.7	160.9	1,670.7	3,369.3
2007 .....	1,501.6	172.2	1,740.1	3,413.9
2008 .....	1,526.3	194.3	1,814.3	3,535.0
2009 <sup>(5)</sup> .....	1,464.4	173.7	1,834.8	3,472.8

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

<sup>(2)</sup> Includes visitors in guesthouses.

<sup>(3)</sup> Includes cruise ship visitors and transient military personnel.

<sup>(4)</sup> Includes visitors in homes of relatives, friends, and in hotel apartments.

<sup>(5)</sup> Preliminary.

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

The Commonwealth, through the Puerto Rico Convention Center District Authority ("PRCDA"), has developed the largest convention center in the Caribbean, and the centerpiece of a 100-acre, private development, that includes hotels, restaurants, office space, and housing. The convention center district is being developed at a total cost of \$1.3 billion in a public/private partnership effort to improve Puerto Rico's competitive position in the convention and group-travel segments. The convention center opened on November 17, 2005 and, since its inauguration, the facility has hosted more than 1,000 events accounting for more than 1,000,000 attendees. A 500 room hotel located next to the Convention Center commenced operations at the end of November 2009.

The PRCDA also owns an 18,500-person capacity multipurpose arena, known as the José Miguel Agrelot Coliseum, located in San Juan, Puerto Rico. The coliseum was inaugurated in 2004 and has hosted more than 2.5 million people attending over 400 world-caliber events. The

venue has received numerous awards including “Best International Large Venue of the Year” from Pollstar magazine in 2005.

### *Government*

The government sector of Puerto Rico plays an important role in the economy. It promoted the transformation of Puerto Rico from an agricultural economy to an industrial one during the second half of the previous century, providing the basic infrastructure and services necessary for the modernization of the Island.

In fiscal year 2009, the government accounted for \$9.3 billion, or 9.7%, of Puerto Rico’s gross domestic product. The government is also a significant employer, employing 285,600 workers (state, including public corporations, and local), or 28.8% of total, non-farm, payroll employment in fiscal year 2009. From fiscal year 2005 to fiscal year 2009, state and municipal government employment has been reduced by approximately 7,500 positions. During the first nine months of fiscal year 2010, state and local government employment decreased by 14,700 jobs. According to the payroll survey, the distribution of these job reductions was 10,200 jobs in the state government and 4,500 jobs in local government.

On February 25, 1998, legislation was enacted permitting the unionization of employees of the central government, which excludes municipal employees and employees of public corporations. Under this law, government employees are given collective bargaining rights subject to a number of limitations. Among those limitations are: employees are prohibited from striking; salary increases are contingent on the availability of budgeted revenues; employees cannot be required to become union members and pay union dues; and collective bargaining negotiations cannot occur in an election year. Currently, approximately 70,000 employees of the central government are unionized under this law.

As discussed previously, Act No. 7, enacted on March 9, 2009, establishes, among other things, a temporary freeze of salary increases and other economic benefits included in laws, collective bargaining agreements, and any other agreements. In addition, Act No. 7 provides that, for a period of two years, collective bargaining agreements that have already expired or that expire while the law is in effect and that relate to public employees may not be renegotiated or renewed. Certain individuals and labor organizations have challenged in court the validity of some of the provisions of Act No. 7. See “Litigation.”

### *Transportation*

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

Puerto Rico’s airport facilities are located in Carolina, San Juan, Ponce, Mayaguez, Aguadilla, Arecibo, Ceiba, Vieques, Culebra, and Humacao.

Luis Muñoz Marín International Airport in the San Juan metropolitan area is currently served by 24 domestic and international airlines. The airport receives over 10 million passengers

per year, making it the busiest airport in the Caribbean. At present, there is daily direct service between San Juan and Atlanta, Baltimore, Boston, Chicago, Dallas, Miami, New York, Orlando, Philadelphia, and numerous other destinations within the U.S. mainland. San Juan has also become a hub for intra-Caribbean service for a major airline. While the main hubs in the U.S. mainland serve as the gateway from San Juan to most international destinations, Latin American destinations are also served through Panama City, Panama, with connections to Central and South America, while European cities are also served through Madrid, Spain. On December 22, 2009, the Federal Aviation Administration (“FAA”) approved the Ports Authority’s preliminary application to participate in the FAA’s airport public-private partnership pilot program. The Ports Authority and the Public-Private Partnerships Authority continue to evaluate entering into a public-private partnership with respect to the Luis Muñoz Marín International Airport. The Public-Private Partnerships Authority has engaged a team of advisors to assist it in the preparation of a study required for the establishment of a public-private partnership.

Regarding other airports, Rafael Hernandez Airport in Aguadilla has regularly scheduled service to and from Fort Lauderdale, New York, Newark and Orlando; and Ponce’s Mercedita Airport has regularly scheduled service to and from New York and Orlando. Both of these airports also have scheduled service to other Caribbean islands. Smaller regional airports serve intra-island traffic. Cargo operations are served by both Federal Express and United Parcel Service (UPS) at the airports in San Juan and Aguadilla.

The island’s major cities are connected by a modern highway system, which, as of December 31, 2009, totaled approximately 4,629 miles and 11,947 miles of local streets and adjacent roads. The highway system comprises 387 miles of primary system highways, which are the more important interregional traffic routes and include PR-52, PR-22, PR-53, PR-66 and PR-20 toll highways, 252 miles of primary urban system highways, 959 miles of secondary system highways serving the needs of intra-regional traffic, and 3,053 miles of tertiary highways and roads serving local, intra-regional traffic.

The Port of the Americas is a deep draft container terminal under development on the south coast of Puerto Rico in the City of Ponce, the Commonwealth’s fourth largest municipality by population. Managed by the Port of the Americas Authority, the terminal can handle containerized import/export and transshipment cargo. The first phase of the port development was completed in 2004 while the second phase, which resulted in container yard with capacity of up to 250,000 Twenty-Foot Equivalent Units per year, was completed in March 2009. A third development phase, which entails a public investment of \$84.4 million, is ongoing through September 2011. The completion of phase three will result in an annual terminal processing capacity of up to 500,000 Twenty-Foot Equivalent Units as well as the installation of basic infrastructure required to develop an industrial value-added zone on land adjacent to the Port. Currently, the Port of the Americas Authority is negotiating a Concession Agreement with respect to the terminal facility and is simultaneously undertaking efforts to maximize private sector interest in the related value-added zones.

### *Construction*

Although the construction industry represents a relatively small segment of the economy compared to other sectors, it has made significant contributions to the growth of economic

activity due to its multiplier effect on the whole economy. During the period from fiscal year 2007 to 2009, however, real construction investment decreased at an average annual rate of 14.7%. During the same time period, the total value of construction permits, in current dollars, decreased at an average annual rate of 9.8%.

Public investment has been an important component of construction investment. During fiscal year 2009, approximately 52.9% of the total investment in construction was related to public projects. The total value of construction permits decreased 28.0% in fiscal year 2009 as compared to fiscal year 2008, and total sales of cement decreased by 25.4%, the largest decline registered since 1959. Average payroll employment in the construction sector during fiscal year 2008 was 60,000, a reduction of 9.9% from fiscal year 2007.

Total construction investment for fiscal year 2009 decreased in real terms by 20.1%, following a 9.0% real decline in fiscal year 2008, due principally to the drop in private construction activity. The Planning Board expects a further construction investment decrease of 5.2% in real terms for fiscal year 2010. Public investment in construction has been negatively affected by the Commonwealth's fiscal difficulties, while private investment in construction is still suffering from the credit conditions that prevailed during the last decade. While the Planning Board had originally projected a further construction investment decrease of 10.5% in real terms for fiscal year 2010, the expected positive impact of the Federal Stimulus and the Local Stimulus led it to reduce its projected decrease in construction investment to 5.2% in real terms. Public investment was primarily in housing, schools (and school reconstruction programs), water projects, and other public infrastructure projects.

During fiscal year 2009, the number of construction permits decreased 20.7%, while the total value of construction permits dropped by 28% compared to fiscal year 2008. For the first six months of fiscal year 2010, the total number of construction permits decreased by 22.9%, while the value of construction permits decreased by 23.5%. These figures are consistent with cement sales, which declined by 25.4% in fiscal year 2009 and by 27.4% during the first nine months of fiscal year 2010, reaching levels not seen in more than a decade.

### *Agriculture*

The Department of Agriculture and related agencies have directed their efforts at increasing and improving local agricultural production, increasing efficiency and the quality of produce, and stimulating the consumption of locally produced agricultural products. It should be noted, however, that agriculture production represents less than 1% of Puerto Rico's gross domestic product. During fiscal year 2009, gross income from agriculture was \$633 million, an increase of 3.4% compared with fiscal year 2008.

The administration supports agricultural activities through incentives, subsidies, and technical and support services, in addition to income tax exemptions for qualified income derived by bona fide farmers. Act No. 225 of 1995 provides a 90% income tax exemption for income derived from agricultural operations, grants for investments in qualified agricultural projects, and a 100% exemption from excise taxes, real and personal property taxes, municipal license taxes and tariff payments. It also provides full income tax exemption for interest income



from bonds, notes and other debt instruments issued by financial institutions to provide financing to agricultural businesses.

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

## **Higher Education**

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

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

## Commonwealth of Puerto Rico Trend in College Enrollment

Academic Year	Commonwealth of Puerto Rico			United States Mainland		
	Population 18-24 Years of Age	Higher Education Enrollment	Percent <sup>(1)</sup>	Population 18-24 Years of Age	Higher Education Enrollment	Percent <sup>(1)</sup>
1970	341,448 <sup>(2)</sup>	57,340	16.8%	23,714,000 <sup>(2)</sup>	8,580,887	36.2%
1980	397,839 <sup>(2)</sup>	130,105	32.7%	30,022,000 <sup>(2)</sup>	12,096,895	40.3%
1990	417,636 <sup>(2)</sup>	156,147	37.4%	26,961,000 <sup>(2)</sup>	13,621,000	50.5%
2000	428,893 <sup>(2)</sup>	176,015	41.0%	27,143,454 <sup>(2)</sup>	15,312,298	56.4%
2001	429,366 <sup>(3)</sup>	184,126	42.9%	27,946,091 <sup>(3)</sup>	15,927,986	57.0%
2002	425,479 <sup>(3)</sup>	190,776	44.8%	28,378,777 <sup>(3)</sup>	16,611,710	58.5%
2003	420,074 <sup>(3)</sup>	199,842	47.6%	28,744,193 <sup>(3)</sup>	16,911,486	58.8%
2004	414,098 <sup>(3)</sup>	206,791	49.9%	29,062,634 <sup>(3)</sup>	17,272,043	59.4%
2005	406,547 <sup>(3)</sup>	208,032	51.2%	29,134,149 <sup>(3)</sup>	17,487,481	60.0%
2006	400,530 <sup>(3)</sup>	209,547	52.3%	29,236,155 <sup>(3)</sup>	17,758,872	60.7%
2007	396,059 <sup>(3)</sup>	225,402	56.9%	29,407,260 <sup>(3)</sup>	18,248,133	62.1%
2008	395,482 <sup>(3)</sup>	227,546	57.5%	29,757,219 <sup>(3)</sup>	19,102,814 <sup>(4)</sup>	62.8%

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

<sup>(2)</sup> Based on census population as of April 1 of the stated year.

<sup>(3)</sup> Estimated population (reference date July 1 of the stated year).

<sup>(4)</sup> Middle alternative projection (NCES).

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

The University of Puerto Rico, the only public university in Puerto Rico, has eleven campuses located throughout the island. The University's total enrollment for academic year 2008-2009 was approximately 65,669 students. The Commonwealth appropriates annually for the University of Puerto Rico an amount equal to 9.60% of the average annual revenue from internal sources (subject to certain exceptions) for each of the two fiscal years immediately preceding the current fiscal year.

In addition to the University of Puerto Rico, there are 40 public and private institutions of higher education located in Puerto Rico. Such institutions had an enrollment during academic year 2008-2009 of approximately 171,541 students and provide programs of study in liberal arts, education, business, natural sciences, technology, secretarial and computer sciences, nursing, medicine, and law. Degrees are offered by these institutions at the associate, bachelor, master, and doctoral levels.

Institutions providing education in Puerto Rico must satisfy state licensing requirements to operate. Also, the vast majority of educational institutions are accredited by U.S. Department of Education-recognized accrediting entities.

## **Tax Incentives**

One factor that has promoted and continues to promote the development of the manufacturing and service sector in Puerto Rico is the various local and federal tax incentives available, particularly those under Puerto Rico's Industrial Incentives Program and, until 2006, Sections 30A and 936 of the U.S. Code. Tax and other incentives have also been established to promote the development of the tourism industry. These incentives are summarized below.

### *Industrial Incentives Program*

Since 1948, Puerto Rico has had various incentives laws designed to promote investment and job creation. Under these laws, companies engaged in manufacturing and certain other designated activities were eligible to receive full or partial exemption from income, property, and other local taxes. The most recent of these incentives laws is the Economic Incentives Act, enacted in May 2008.

The benefits provided by the Economic Incentives Act are available to new companies as well as companies currently conducting tax-exempt operations in Puerto Rico that choose to renegotiate their existing tax exemption grants, expand current operations or commence operating a new eligible business. The activities eligible for tax exemption under the Economic Incentives Act include manufacturing, certain designated services performed for markets outside Puerto Rico (including the United States), the production of energy from local renewable sources for consumption in Puerto Rico and laboratories for research and development. The Economic Incentives Act expands the definition of manufacturing activity from that included in Act No. 135 of December 2, 1997, as amended (the "1998 Tax Incentives Act"), to include clusters and supply chains.

Companies qualifying under the Economic Incentives Act can benefit from a simplified income tax system: in most cases, an income tax rate of 4% and a withholding tax rate of 12% on royalty payments. Alternatively, the income tax rate can be 8% and a withholding rate of 2% on royalty payments. Special rates apply to projects located in low and mid-development zones (an income tax reduction of 0.5%), certain local projects (an income tax rate as low as 3%), certain small- and medium-sized businesses (an income tax rate as low as 1%) and pioneering activities (an income tax rate of 1%, but for those using intangible property created or developed in Puerto Rico the income tax rate may be 0%). In addition, as with the 1998 Tax Incentives Act, the Economic Incentives Act grants 90% exemption from property taxes, 100% exemption from municipal license taxes during the first three semesters of operations and at least 60% thereafter, and 100% exemption from excise taxes with respect to the acquisition of raw materials and certain machinery and equipment used in the exempt activities.

The Economic Incentives Act is designed to stimulate employment and productivity, research and development, capital investment, reduction in the cost of energy and increased purchase of local products.

Under the Economic Incentives Act, as with the 1998 Tax Incentives Act, companies can repatriate or distribute their profits free of Puerto Rico dividend taxes. In addition, passive income derived by exempted businesses from the investment of eligible funds in Puerto Rico

financial institutions, obligations of the Commonwealth, and other designated investments is fully exempt from income and municipal license taxes. Gain from the sale or exchange of shares of an exempted business by its shareholders during the exemption period that is otherwise subject to Puerto Rico income tax would be subject to a special Puerto Rico income tax rate of 4%.

The Economic Incentives Act, like the 1998 Tax Incentives Act, also provides investors that acquire an exempted business that is in the process of closing its operations in Puerto Rico a 50% credit in connection with the cash purchase of such corporation's stocks or operational assets.

### *Tourism Incentives Program*

For many years, Puerto Rico has enacted incentives laws designed to stimulate investment in hotel operations on the island. The Tourism Incentives Act of 1993 (the "Tourism Incentives Act") provides partial exemptions from income, property, and municipal license taxes for a period of up to ten years. The Tourism Incentives Act also provides certain tax credits for qualifying investments in tourism activities, including hotel and condo-hotel development projects. Other legislation enacted in 2001 and 2002 provides further tourism incentives by granting certain tax exemptions on interest income received from permanent or interim financing of tourism development projects and fees derived from credit enhancements provided to the financing of such projects.

As part of the incentives to promote the tourism industry, in 1993 the Commonwealth established the Tourism Development Fund as a subsidiary of GDB with the authority to (i) make investments in or provide financing to entities that contribute to the development of the tourism industry and (ii) provide financial guarantees and direct loans for financing tourism development projects. To date, the Fund has provided direct loans and financial guarantees in the aggregate \$1.137 billion for loans made or bonds issued to finance the development of twenty tourism projects representing 4,585 new hotel rooms and a total investment of \$1.795 billion.

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

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

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

As a result of amendments to Section 936 of the U.S. Code made in 1996, its income tax credit based on operating and certain investment income was phased out over a ten-year period for companies that were operating in Puerto Rico in 1995, and is no longer available.

### *Controlled Foreign Corporations*

As a result of the modification and phase-out of the federal tax incentives under Section 936 of the U.S. Code, many corporations previously operating thereunder reorganized their operations in Puerto Rico to become controlled foreign corporations (“CFCs”). A CFC is a corporation that is organized outside the United States (including, for these purposes, in Puerto Rico) and is controlled by United States shareholders. In general, a CFC may defer the payment of federal income taxes on its trade or business income until such income is repatriated to the United States in the form of dividends or through investments in certain United States properties. The Puerto Rico Office of Industrial Tax Exemption has received notification from numerous corporations that have converted part or all of their operations to CFCs. These include most of the major pharmaceutical, instrument and electronics manufacturing companies in Puerto Rico.

CFCs operate under transfer pricing rules for intangible income that are different from those applicable to United States corporations operating under Section 936 of the U.S. Code (“Section 936 Corporations”). In many cases, they are allowed to attribute a larger share of this income to their Puerto Rico operation but must make a royalty payment “commensurate with income” to their U.S. affiliates. Section 936 Corporations were exempted from Puerto Rico withholding taxes on any cost-sharing payments they might have opted to make, but CFCs are subject to a 15% Puerto Rico withholding tax on royalty payments, unless they have a renegotiated Puerto Rico tax grant issued under the Economic Act in which case this withholding tax could be lowered to 2% or 12%.

For taxable years beginning after December 31, 2005 and before January 1, 2010, the special deduction granted under Section 199 of the U.S. Code against income derived from domestic production activities is extended to taxpayers operating in Puerto Rico that are subject to U.S. federal income taxation at gradual rates, such as branches of U.S. companies operating in Puerto Rico.

In May 2009, the U.S. Department of the Treasury announced proposed changes to the U.S. Code that include, among others, changes to remove incentives for shifting jobs overseas. Several of these initiatives could affect CFCs operating in Puerto Rico. It is not possible at this time to determine the legislative changes that may be made to the U.S. Code, or their effect on the long-term outlook on the economy of Puerto Rico. The administration has commenced evaluating the impact of these proposals and will develop policy responses to the U.S. government to seek to safeguard Puerto Rico’s economic reconstruction and development plans.

## **DEBT**

### **Public Sector Debt**

Public sector debt comprises bonds and notes of the Commonwealth, its municipalities, and public corporations (“notes” as used in this section refers to certain types of non-bonded debt regardless of maturity), subject to the exclusions described below.

Section 2 of Article VI of the Constitution of the Commonwealth provides that direct obligations of the Commonwealth evidenced by full faith and credit bonds or notes shall not be issued if the amount of the principal of and interest on such bonds and notes and on all such bonds and notes theretofore issued that is payable in any fiscal year, together with any amount paid by the Commonwealth in the fiscal year preceding the fiscal year of such proposed issuance on account of bonds or notes guaranteed by the Commonwealth, exceed 15% of the average annual revenues raised under the provisions of Commonwealth legislation and deposited into the treasury (hereinafter “internal revenues”) in the two fiscal years preceding the fiscal year of such proposed issuance. Section 2 of Article VI does not limit the amount of debt that the Commonwealth may guarantee so long as the 15% limitation is not exceeded through payments by the Commonwealth on such guaranteed debt. Internal revenues consist principally of income taxes, property taxes, sales taxes and excise taxes. Certain revenues, such as federal excise taxes on offshore shipments of alcoholic beverages and tobacco products and customs duties, which are collected by the United States Government and returned to the Treasury Department and motor vehicle fuel taxes and license fees, which are allocated to the Highway and Transportation Authority, are not included as internal revenues for the purpose of calculating the debt limit, although they may be available for the payment of debt service. In addition, the portion of the Sales Tax (as defined under “Major Sources of General Fund Revenues—Sales and Use Taxes” under “Puerto Rico Taxes, Other Revenues, and Expenditures” below) allocated to COFINA is not included as internal revenues since the legislation that created COFINA transferred ownership of such portion of the Sales Tax to COFINA and provided that such portion was not “available resources” under the Constitutional provisions relating to full faith and credit bonds.

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

Future maximum annual debt service for the Commonwealth’s outstanding general obligation debt is \$984,688,996 in the fiscal year ending June 30, 2016 (based on the assumption that the Public Improvement Refunding Bonds, Series 2004 A, which are variable rate bonds, bear interest at their actual rate per annum through July 1, 2012 and thereafter at 12% per annum, and the Public Improvement Refunding Bonds, Series 2004 B, the Public Improvement Refunding Bonds, Series 2008 B, a portion of the Public Improvement Refunding Bonds, Series 2003 C, a portion of the Public Improvement Bonds of 2006, Series A, and a portion of the Public Improvement Refunding Bonds, Series 2007 A, each of which are also variable rate bonds, bear interest at 12% per annum). This amount (\$984,688,996) is equal to 12.82% of

\$7,679,421,000, which is the average of the adjusted internal revenues for the fiscal years ended June 30, 2008 and June 30, 2009. If bonds refunded with non-eligible investments described in the preceding paragraph were treated as not being outstanding, and the interest on the Public Improvement Refunding Bonds, Series 2004 B, the Public Improvement Refunding Bonds, Series 2008 B, the portion of the Public Improvement Refunding Bonds, Series 2003 C, the portion of the Public Improvement Bonds of 2006, Series A, and the portion of the Public Improvement Refunding Bonds, Series 2007 A, was calculated using the effective fixed interest rate payable by the Commonwealth under the interest rate exchange agreements entered into in respect thereof, the percentage referred to in the preceding sentence would be 10.77% and future maximum annual debt service for the Commonwealth's outstanding general obligation debt would be \$826,812,043 in the fiscal year ending June 30, 2020. Annual debt service payments on bonds guaranteed by the Commonwealth are not included in the calculation of the 15% debt limitation. In the event any of the public corporations issuers of guaranteed bonds are unable to make any portion of the future debt service payments on its guaranteed bonds, the Commonwealth would be required to make such payments under its guarantee from the General Fund, and such debt service would be included in the calculation of the 15% debt limitation.

The Commonwealth's policy has been and continues to be to maintain the amount of such debt prudently below the constitutional limitation. Debt of municipalities, other than bond anticipation notes, is supported by real and personal property taxes and municipal license taxes. Debt of public corporations, other than bond anticipation notes, is generally supported by the revenues of such corporations from rates charged for services or products. See "Public Corporations." However, certain debt of public corporations is supported, in whole or in part, directly or indirectly, by Commonwealth appropriations or taxes.

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

The following table presents a summary of public sector debt as of December 31, 2009. This table includes debt not primarily payable from either Commonwealth or municipal taxes, Commonwealth appropriations or rates charged by public corporations for services or products, some of which debt is set forth in footnote 5 below. Excluded from the table is debt the inclusion of which would reflect double counting including, but not limited to, \$1.17 billion of outstanding bonds (as of December 31, 2009) issued by Municipal Finance Agency to finance its purchase of bonds of Puerto Rico municipalities, and \$1.6 billion of obligations of Public Finance Corporation issued to purchase certain Commonwealth public sector debt.

**Commonwealth of Puerto Rico**  
**Public Sector Debt\***  
**(in millions)**

	<u>December 31, 2009</u>
Direct full faith and credit obligations <sup>(1)</sup>	\$10,411
Sales Tax debt <sup>(2)</sup>	12,843
Municipal debt	3,139
Puerto Rico guaranteed debt <sup>(3)</sup>	4,308
Debt supported by Puerto Rico appropriations or taxes <sup>(4)</sup>	1,498
Public corporations and agencies	23,050
Sub-total	<u>55,249</u>
Limited obligation/non-recourse debt <sup>(5)</sup>	<u>5,407</u>
Total public sector debt	<u><u>\$60,656</u></u>

\* Totals may not add due to rounding.

<sup>(1)</sup> Includes general obligation bonds, tax and revenue anticipation notes ("TRANs") and related short-term financings.

<sup>(2)</sup> Includes Public Finance Corporation and Sales Tax Financing Corporation bonds.

<sup>(3)</sup> Consists of \$607 million of bonds issued by Aqueduct and Sewer Authority, \$353 million of State Revolving Fund Loans incurred under various federal water laws, \$193.8 million of bonds issued by Port of the Americas Authority and \$3.154 billion of Public Buildings Authority bonds. Excludes \$267 million of GDB bonds payable from available moneys of GDB.

<sup>(4)</sup> Represents bonds and notes payable from the Commonwealth General Fund and Public Improvement Fund.

<sup>(5)</sup> Includes the following: \$1.3 billion of Children's Trust bonds, which are payable solely from the payments to be received pursuant to the tobacco litigation settlement; \$189 million of Housing Finance Authority bonds, which are payable from Puerto Rico Housing Administration's annual allocation of Public Housing Capital Funds from the United States Department of Housing and Urban Development; \$151.9 million of Special Facilities Revenue Bonds issued by Highways and Transportation Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge; \$155 million of Special Facilities Bonds issued by Ports Authority, which are solely payable from the pledge of certain payments made by a private corporation under a special facilities agreement; \$78.0 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority ("AFICA"), which are payable from rent payments made by the University of Puerto Rico; approximately \$80.8 million of bonds issued by AFICA to finance the construction of various government infrastructure projects, which are payable from rent payments made by various government entities; and \$2.948 billion of Employees Retirement System Senior Pension Funding Bonds, Series A, B and C, which are payable solely from employer contributions made to the Employees Retirement System by the Commonwealth and its instrumentalities after the issuance of the bonds.

*Source:* Government Development Bank for Puerto Rico

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



## **Debt Service Requirements for Commonwealth General Obligation Bonds**

The following table presents the debt service requirements for Commonwealth general obligation bonds outstanding as of December 31, 2009.

The table excludes debt service on \$217.4 million of general obligation bonds refunded with refunding bonds the proceeds of which, pending the redemption of the refunded bonds on July 1, 2010, were invested in guaranteed investment contracts or other securities not eligible to effect a legal defeasance. Prior to their redemption, such refunded bonds will be considered to be outstanding under their respective authorizing resolutions and for purposes of calculating the Commonwealth's constitutional debt limitation described above.

In addition, in respect of certain variable rate general obligation bonds, as to which the Commonwealth has entered into interest rate exchange agreements, the interest in the table is calculated by using the respective fixed rates of interest that the Commonwealth is paying under said agreements.

Debt service requirements for each fiscal year, as shown in the following table, include principal and interest due on July 1 immediately following the close of such fiscal year.

**Puerto Rico Debt Service Requirements\***  
(In thousands)

<b>Fiscal Year Ending June 30</b>	<b>Outstanding Bonds</b>		
	<b>Principal</b>	<b>Interest</b>	<b>Debt Service</b>
2010	317,855	64,948	382,803
2011	332,472	469,328	801,800
2012	362,335	446,203	808,538
2013	387,005	424,614	811,619
2014	374,613	424,531	799,143
2015	406,765	406,454	813,218
2016	426,790	386,282	813,072
2017	373,392	365,360	738,751
2018	376,110	346,723	722,832
2019	479,356	312,340	791,696
2020	546,400	280,412	826,812
2021	421,540	253,168	674,708
2022	351,420	233,245	584,665
2023	321,255	216,509	537,764
2024	312,875	201,852	514,727
2025	327,060	187,792	514,852
2026	332,845	171,616	504,461
2027	348,020	154,758	502,778
2028	366,700	136,769	503,469
2029	339,095	119,928	459,023
2030	352,240	103,163	455,403
2031	371,395	86,345	457,740
2032	208,070	68,429	276,499
2033	180,325	58,215	238,540
2034	133,865	50,648	184,513
2035	135,555	44,758	180,313
2036	143,245	37,070	180,315
2037	151,790	28,525	180,315
2038	160,675	19,640	180,315
2039	170,105	10,206	180,311
	<b>\$9,511,167</b>	<b>\$6,109,828</b>	<b>\$15,620,995</b>

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

Sources: Government Development Bank for Puerto Rico and Treasury Department

## Interest Rate Exchange Agreements

As of March 31, 2010, the Commonwealth and various public corporations were party to various interest rate exchange agreements or swaps with eleven different counterparties. These interest rate exchange agreements involve eleven different counterparties. Except for the basis swaps discussed below, the purpose of all of the interest rate exchange agreements is to hedge the Commonwealth's variable rate debt exposure and the interest rate risks associated therewith. When the Commonwealth or a public corporation issues variable rate bonds it enters into an interest rate exchange agreement ("synthetic fixed rate swap") with a counterparty pursuant to which the Commonwealth or the public corporation agree to pay the counterparty a fixed rate and the counterparty agrees to pay the Commonwealth or public corporation a variable rate intended to match the variable rate payable on the bonds. In theory, the variable rate payments off-set and the Commonwealth or the public corporation is left with a net fixed rate payment to a counterparty. The intention of these swaps was to lower the cost of borrowing below what could have been achieved by issuing fixed rate bonds.

The Commonwealth and the Puerto Rico Electric Power Authority are also party to agreements ("basis swaps"), entered into in June 2006 and March 2008, respectively, pursuant to which they are making payments on a specified notional amount based on a short-term interest rate index published by the Securities Industry and Financial Markets Association ("SIFMA") and are receiving from their counterparties payments on the same notional amount based on the published three-month London Interbank Offered Rate ("LIBOR"). For fiscal year 2009 and the first nine months of fiscal year 2010, the Commonwealth received \$10.8 million and \$5.4 million, respectively, from its counterparties under the basis swap and the Puerto Rico Electric Power Authority received \$7.9 million and \$7.0 million, respectively, from its counterparty under the basis swap.

The table below shows the aggregate notional amount as of March 31, 2010 of synthetic fixed rate swaps and basis swaps of the Commonwealth and the public corporations.

### Swap Portfolio Breakdown (as of March 31, 2010)

	<u>Synthetic Fixed</u>	<u>Basis Swaps</u>	<u>Total</u>
Commonwealth (General Obligation)	\$1,536,125,000	\$1,698,370,000	\$3,234,495,000
Electric Power Authority	846,015,000	1,375,000,000	2,221,015,000
Highways and Transportation Authority	647,025,000	—	647,025,000
Ports Authority	411,705,000	—	411,705,000
Sales Tax Financing Corporation	1,043,000,000	—	1,043,000,000
Total	<u>\$4,483,870,000</u>	<u>\$3,073,370,000</u>	<u>\$7,557,240,000</u>

Generally, the interest rate exchange agreements may be terminated by the Commonwealth or the public corporations at any time at their then current market values. The agreements may also be terminated upon the occurrence of certain credit events. If a termination occurs due to a credit event, the Commonwealth or the public corporations may be obligated to pay to the applicable swap counterparty an amount based on the terminating swap's market value, which may be substantial, or vice versa. The mark-to-market value fluctuates with interest rates and other market conditions. The Commonwealth's obligations under the interest

rate exchange agreements are secured by the full faith, credit and taxing power of the Commonwealth. The following table shows, as of March 31, 2010, the net mark-to-market value of all outstanding interest rate exchange agreements. Since the mark-to-market value of all swaps was negative as of March 31, 2010, the Commonwealth or the public corporations, as applicable, would owe money to the counterparties should all the agreements be terminated. Pursuant to the terms of the swap documents, any termination payment would generally be based on the market value of the swap at that time, plus other termination costs in favor for the non-defaulting party. Based on the current mark-to-market valuation of the swap portfolio, however, neither the Commonwealth nor the public corporations are required to post collateral to their counterparties at this time.

**Swap Portfolio Mark-to-Market Valuation**  
(as of March 31, 2010)

	<b>Synthetic Fixed</b>	<b>Basis Swaps</b>	<b>Total</b>
Commonwealth (General Obligation)	\$(154,234,039)	\$(35,399,161)	\$(189,633,200)
Electric Power Authority	(80,250,355)	(15,516,870)	(95,767,225)
Highways and Transportation Authority	(71,620,918)	—	(71,620,918)
Ports Authority	(39,472,721)	—	(39,472,721)
Sales Tax Financing Corporation	(117,702,521)	—	(117,702,521)
Total	<u>\$(463,280,553)</u>	<u>\$(50,916,031)</u>	<u>\$(514,196,584)</u>

By using derivative financial instruments, the Commonwealth exposes itself, among other risks, to credit risk (based on the counterparty's ability to perform under the terms of the agreement), market risk (based on the changes in the value of the instrument resulting from changes in interest rates and other market factors) and basis risk (based on changes to the relationship between different indexes used in connection with a derivative). GDB, as fiscal agent, regularly monitors and attempts to minimize these risks. To minimize some of the credit risk, the Commonwealth and the public corporations enter into agreements with counterparties that have good credit ratings. All of the outstanding interest rate exchange agreements are with counterparties rated in one of the three highest rating categories by either Moody's or S&P and contain requirements of posting collateral by the counterparties based on certain thresholds and credit ratings.

In addition, under the majority of the interest rate exchange agreements, the Commonwealth and the public corporations are required to deliver collateral to the counterparties to guarantee their performance under the agreements based on their credit ratings and certain contractual mark-to-market value thresholds. During the financial market crisis of 2008, the Commonwealth and the public corporations were required to deliver at one time approximately \$251.8 million and \$82.5 million, respectively, in collateral to its counterparties on certain interest rate exchange agreements. However, based on an improvement in the mark-to-market value of the swap portfolio during fiscal year 2010, as of March 31, 2010, the Commonwealth and the public corporations had no collateral posted to their counterparties. However, if the mark-to-market value of the swaps portfolio deteriorates or the credit ratings of the Commonwealth or the public corporations are lowered, the collateral posting obligations contained in the agreements may require further deliveries of collateral.

The aggregate notional amount of the swaps for the Commonwealth and the public corporations has decreased from \$9.2 billion as of June 30, 2008, to \$7.9 billion as of June 30, 2009 and \$7.6 billion as of March 31, 2010, an aggregate decrease of 17.4%. As part of GDB's continuous efforts to minimize the Commonwealth's exposure to interest rate risk, the Commonwealth terminated in May and September 2009 a swap with an \$850 million notional amount pursuant to which the Commonwealth was making payments based on the published short-term SIFMA municipal swap rate and was receiving payments based on the 10-year SIFMA (the "constant maturity swap") at an aggregate gain of approximately \$24.8 million. The constant maturity swap was not hedging any variable rate debt of the Commonwealth. GDB continues to actively manage the Commonwealth's exposure to interest rate risks.

### **Variable Rate Bonds and Mandatory Tender Bonds**

As of March 31, 2010, the Commonwealth had approximately \$1.47 billion of outstanding variable rate general obligation bonds, which consist of approximately \$1.34 billion of variable rate demand bonds ("VRDO Bonds) and approximately \$126.7 million of bonds bearing interest at a rate that changes periodically based on changes in the United States consumer price index ("CPI Bonds"). The Commonwealth has hedged its variable rate debt exposure by entering into interest rate exchange agreements with certain swap providers with respect to all VRDO Bonds and CPI Bonds. Pursuant to these agreements, the Commonwealth receives a variable rate payment expected to approximate the costs of the variable rate bonds, and pays a fixed rate. See "Interest Rate Exchange Agreements."

The VRDO Bonds bear a floating interest rate adjusted at specified intervals (such as daily or weekly) and provide investors the option to tender or put the bonds at par. The tendered bonds are then resold by a remarketing agent in the secondary market to other investors. Most of the VRDO Bonds are secured by letters of credit or other liquidity or credit facilities ("credit/liquidity facilities") that provide for the payment of the purchase price payable upon the tender of the bonds. The credit/liquidity facilities expire prior to the final maturity of the bonds. If upon the expiration or termination of any credit/liquidity facility with respect to a series of VRDO Bonds, the Commonwealth is unable to renew or replace such facility with an alternate credit/liquidity facility, the VRDO Bonds of such series are subject to mandatory tender for purchase by the credit/liquidity facility provider and generally become subject to higher interest rates and accelerated amortization schedules.

In the case of the VRDO Bonds for which the Commonwealth has entered into interest rate exchange agreements, if the Commonwealth cannot renew or replace a credit/liquidity facility upon its expiration and remarket the related series of bonds successfully upon their mandatory tender as variable rate bonds, the Commonwealth may have to terminate the interest rate exchange agreements associated with such series of bonds. Termination of the applicable interest rate exchange agreement may result, depending on then current interest rate levels and market conditions, in the payment of a termination amount by the Commonwealth to compensate the counterparty for its economic losses.

VRDO Bonds subject to mandatory tender upon expiration of the applicable credit/liquidity facilities and for which there is a related interest rate exchange agreement amount

to approximately \$100.0 million for fiscal year 2010, \$472.9 million for fiscal year 2011 and \$769.7 million for fiscal year 2012.

As of March 31, 2010, the Commonwealth also had outstanding approximately \$279.2 million of general obligation bonds bearing interest at a fixed rate but subject to mandatory tender, payable from the remarketing of the bonds, on July 1, 2012 (the “Mandatory Tender Bonds”). After the mandatory tender date, the Commonwealth may from time to time change the method of determining the interest on the Mandatory Tender Bonds, which may be a fixed or variable rate. The Commonwealth has not provided any liquidity facility for the payment of the purchase price payable upon the mandatory tender, which purchase price is expected to be obtained from the remarketing of the bonds.

With respect to approximately \$69.2 million of the Mandatory Tender Bonds, the Commonwealth has entered into forward starting interest rate exchange agreements that assume that the Mandatory Tender Bonds will be remarketed as variable rate bonds after the mandatory tender date of July 1, 2012. If the Commonwealth cannot remarket these bonds as variable rate bonds at that time, the Commonwealth may have to terminate the forward starting interest rate exchange agreements, which may result in the payment of a termination amount by the Commonwealth. As of March 31, 2010, the mark-to-market- value of these forward starting swaps to the Commonwealth was negative \$3.7 million, which is the amount the Commonwealth would have been required to pay to terminate these swaps on that date.

In addition, several of the Commonwealth’s public corporations also have outstanding variable rate bonds and bonds subject to mandatory tender.

### **Ratings of Commonwealth General Obligation Bonds**

In December 2009, S&P confirmed its “BBB–” rating of the Commonwealth’s general obligation and appropriation debt, and its stable outlook thereon.

In April 2010, Moody’s began to recalibrate its ratings of certain U.S. municipal bond issues and issuers in order to enhance the comparability of credit ratings across its portfolio of rated securities. As a result of this recalibration, the Commonwealth’s general obligation debt is now rated “A3” with a stable outlook by Moody’s, which is three categories above the previous “Baa3” rating.

### **Commonwealth Guaranteed Debt**

As of December 31, 2009, \$3.15 billion of Commonwealth guaranteed bonds of the Public Buildings Authority were outstanding. Maximum annual debt service on these bonds is \$258.8 million in fiscal year 2011, with their final maturity being July 1, 2039. No payments under the Commonwealth guaranty have been required to date for these bonds.

As of December 31, 2009, \$267 million of Commonwealth guaranteed bonds of GDB were outstanding. No payments under the Commonwealth guaranty have been required for these bonds.

As of December 31, 2009, GDB held approximately \$193.8 million of the Port of the Americas Authority's outstanding bonds, which are guaranteed by the Commonwealth. The Authority is authorized to issue and GDB is authorized to purchase its bonds guaranteed by the Commonwealth in a maximum aggregate principal amount of \$250 million. The proceeds from these bonds will be used to continue the development of the Port of the Americas. No payments under the Commonwealth guaranty have been required for these bonds. See "Other Public Corporations—Port of the Americas Authority" under "Public Corporations" below.

As of December 31, 2009, the aggregate outstanding principal amount of obligations of PRASA guaranteed by the Commonwealth was \$959.5 million. This amount consisted of \$284.8 million in revenue bonds sold to the public, \$322.2 million in bonds issued to the United States Department of Agriculture, Rural Development, and \$352.5 million of loans by the State Revolving (Clean Water and Safe Drinking Water Act) Funds for the benefit of PRASA. From January 1997 through fiscal year 2005, the Commonwealth made debt service payments under its guaranty. Beginning with the debt service payment due January 1, 2006, the Commonwealth stopped making guarantee payments on these obligations and PRASA resumed making payment on this debt. In the event PRASA is unable to make any portion of the future debt service payments on its guaranteed obligations, the Commonwealth would be required once more to make such payments from the General Fund under its guarantee. See "Other Public Corporations—Puerto Rico Aqueduct and Sewer Authority" under "Public Corporations" below.

## Trends of Public Sector Debt

The following table shows the growth rate of short-term and long-term public sector debt and the growth rate of gross national product (in current dollars) for the five fiscal years ended June 30, 2009 and for the first six months of fiscal year 2010. As of December 31, 2009, outstanding short-term debt, relative to total debt, was 10.3%.

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

June 30,	Public Sector					Gross National Product <sup>(1)</sup>	
	Long Term <sup>(2)</sup>	Short Term <sup>(3)</sup>	Total	Short Term as % of Total	Rate of Increase	Amount	Rate of Increase
2005 .....	\$34,789	\$1,914 <sup>(4)</sup>	\$36,703	5.2%	8.1%	\$53,752	6.0%
2006 .....	37,313	2,620 <sup>(4)(5)</sup>	39,933	6.6	8.8	56,732	5.5
2007 .....	39,492	3,326 <sup>(4)</sup>	42,818	7.8	7.2	59,521	4.9
2008 .....	43,663	3,269 <sup>(4)</sup>	46,932	7.0	10.0	61,527	3.4
2009 .....	48,332	4,648 <sup>(4)</sup>	52,980	8.8	13.0	62,759	2.0
December 31, 2009	49,582	5,667	55,249	10.3	4.8	-	-

\* Totals may not add due to rounding.

(1) In current dollars.

(2) Does not include the bonds identified in footnote 5 of the table above entitled "Commonwealth of Puerto Rico—Public Sector Debt," which would have been issued and outstanding at the time, all of which would be considered long-term debt.

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

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

(5) Includes a \$368 million line of credit from GDB to the Secretary of the Treasury, the proceeds of which were applied to pay debt service on general obligation bonds.

Source: Government Development Bank for Puerto Rico



The following table shows the trend of public sector debt by major category for the five fiscal years ended December 31, 2009 and for the first six months of fiscal year 2010.

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

<u>June 30,</u>	<u>Commonwealth</u>			<u>Municipalities</u>			<u>Public Corporation<sup>(1)</sup></u>			<u>Total</u>		
	<u>Long</u> <u>Term</u>	<u>Short</u> <u>Term<sup>(2)</sup></u>	<u>Total</u>	<u>Long</u> <u>Term</u>	<u>Short</u> <u>Term<sup>(2)</sup></u>	<u>Total</u>	<u>Long</u> <u>Term</u>	<u>Short</u> <u>Term<sup>(2)</sup></u>	<u>Total</u>	<u>Long</u> <u>Term</u>	<u>Short</u> <u>Term<sup>(2)</sup></u>	<u>Total</u>
2005.....	\$8,761	\$257 <sup>(3)</sup>	\$9,018	\$1,927	\$254	\$2,181	\$24,101	\$1,403	\$25,504	\$34,789	\$1,914	\$36,703
2006.....	9,841	552 <sup>(3)(4)</sup>	10,393	2,037	293	2,330	25,435	1,775	27,210	37,313	2,620	39,933
2007.....	10,335	224 <sup>(3)</sup>	10,559	2,164	299	2,463	26,993	2,803	29,796	39,492	3,326	42,818
2008.....	9,273	519 <sup>(3)</sup>	9,792	2,507	313	2,820	31,633	2,437	34,070	43,413	3,269	46,682
2009.....	9,382	557 <sup>(3)</sup>	9,939	2,691	306	2,997	36,259	3,785	40,044	48,332	4,648	52,980
December 31, 2009 ..	10,081	1,132	11,213	2,842	297	3,139	36,659	4,238	40,897	49,582	5,667	55,249

\* Totals may not add due to rounding.

(1) Includes Commonwealth guaranteed debt; does not include the bonds identified in footnote 5 of the table above entitled "Commonwealth of Puerto Rico—Public Sector Debt."

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

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

(4) Includes a \$368 million line of credit from GDB to the Secretary of the Treasury, the proceeds of which were applied to pay debt service on general obligation bonds.

Source: Government Development Bank for Puerto Rico

## PUBLIC CORPORATIONS

In Puerto Rico, many governmental and quasi-governmental functions are performed by public corporations created by the Legislative Assembly with varying degrees of independence from the central government to perform generally a single function or a limited number of related functions. Most public corporations obtain revenues from rates charged for services or products, but many are subsidized to some extent by the central government. Most public corporations are governed by boards whose members are appointed by the Governor with the advice and consent of the Senate, but some public corporations are attached to departments of the central government. Capital improvements of most of the larger public corporations are financed by revenue bonds issued under trust agreements or bond resolutions, or by notes issued under loan agreements. The following table presents the outstanding bonds and notes of certain of the public corporations as of December 31, 2009 ("notes" as used in this section refers primarily to certain types of non-bonded debt regardless of maturity). Debt of certain other public corporations is excluded from this table because such debt is payable primarily from funds or grants provided by the federal government, is payable from sources other than Commonwealth appropriations or taxes or revenues of public corporations, or is payable from revenues derived from private sector services or products, such as industrial development bonds. Also excluded from this table is debt of certain public corporations the inclusion of which would reflect double counting. No deductions have been made in the table for debt service funds and debt service reserve funds. More detailed information about the major public corporations is presented in the following sections.

**Commonwealth of Puerto Rico**  
**Outstanding Debt of Public Corporations**  
**December 31, 2009**  
**(in thousands)**

	<b>Bonds</b>			<b>Notes</b>			<b>Total Bonds and Notes</b>		
	<b><u>With Guaranty</u></b>	<b><u>Without Guaranty</u></b>	<b><u>Total</u></b>	<b><u>With Guaranty</u></b>	<b><u>Without Guaranty</u></b>	<b><u>Total</u></b>	<b><u>With Guaranty</u></b>	<b><u>Without Guaranty</u></b>	<b><u>Total</u></b>
Aqueduct and Sewer Authority	\$ 606,975	\$ 1,338,650	\$ 1,945,625	\$352,518	\$846,262	\$1,198,780	\$ 959,493	\$ 2,184,912	\$ 3,144,405
Convention Center District Authority	-	455,800	455,800	-	151,076	151,076	-	606,876	606,876
Electric Power Authority	-	5,858,051	5,858,051	-	1,332,488	1,332,488	-	7,190,539	7,190,539
Highway and Transportation Authority	-	6,240,044 <sup>(1)</sup>	6,240,044	-	869,927	869,927	-	7,109,971	7,109,971
Housing Finance Authority <sup>(2)</sup>	-	357,974	357,974	-	61,688	61,688	-	419,662	419,662
Industrial Development Company	-	252,705	252,705	-	89,075	89,075	-	341,780	341,780
Infrastructure Financing Authority	-	1,828,298	1,828,298	-	34,501	34,501	-	1,862,799	1,862,799
Port of the Americas Authority	193,796	-	193,796	-	-	-	193,796	-	193,796
Ports Authority	-	55,580 <sup>(3)</sup>	55,580	-	686,102	686,102	-	741,682	741,682
Public Buildings Authority	3,154,389	-	3,154,389	-	145,514	145,514	3,154,389	145,514	3,299,903
Public Finance Corporation	-	1,626,899 <sup>(4)</sup>	1,626,899	-	99,000	99,000	-	1,725,899	1,725,899
P.R. Sales Taxes Financing Corp. (COFINA)	-	10,511,694	10,511,694	-	500,000	500,000	-	11,011,694	11,011,694
University of Puerto Rico	-	569,188 <sup>(5)</sup>	569,188	-	71,239	71,239	-	640,427	640,427
Others <sup>(6)</sup>	-	-	-	-	2,607,667	2,607,667	-	2,607,667	2,607,667
Total <sup>(7)</sup>	<u>\$3,955,160</u>	<u>\$29,094,883</u>	<u>\$33,050,043</u>	<u>\$352,518</u>	<u>\$7,494,539</u>	<u>\$7,847,057</u>	<u>\$4,307,678</u>	<u>\$36,589,422</u>	<u>\$40,897,100</u>

<sup>(1)</sup> Excludes \$152 million of Special Facilities Revenue Bonds issued by the Highway and Transportation Authority, which are payable from net toll revenues collected from the Teodoro Moscoso Bridge.

<sup>(2)</sup> Excludes the \$189 million of Housing Finance Authority bonds, which are payable solely from Puerto Rico Public Housing Administration's annual allocation of Public Housing Capital Funds from the U.S. Department of Housing and Urban Development.

<sup>(3)</sup> Excludes \$155 million of Special Facilities Bonds issued by the Ports Authority, which bonds are payable solely from the pledge of certain payments made by a private corporation under a special facilities agreement.

<sup>(4)</sup> Payable primarily from Commonwealth appropriations.

<sup>(5)</sup> Excludes \$78.0 million of Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) issued by AFICA, which bonds are payable from rent payments made by the University of Puerto Rico.

<sup>(6)</sup> Includes lines of credit with GDB.

<sup>(7)</sup> Excludes accretion of interest from the respective issuance dates on capital appreciation bonds. Also excludes \$1.3 billion original principal amount of Children's Trust Tobacco Settlement Asset-Backed Bonds, Series 2002, which bonds will be repaid from payments made by certain tobacco companies under a master settlement agreement. See "Children's Trust" under "Other Public Corporations" below.

Source: Government Development Bank for Puerto Rico

## Government Development Bank for Puerto Rico

The principal functions of GDB are to act as financial advisor to and fiscal agent for the Commonwealth, its municipalities and public corporations in connection with the issuance of bonds and notes, to make loans and advances to public corporations and municipalities, and to promote the economic development of Puerto Rico. As part of its role as fiscal agent, during fiscal years 2009 and 2010, GDB entered into fiscal oversight agreements with the Aqueduct and Sewer Authority, Electric Power Authority, Highway and Transportation Authority, Ports Authority and Public Buildings Authority. As part of these agreements, GDB imposed certain conditions on the extension of credit to these entities and continually monitors their finances, among other things.

As of December 31, 2009, GDB had total assets of \$12.8 billion and total liabilities of \$11.1 billion. GDB's total capital as of such date was \$1.7 billion and its total capital ratio was 17%. GDB's debt is currently rated A3 and BBB by Moody's and S&P, respectively, with a stable outlook.

As of December 31, 2009, \$3.2 billion of bonds and notes of GDB (excluding its subsidiaries) were outstanding, consisting of \$267 million in Commonwealth guaranteed bonds and \$3 billion of medium term senior notes. Act No. 12 of May 9, 1975, as amended, provides that the payment of principal of and interest on specified notes and other obligations of GDB, not exceeding \$550 million, may be guaranteed by the Commonwealth, of which \$267 million were outstanding as of December 31, 2009. As of said date, GDB also had \$6.9 billion in loans outstanding to the central government of the Commonwealth and its public corporations and municipalities.

Act No. 82 of June 16, 2002 ("Act 82") amended GDB's Charter to authorize GDB to transfer annually to the General Fund, beginning with fiscal year 2001, up to 10% of its audited net income or \$10,000,000, whichever is greater. GDB is not required by Act 82 to transfer any funds. GDB made payments to the General Fund of \$11.6 million for fiscal year 2003 and \$18.4 million for fiscal year 2004. GDB did not make a payment to the General Fund under Act 82 for fiscal years 2005, 2006, 2007, 2008, and 2009 and does not expect to make a payment for fiscal year 2010.

Under Act No. 271 of November 21, 2002, GDB made a required special capital contribution to the Special Communities Perpetual Trust (the "Perpetual Trust") of \$500 million and provided the Perpetual Trust with a \$500 million, non-revolving, line of credit. The amounts transferred to the Perpetual Trust were deposited in two investment accounts held by GDB for the benefit of the Perpetual Trust. As of December 31, 2009, the Perpetual Trust had repaid \$123.9 million of its line of credit and had an outstanding balance of \$376 million and interest due of \$11.9 million. The line of credit is payable from legislative appropriations.

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

*Puerto Rico Housing Finance Authority.* Puerto Rico Housing Finance Authority ("Housing Finance Authority") (formerly known as Housing Finance Corporation) was created to provide needed rental housing units and stimulate the construction industry under federally subsidized programs. Effective February 8, 2002, Housing Finance Corporation became the Housing Finance Authority and the Housing Bank and Finance Agency was dissolved and its powers transferred to the Housing Finance Authority. Housing Finance Authority provides financing for rental housing units, stimulates the construction industry under federally subsidized programs and provides interim financing for low-income housing projects and single-family homeownership programs. It is also engaged in insuring and servicing mortgages originated by the former Housing Bank and Finance Agency. As of December 31, 2009, Housing Finance Authority's total outstanding loans to the private sector for development of housing projects targeted to low and moderate income families were \$112.9 million. The Authority's mortgage loans to low and moderate income homeowners represented an additional \$88.5 million as of the same date.

Housing Finance Authority has outstanding tax-exempt revenue bonds and notes that were issued to finance the construction of housing units approved for federal rental subsidies and to finance home ownership of single family housing units. Such bonds and notes are generally limited obligations of Housing Finance Authority payable solely from revenues collected from such housing units, with certain exceptions. As of December 31, 2009, the Housing Finance Authority had total notes and bonds outstanding of \$1.021 billion (including \$914 million in outstanding bonds, \$101.8 million of debt outstanding under GDB lines of credit, and \$4.8 million in notes payable and total unrestricted net assets of \$306.6 million.

*Puerto Rico Tourism Development Fund.* Puerto Rico Tourism Development Fund (“TDF”) promotes Puerto Rico’s hotel and tourism industry by making available direct loans and guarantees to secure the private financing for new hotel development projects. TDF is also authorized to make capital investments in tourism related projects. As of December 31, 2009, TDF had outstanding direct loans in an aggregate principal amount of \$323.0 million and guarantees in the amount of \$116.3 million to finance several hotels and tourism-related projects. In April 2010, TDF received \$115 million in capital, consisting of \$100 million from the GDB Capital Fund and \$15 million from the Local Stimulus.

TDF has made payments under its guarantees and letters of credit in the aggregate amount of approximately \$320.9 million with respect to several projects. Of the total amount disbursed, TDF has been able to recover approximately \$242.9 million from the borrowers. After taking these payments and all related recoveries into account, the unrestricted net assets of TDF as of December 31, 2009, were approximately \$101.4 million, and its allowances for losses on guarantees, loans, other assets and letters of credit were approximately \$78.8 million.

*Government Development Bank for Puerto Rico Capital Fund.* The Government Development Bank for Puerto Rico Capital Fund (the “Capital Fund”) invests and trades in debt obligations and publicly traded shares of domestic and foreign corporations separate from GDB’s general investment operations. As of December 31, 2009, the Capital Fund had assets of \$76.5 million, of which \$38.1 million were invested in an equity index fund that invests mainly in growth, value, small cap and international stocks, \$13.2 million in a global opportunity investment fund, and \$25 million were invested in structured notes.

*Development Fund.* The Puerto Rico Development Fund (the “Development Fund”) provides an alternate source of financing to private enterprises in Puerto Rico that have difficulties in obtaining financing from traditional sources. The Development Fund also guarantees obligations of these enterprises and invests in their equity securities. As of December 31, 2009, the Development Fund had an investment of \$3.2 million in preferred shares of a private entity. In addition, the Development Fund provided guarantees of \$15 million, to guarantee 33% of loans under the “Key to Your Business” program of the Economic Development Bank. As of December 31, 2008, the allowance for losses on guarantees was approximately \$962,258.

*Puerto Rico Public Finance Corporation.* Puerto Rico Public Finance Corporation (“PFC”) provides agencies and instrumentalities of the Commonwealth with alternate means of meeting their financing requirements. PFC currently holds notes payable by the Commonwealth, the Maritime Shipping Authority, the Office for the Improvement of Public Schools, the

Department of Health, and the Aqueduct and Sewer Authority, among others. As of December 31, 2008, it had \$1.6 billion aggregate principal amount of bonds outstanding. All such bonds are limited, non-recourse obligations of PFC payable from Commonwealth appropriations made to pay the notes held by PFC. In addition, PFC had \$101.3 million of notes outstanding under a line of credit with GDB whose proceeds were used to pay fiscal year 2007 debt service on its bonds due to the failure of the Commonwealth to make the required debt service appropriations on account of its fiscal problems.

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

### **Other Public Corporations**

*Puerto Rico Aqueduct and Sewer Authority.* PRASA owns and operates Puerto Rico’s public water supply and wastewater systems.

PRASA reported net operating losses of \$63.7 million for fiscal year 2009, compared to net operating losses of \$101.2 million for fiscal year 2008, and net operating income of \$31.2 million for fiscal year 2007. In order to improve its financial condition, PRASA adopted a comprehensive plan to increase its revenues and reduce its expenses.

As of December 31, 2009, PRASA’s total debt was \$3.1 billion. This debt includes outstanding bonds in the principal amount of \$1.9 billion and interim financing for capital improvements in the principal amount of 1.2 billion. PRASA’s senior debt is rated Baa1, BBB- and BBB+ by Moody’s, S&P and Fitch Ratings (“Fitch”), respectively.

The Commonwealth guarantees the principal and interest payments on the outstanding revenue refunding bonds, 2008 Series A and 2008 Series B, any bonds issued on or before June 30, 2010 to the Rural Utilities Service of the United States Department of Agriculture, and the loans granted on or before June 30, 2010 by the Puerto Rico Water Pollution Control Revolving Fund and the Puerto Rico Safe Drinking Water Revolving Fund to PRASA. In the event that PRASA is unable to make all or any portion of the future debt service payments on these guaranteed debts, the Commonwealth will be responsible for covering such payments.

On April 28, 2006, the Authority entered into a consent decree with the U.S. Environmental Protection Agency (“EPA”) that requires the Authority to implement system wide remedial measures at all of the wastewater treatment plants operated by the Authority. The EPA consent decree establishes deadlines for the compliance with the conditions set forth therein and stipulates penalties for violation of any of those deadlines.

On December 15, 2006, a settlement agreement was signed between the Authority and the Department of Health of the Commonwealth (“DOH”) relating to violations of the Safe Drinking Water Act. The settlement agreement was preliminarily approved by the supervising court on March 15, 2007, and was amended and finally approved by that court on June 20, 2008. The Authority agreed to implement a work plan to remediate the violations, establish preventive and mitigation measures, and execute a preventive maintenance program for the purpose of meeting the requirements of the Safe Drinking Water Act.

PRASA has established a 15-year capital improvement program with a total investment of \$2.2 billion in order to comply with the agreements signed with the EPA and DOH agencies. PRASA has committed an investment of \$1.2 billion to comply with the EPA consent decree and \$1.0 billion to comply with the DOH settlement agreement.

PRASA has already invested \$941 million in capital investment projects covering the first 5-year term of the above mentioned agreements.

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

Children's Trust issued \$1.2 billion Tobacco Settlement Asset-Backed Bonds in October 2002. The bond proceeds were used, among other things, to pay the cost of certain capital expenses of the Commonwealth and certain capital and working capital expenses of PRASA. On June 30, 2005, the Children's Trust issued \$108.2 million subordinate Tobacco Settlement Asset-Backed Bonds to pay working capital expenses of the Commonwealth. On May 1, 2008, Children's Trust issued an additional \$195.9 million of subordinate Tobacco Settlement Asset-Backed Bonds. As of December 31, 2009, the Children's Trust had outstanding bonds in the principal amount of \$1.3 billion. These bonds and any, other additional senior bonds issued by Children's Trust are payable solely from, and secured by a statutory pledge of, the payments made and to be made by the participating cigarette manufacturers under the Master Settlement Agreement. To date, all principal and interest payments required to be made by the Children's Trust on its outstanding bonds have been made on a timely basis from contribution payments made by the participating cigarette manufacturers under the Master Settlement Agreement.

*Puerto Rico Convention Center District Authority.* The Puerto Rico Convention Center District Authority (the "Convention Center District Authority") was created to own, develop, finance, plan, design, build, operate, maintain, administrate and promote a new convention center and designated private parcels located within the Convention Center District in San Juan. The convention center opened in November 2005. The Convention Center District Authority also owns a multipurpose coliseum in San Juan, known as the José Miguel Agrelot Coliseum. As of December 31, 2009, the Convention Center District Authority's debt was \$606.8 million, consisting of \$455.8 million in outstanding bonds issued to finance the Convention Center that are payable from a portion of a hotel room tax and \$151.0 million line of credit with GDB used to finance the construction of the Coliseum that is payable from the Commonwealth's General Fund.

*Puerto Rico Electric Power Authority.* The Puerto Rico Electric Power Authority ("PREPA") owns and operates Puerto Rico's electric power system.

PREPA reported net operating income of \$362.6 million, \$181.1 million and \$370.9 million during fiscal years 2009, 2008 and 2007, respectively. The total debt of PREPA

was \$7.2 billion as of December 31, 2009. This debt includes outstanding bonds of \$5.8 billion, interim financing for capitals improvements of \$697.7 million and interim financing for operations of \$660.9 million. PREPA's debt is rated A3, BBB+ and BBB+ by Moody's, S&P and Fitch, respectively.

In April 2010, PREPA issued its Power Revenue Bonds, Series XX in the amount of \$822,210,000 and its Power Revenue Bonds, Series YY (Issuer subsidy Build America Bonds) in the amount of \$320,175,000. PREPA also expects to issue its Power Revenue Bonds, Series ZZ in the amount of \$631,160,000 and Power Revenue Bonds, Series AAA in the amount of \$363,075,000 in May 2010. PREPA has used and will use the proceeds of these bonds to repay outstanding lines of credit used to fund capital improvements and finance working capital needs as well as to refund a portion of its outstanding bonds and provide for the termination of certain synthetic fixed swaps associated with the refunded bonds. As part of its continuing financing program, PREPA expects to issue additional bonds during fiscal year 2010.

As a means of reducing its dependency on oil, PREPA has entered into long-term power purchase agreements with private operators of two co-generation plants that use fuels other than oil. Currently, these two co-generation plants provide approximately 31% of PREPA's energy needs. PREPA has also commenced developing plans for the conversion of its main oil-fired units into natural gas and clean-coal fired units.

*Health Insurance Administration.* The Health Insurance Administration was created in 1993 to negotiate and contract for the provision of comprehensive health insurance coverage for qualifying (generally low income) Puerto Rico residents. Under this system, the government selects, through a bidding system, one private health insurance company in each of eight designated regions of the island and pays such insurance company the insurance premium for each eligible beneficiary within such region. The health insurance system covers the entire island, and approximately 1.5 million persons were covered by the system during fiscal year 2009.

The Commonwealth has entered into various contracts with several Medicare Advantage organizations for the provision of health coverage to approximately 200,000 eligible beneficiaries. Pursuant to these agreements, the Commonwealth pays each Medicare Advantage organization a premium difference to cover services not included in their contracts with the Center for Medicaid and Medicare Services.

The total cost of the health insurance program for fiscal year 2009 was \$1.8 billion, compared to \$1.68 billion for fiscal year 2008 and \$1.59 billion for fiscal year 2007. For fiscal year 2009, the General Fund covered \$1 billion of the total cost of the health insurance program. The remaining \$767 million will be paid from federal, municipal and other sources. The fiscal year 2010 budget estimates the cost of the health insurance program at \$1.9 billion, of which the General Fund is expected to cover \$1.1 billion, while the difference will be paid from federal, municipal, internally generated funds and other sources.

*Puerto Rico Highways and Transportation Authority.* The Puerto Rico Highways and Transportation Authority ("PRHTA") is responsible for highway construction in Puerto Rico.

Such construction is financed by debt (interim notes and revenue bonds), revenues of PRHTA, and federal and Commonwealth grants.

PRHTA reported a net operating loss of \$491.9 million for fiscal year 2009, compared to net operating losses of \$448.6 million and \$386.0 million for fiscal years 2008 and 2007, respectively.

Debt service on PRHTA's revenue bonds constitutes a first lien on its gross revenues, which consist currently of all the proceeds of the tax on gasoline, one-half of the proceeds of the tax on gas oil and diesel oil, all the proceeds of the excise taxes on crude oil, unfinished oil and derivative products, up to \$120 million per fiscal year, highway toll revenues and the gross receipts of \$15.00 per vehicle per year from certain motor vehicle license fees. Such revenues (except for toll revenues) may be applied first to the payment of debt service on general obligation bonds and notes of the Commonwealth and to payments required to be made by the Commonwealth under its guarantees of bonds and notes, to the extent that no other revenues are available for such purpose. The Commonwealth has never applied such revenues for such payment.

As of December 31, 2009, PRHTA's total debt was \$7.1 billion, including \$6.3 billion in outstanding bonds and interim, subordinated financings with GDB in the aggregate principal amount of \$869.9 million. PRHTA's Highway Revenue Bonds are rated A2 and BBB+ by Moody's and S&P, respectively, and the Senior Transportation Revenues Bonds are rated A3 and BBB by Moody's and S&P, respectively.

PRHTA has a mass transit system, known as Tren Urbano, serving a portion of metropolitan San Juan. It was constructed under several design/build contracts and is being privately operated under a five-year contract with an additional five-year option at PRHTA's election. The cost of the project was \$2.25 billion, which cost was financed by federal Transit Administration grants, other federal funding sources and PRHTA's own resources, including revenue bonds. Tren Urbano commenced operations in June 2005 and currently has ridership of about 35,000 persons per day.

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

*Puerto Rico Industrial Development Company.* The Puerto Rico Industrial Development Company ("PRIDCO") participates in the Commonwealth-sponsored economic development program by providing physical facilities, general assistance, and special incentive grants to



manufacturers. PRIDCO reported consolidated net operating losses of \$5.9 million for fiscal year 2009, compared to consolidated net operating losses of \$6.1 million for fiscal year 2008 and consolidated net income of \$2.1 million for fiscal year 2007. The total debt of PRIDCO was \$425.8 million as of December 31, 2009. This debt includes outstanding bonds of \$252.7 million and financings for operations of \$173.9 million. PRIDCO's debt is rated Baal and BBB- by Moody's and S&P, respectively.

During fiscal years 2006 and 2007 PRIDCO entered into a company reorganization plan establishing an early retirement plan and a voluntary separation plan with the objective of reducing workforce and to achieve expense reductions. This plan was financed by a line of credit from GDB, which had an outstanding balance of \$45.7 million as of December 31, 2009.

*Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority.* The Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority ("AFICA") was created to finance (through the issuance of its revenue bonds) industrial, tourist, educational, medical, and environmental control facilities in Puerto Rico for the use of private companies, non-profit entities, or government agencies. The bonds are payable solely from payments to be made to AFICA by such private companies, non-profit entities, or government agencies, and do not constitute a debt of the Commonwealth or any of its other public corporations or municipalities. As of December 31, 2009, approximately \$1.4 billion of AFICA's bonds were outstanding. In addition, as of December 31, 2009, AFICA has a \$67 million line of credit with GDB with an outstanding balance of \$60 million used to purchase certain assets from PREPA.

*Puerto Rico Infrastructure Financing Authority.* The Puerto Rico Infrastructure Financing Authority ("PRIFA") was created to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other public corporations, governmental instrumentalities, political subdivisions and municipalities (collectively, "Benefited Entities") authorized to develop infrastructure facilities and to establish alternate means for financing those facilities. PRIFA is authorized to issue bonds and provide loans, grants and other financial assistance for the construction, acquisition, repair, maintenance and reconstruction of infrastructure projects by Benefited Entities.

As of December 31, 2009, PRIFA's total debt was \$1.86 billion. This debt includes bonds outstanding of \$1.83 billion and interim financing for capital improvements of \$34.5 million. PRIFA's debt is rated Baa3 and BBB+ by Moody's and S&P, respectively.

PRIFA oversees the Puerto Rico Infrastructure Fund, which is being funded annually thru fiscal year 2052 with the first \$117 million of proceeds of federal excise taxes imposed on rum and other articles produced in Puerto Rico and sold in the United States that are transferred to Puerto Rico pursuant to the United States Internal Revenue Code of 1986, as amended. Rum is the only article currently produced in Puerto Rico subject to federal excise taxes, the proceeds of which are required to be returned to the Treasury Department. The Authority is using these funds to pay debt service of bonds issued to finance various infrastructure projects.

PRIFA also has custody and control of the Infrastructure Development Fund and its Corpus Account, a perpetual account established under Act No. 92 of June 24, 1998 that was

funded with \$1.2 billion of the proceeds of the sale of Puerto Rico Telephone Company. The interest earned on the securities held in the Corpus Account were being used by PRIFA to pay debt service on its \$1.1 billion Series 2000 A and B Bonds. Act No. 3, approved by the Legislative Assembly of the Commonwealth on January 14, 2009 (“Act 3”), authorized the sale of the securities held in the Corpus Account. PRIFA sold the securities in January 2009 and used the proceeds to: (i) make a deposit into an escrow account in an amount sufficient to retire the Series 2000 A and B Bonds on October 1, 2010, (ii) make a deposit to the General Fund which was applied to cover a portion of the Commonwealth’s budget deficit, (iii) make a transfer to GDB as a capital contribution, and (iv) make a deposit to the Corpus Account to be invested in a long-term investment agreement with GDB.

Pursuant to Act No. 8 of March 9, 2009, PRIFA is responsible for implementing in the Commonwealth the applicable provisions of ARRA. One of its main responsibilities regarding ARRA is to maximize the flow of funds from the Federal Government for the appropriate investment in qualified projects and activities. PRIFA also has responsibility for the receipt, administration and disbursement of such funds and monitoring those governmental agencies and entities that receive ARRA funds.

PRIFA is investing a portion of its resources in new infrastructure projects in connection with the celebration of the Central American and Caribbean Games in Mayagüez, Puerto Rico, in 2010. In September 2006, the Authority issued \$469.8 million of bonds to finance these and other infrastructure projects.

*Puerto Rico Municipal Finance Agency.* The Puerto Rico Municipal Finance Agency (“MFA”) is authorized to issue bonds to purchase general obligation bonds and notes of Puerto Rico municipalities and to fund a debt service reserve. Debt service on MFA’s bonds is payable from debt service payments on municipal bonds and notes held by MFA and from the debt service reserve, including investment income thereon. The Commonwealth has agreed to pay such amounts to the debt service reserve as may be necessary to maintain it at its required level, subject to appropriation by the Legislative Assembly, which appropriation is authorized but not legally required to be made. To date no such payments have been required. As of December 31, 2009, MFA had \$1.17 billion of bonds outstanding.

*Port of the Americas Authority.* The Port of the Americas Authority (“PAA”) is responsible for the development and operation of the Port of the Americas (the “Port”), a deep draft port on the south coast of Puerto Rico.

PAA is authorized to issue bonds guaranteed by the Commonwealth in a maximum aggregate principal amount of \$250 million. The proceeds from these bonds will be used to continue the development of the Port. Currently, GDB is authorized by law to purchase bonds of PAA in an aggregate principal amount not to exceed \$250 million. As of December 31, 2009, GDB held approximately \$193.8 million of PAA’s outstanding bonds, which are guaranteed by the Commonwealth.

The first phase of the Port was completed in fiscal year 2004. This initial phase included the improvement of piers 4, 5, and 6 of the Port and the acquisition of heavy equipment at a cost of \$40 million. During calendar year 2005, the PAA began the second phase of the Port, which

phase will provide capacity to handle up to 250,000 Twenty-Foot Equivalent Units (“TEU”) per year. This second phase includes (i) dredging the entrance channel and adjacent areas of the Port to a depth of 50 feet, (ii) reconstructing the container terminals, (iii) commencing certain required environmental risk mitigation procedures, and (iv) preparing final construction schematics.

A third phase, which provides for the expansion of the Port’s capacity, was initiated in May 2007. This phase includes (i) infrastructure improvements related to access roads, (ii) the development of utility infrastructure, namely, a new storm canal and the relocation of electricity lines and the water and sanitation system, (iii) additional dredging at certain pier locations, and (iv) the expansion of the container terminal. The first expansion under this phase will provide sufficient capacity to process 500,000 TEU annually and is expected to be finished in the second half of 2011.

*Puerto Rico Ports Authority.* The Puerto Rico Ports Authority (“Ports Authority”) owns and operates the major airport and seaport facilities in Puerto Rico. Ports Authority derives revenues from a variety of sources, including charges on airplane fuel sales, air terminal space rentals, landing fees, wharfage, dockage and harbor fees, and rentals for the lease of property and seaport equipment. Ports Authority reported net operating losses of \$46.7 million and \$37.8 million during fiscal years 2009 and 2008, respectively. The total debt of PRPA was \$741.7 million as of December 31, 2009. This debt includes outstanding bonds of \$55.6 million, credit facilities for capital improvements with GDB and private financial institutions of \$274.4 million and a loan for operational purposes with private financial institutions of \$411.7 million. The loan for operational purposes and a portion of the credit facilities for capital improvements are guaranteed by GDB. PRPA debt is rated Baa3 and BBB– by Moody’s and S&P, respectively.

As of December 31, 2009, the outstanding balance of the credit facilities for capital improvements with private financial institutions was \$160.1 million, which is due on June 30, 2010. Of this amount, \$88.3 million, plus interest, is guaranteed by GDB.

*Puerto Rico Public Buildings Authority.* The Puerto Rico Public Buildings Authority (“PBA”) is authorized to construct, purchase or lease office, school, health, correctional and other facilities for lease to departments, public corporations, and instrumentalities of the Commonwealth. Bonds that have been issued by PBA to finance such facilities (through retirement of interim notes or otherwise) are payable from lease payments, which are largely derived from legislative appropriations and are secured by the Commonwealth’s guaranty. PBA is authorized by law to have outstanding at any one time up to \$3.325 billion of bonds guaranteed by the Commonwealth. As of December 31, 2009, \$3.154 billion of such bonds of PBA were outstanding (not including accretion of interest from the respective issuance dates on capital appreciation bonds). As of December 31, 2009, PBA’s line of credit with GDB had an outstanding balance of \$145.5 million. PBA debt is rated A3 and BBB– by Moody’s and S&P, respectively.

*Puerto Rico Public-Private Partnerships Authority.* The Authority is an independent governmental instrumentality of the Commonwealth created by Act No. 29 of June 8, 2009. The Authority is tasked with implementing the Commonwealth’s public policy regarding public-private partnerships to further the development and maintenance of infrastructure facilities,

improve the services rendered by the Government and foster the creation of jobs. As of April 2010, the Authority had engaged various financial advisors to assist it in the evaluation of various projects in the energy, transportation, water and education sectors. The Authority is in the process of evaluating these projects and expects to issue a request for proposal with respect to approximately four projects during the first semester of fiscal year 2011. As of December 31, 2009, the Authority has a \$20 million line of credit with GDB with an outstanding balance of \$1.2 million.

*Puerto Rico Sales Tax Financing Corporation.* COFINA is an independent governmental instrumentality of the Commonwealth created by Act 91. COFINA was originally created for the purpose of financing the payment, retirement, or defeasance of certain appropriation-backed debt outstanding as of June 30, 2006, payable to GDB and PFC.

Recently, the Legislative Assembly of Puerto Rico expanded the purposes for which COFINA was created and, correspondingly, increased its revenues by increasing from 1% to 2.75% (one-half of the tax rate of 5.5%) the portion that is transferred to COFINA of the sales and use tax imposed by the central government. As a result, COFINA was authorized to issue bonds for the following additional purposes: (i) to pay, in whole or in part, the debt of the Secretary of the Treasury with GDB in the amount of \$1 billion, the proceeds of which were used to cover the budgetary deficit for fiscal year 2009, (ii) to pay, in whole or in part, certain financing granted to the Secretary of the Treasury by GDB payable from future Commonwealth general obligation bonds, and any debt of the Commonwealth outstanding as of December 31, 2008 that did not have a source of repayment or was payable from budgetary appropriations, (iii) to pay, in whole or in part, the accounts payable to suppliers of the Commonwealth, (iv) to pay or finance operational expenses of the Commonwealth for fiscal years 2009, 2010, and 2011, (v) to pay or finance operational expenses of the Commonwealth for fiscal year 2012, which would have to be included in the annual budget of the Government of Puerto Rico, (vi) to fund the Puerto Rico Economic Stimulus Fund, (vii) to fund the Commonwealth Emergency Fund in order to cover expenses resulting from catastrophic events such as hurricanes or floods, and (viii) to generate moneys to fund the Economic Cooperation and Public Employees Alternatives Fund. As of December 31, 2009, COFINA had approximately \$10.5 billion outstanding of its Sales Tax Revenue Bonds (excluding all accretion on capital appreciation bonds). COFINA's Sales Tax Revenue Bonds are rated Aa2, AA- and AA- by Moody's, S&P and Fitch, respectively, and the Sales Tax Revenue Bonds, First Subordinate Series are rated A1, A+ and A+ by Moody's, S&P and Fitch, respectively.

In February 2010, COFINA issued its Sales Tax Revenue Bonds, First Subordinate Series 2010A in the amount of \$1,823,757,271 and its Sales Tax Revenue Bonds First Subordinate Series 2010B Bond Anticipation Notes in the aggregate principal amount of \$172,100,000. The proceeds of the Series 2010A and Series 2010B Bonds were used to repay the Sales Tax Revenue Bonds, First Subordinate Series 2009D Bond Anticipation Notes issued to a commercial bank in Puerto Rico, provide for the payment of operational expenses for the Commonwealth, and fund a portion of the Local Stimulus Fund.

*Special Communities Perpetual Trust.* The Perpetual Trust is a public corporation created by law to be an irrevocable and permanent trust. The Perpetual Trust's principal purpose is to fund development projects that address the infrastructure and housing needs of

underprivileged communities. GDB has made a special capital contribution to the Perpetual Trust of \$500 million and provided the Trust with a \$500 million, non-revolving, line of credit. The amounts transferred by GDB were deposited in two investment accounts held by GDB for the benefit of the Perpetual Trust, which generated interests ascending to \$80 million as of December 31, 2009. These additional funds were distributed among 56 new identified special communities for the construction of new infrastructure projects in these communities, and a portion was assigned to complete construction projects in the original 686 special communities. The Perpetual Trust has disbursed the total amount of \$895 million as of December 31, 2009. As of December 31, 2009, the Perpetual Trust's line of credit with GDB had an outstanding balance of \$376.1 million. The line of credit is payable from legislative appropriations.

*University of Puerto Rico.* The University of Puerto Rico (the "University"), with approximately 65,669 students in academic year 2009-2010, is the largest institution of higher education on the island. Government appropriations are the principal source of University revenues, but additional revenues are derived from tuition, student fees, auxiliary enterprises, interest income, federal grants, and other sources. University capital improvements have been financed mainly by revenue bonds. As of December 31, 2009, the University's total debt was \$660.7 million, including \$569.2 million of outstanding revenue bonds. The University's debt is rated Baa2 and BBB- by Moody's and S&P, respectively.

In 2000, AFICA issued its \$86,735,000 Educational Facilities Revenue Bonds, 2000 Series A (University Plaza Project) for the purpose of financing the construction of additional student housing and parking and office space for the University. The project was built, is being operated by Desarrollos Universitarios, Inc., a Puerto Rico not-for-profit corporation, and is leased to the University for a term equal to the term of the bonds, with University lease payments being sufficient to pay debt service on said bonds as they become due. These bonds are not included in the University's total debt or outstanding revenue bonds set forth in the prior paragraph.

In June 2007, the Board of Trustees of the University approved Certification No. 60 establishing a new policy and methodology for tuition fees structure. This new structure covers the tuition fees to be charged to new students until academic year 2012-2013. This policy was adopted to pursue continued development and financial stability of the University.

*Other public corporations.* Public corporations not described above have outstanding debt in the aggregate amount of \$1.8 billion as of December 31, 2009. Debt service on \$784 million of such outstanding debt is being paid from legislative appropriations. The Commonwealth is not, however, obligated to make any such appropriations. Additional legislative appropriations are made to enable certain of such corporations to pay their operating expenses.

## **INSURANCE MATTERS**

Government-owned property is insured through policies obtained by the Secretary of the Treasury and through self-insurance, except for property owned by the Electric Power Authority and the Puerto Rico Aqueduct and Sewer Authority, whose properties are insured through

arrangements and policies obtained by the respective Authorities. Personal injury awards against the Commonwealth are limited by law to \$150,000 per occurrence.

## **RETIREMENT SYSTEMS**

*General.* Public employees of the Commonwealth and its instrumentalities are covered by five retirement systems: the Employees Retirement System, the Puerto Rico System of Annuities and Pensions for Teachers (the “Teachers Retirement System”), the Commonwealth Judiciary Retirement System (the “Judiciary Retirement System”), the Retirement System of the University of Puerto Rico (the “University Retirement System”), and the Employees Retirement System of Puerto Rico Electric Power Authority (the “Electric Power Authority Retirement System”).

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

*Covered Employees.* The Teachers Retirement System covers public school teachers and certain private school teachers, as well as teachers working in administrative positions. Substantially all active teachers of the Commonwealth’s Department of Education are covered by Act No. 91 of March 29, 2004, which superseded Act No. 218 of May 6, 1951. The new law establishes that: (i) the Teachers Retirement System’s active employees as of March 29, 2004 (not public school teachers or other Education Department employees) have the option to participate in the Teachers Retirement System or in the Employees Retirement System; (ii) persons hired by the Teachers Retirement System after the approval of the new law may only become members of the Teachers Retirement System, (iii) active teacher employees of the Department of Education are members of the Teachers Retirement System, and (iv) licensed teachers working in private schools or other educational organizations may elect to become members of the Teachers Retirement System as long as the required employer and employee contributions are satisfied. The Judiciary Retirement System covers judges, and the Employees Retirement System covers all other employees of the Commonwealth, its municipalities and instrumentalities.

As of June 30, 2009, the total number of participants, including active participants and retirees, in the three systems was as follows: Employees Retirement System, 265,024; Teachers Retirement System, 79,519; and Judiciary Retirement System, 764. The three systems are financed by contributions made by employers (the Commonwealth, public corporations, and municipalities) and employees, and investment income.

*Funding Requirements.* The central government is responsible for approximately 64% of total employer contributions to the Employees Retirement System, and the other 36% is the responsibility of public corporations and municipalities. The central government is also responsible for 100% and 99% of total employer contributions to the Judiciary and Teachers Retirement Systems, respectively. Retirement and related benefits provided by the systems and required contributions to the systems by employers and employees are determined by law rather than by actuarial requirements. For the Employees Retirement System, required employer

contributions are 9.275% of applicable payroll. Required employee contributions for the Employees Retirement System vary according to salary and how the individual employee's retirement benefits are coordinated with social security benefits. For the Judiciary Retirement System, required contributions are 30.34% of applicable payroll for the employer and 8% for the employees. For the Teachers Retirement System, required contributions are 8.5% of applicable payroll for the employer and 9.0% for the employees.

*Actuarial Valuation of Employees Retirement System.* According to the most recent actuarial valuation of the Employees Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2009, the total pension benefit obligations of the System were \$18.944 billion. The unfunded pension benefit obligations of the Employees Retirement System as of the same date were \$17.092 billion, representing a funding ratio of 9.8%. Any amounts receivable from the Commonwealth with respect to benefits under special benefits laws (discussed below) are considered in the actuarial evaluation process to determine the unfunded pension benefit obligation of the Employees Retirement System to the extent receivables are recognized as such by the System.

The June 30, 2009 actuarial valuation was completed in accordance with the "Projected Unit Credit" method and assumed an investment return of 7.5% per year and a salary increase of 3% per year. Insofar as the statutorily mandated annual deposit to the Employees Retirement System is insufficient to cover the actuarial pension benefit obligation, the unfunded pension benefit obligation of the System will continue to increase in the short term, and additional funding from the Commonwealth may ultimately be necessary to cover such unfunded obligation.

*Actuarial Valuation of Judiciary Retirement System.* According to the most recent actuarial valuation of the Judiciary Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2009, the total pension benefit obligations of the System were \$324.6 million. The unfunded pension benefit obligations of the Judiciary Retirement System as of the same date were \$273 million, representing a funding ratio of 15.6%.

The June 30, 2009 actuarial valuation was completed in accordance with the "Projected Unit Credit" method and assumed an investment return of 7.5% per year and a salary increase of 3% per year. Insofar as the statutorily mandated annual deposit to the Judiciary Retirement System is insufficient to cover the actuarial pension benefit obligation, the unfunded pension benefit obligation of the System will continue to increase in the short term, and additional funding from the Commonwealth may ultimately be necessary to cover such unfunded obligation.

*Actuarial Valuation of Teachers Retirement System.* According to the most recent actuarial valuation of the Teachers Retirement System submitted by a firm of independent consulting actuaries, as of June 30, 2009, the accrued actuarial liability of the System was \$8.722 billion and the value of its assets amounted to \$2.158 billion, representing a funding ratio of 24.7%, and the resulting unfunded accrued liability was \$6.564 billion.

The actuarial valuation assumed an investment return of 8%, yearly salary increases of 3.5%, employee and employer contributions of 9% and 8.5%, respectively, an inflation rate of 2.5%, and a remaining amortization period of 30 years for the unfunded accrued liability.

*Special Benefits.* Various special benefits laws enacted in the past provided additional benefits for the beneficiaries of the Employees Retirement System, Teachers Retirement System and Judiciary Retirement System. In the case of the Employees Retirement System, Act No. 10 of May 21, 1992 provided for special benefit increases of 3% every three years. The first 3% increase was granted to retirees who had been receiving their annuities for three or more years as of that date. The second 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1995. This increase is financed by additional contributions from the employers. The third 3% increase was granted to retirees who had been receiving their annuities for three or more years as of January 1, 1998. This third increase is partially funded with additional contributions from some of the employers. In June 2001, the Legislative Assembly approved a fourth 3% increase, effective as of January 1, 2001, in post-retirement annuity payments granted on or prior to January 1, 1998. This increase is being funded by the General Fund for retirees who were employees of the central government and by municipalities and public corporations for retirees who were their respective employees. In June 2003, the Legislative Assembly approved a fifth increase of 3% in post retirement benefits effective January 1, 2004. This increase will also be funded by the General Fund for retirees who were employees of the central government and by municipalities and public corporations for retirees who were their respective employees. In June 2007, the Legislative Assembly approved a sixth increase of 3% in post retirement benefits effective January 1, 2007. This increase is also being funded by the General Fund for retirees who were employees of the central government and by municipalities and public corporations for retirees who were their respective employees. Subsequent increases will depend upon the express approval of the Board of Trustees of the Employees Retirement System and the Legislative Assembly, and must provide a funding source. In the case of the Judiciary Retirement System, Act No. 41 of June 13, 2001 provided a 3% special benefit increase in annuity payments, commencing on January 1, 2002 and every three years thereafter, to retirees who had been receiving their annuities for three or more years as of that date. This increase is being funded by the General Fund.

The Teachers Retirement System is seeking reimbursement from the Commonwealth's General Fund in the amount of \$119 million for special benefits paid by the System to its beneficiaries through June 30, 2004 pursuant to special benefit laws enacted by the Legislative Assembly. The Teachers Retirement System's interpretation of these special benefit laws, to the effect that the Commonwealth is required to reimburse the Teachers Retirement System for such special benefits paid, is being disputed by the Office of Management and Budget. In March 2009 the Department of Education paid to the Teachers Retirement System the amount of \$12 million as partial payment. The dispute for the pending amount of \$107 million continues under inter-agency arbitration proceedings. The Employees Retirement System is also seeking reimbursement from the Commonwealth (in connection with other special benefits laws applicable to its beneficiaries) in the amount of \$73.9 million, representing cumulative benefits paid to beneficiaries through June 30, 2005.

*Amendments to Employees Retirement System.* In 1999, the organic act of the Employees Retirement System was further amended to change it, prospectively, from a defined benefit



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

*Cash Flow Shortfalls.* The Employees Retirement System's disbursements of benefits during fiscal years 2004 through 2007 exceeded contributions and investment income for those years. The cash shortfall for fiscal year 2004 was covered with a loan received from the Treasury Department. Balances owed to the Treasury Department and other pending working capital needs through fiscal year 2005 were refinanced through a repurchase agreement with a financial institution in an amount of \$138 million collateralized with the assets of the Employees Retirement System. The cash shortfall for fiscal year 2006 was approximately \$70 million. This shortfall was covered with a line of credit provided by a private financial institution and collateralized with the assets of the Employees Retirement System. There was no cash shortfall for fiscal year 2007 on account of the receipt of the proceeds from the sale of the Puerto Rico Telephone Company stock that Puerto Rico Telephone Authority held for the benefit of the Employees Retirement System. Also with these proceeds the Employees Retirement System paid off the balances of the 2005 repurchase agreement and the 2006 line of credit used to cover the respective year's cash shortfalls.

For fiscal years 2008 and 2009, the System was able to cover its annual cash flow needs from various non-recurring sources of income and from proceeds of the issuance of pension obligation bonds, which were issued to increase the System's funding ratio and reduce its unfunded pension benefit obligation. These bond issues were secured by a pledge of future employer contributions over the next 50 years. All net cash generated by these bond issues was deposited into the Employees Retirement System trust and invested along with its other assets. As of June 30, 2008, the Employees Retirement System had issued three series of bonds totaling approximately \$2.9 billion of its Senior Pension Funding Bonds.

With respect to the Teachers Retirement System, the cash shortfalls for fiscal years 2007, 2008 and 2009 were \$40 million, \$75 million, and \$110 million respectively. Investments were liquidated to cover these shortfalls. For fiscal year 2010, the Teachers Retirement System expects to have a cash shortfall of approximately \$140 million. Based on the Teachers Retirement System's estimates, it could have a \$150 million cash flow deficit for fiscal year 2011. This negative trend is expected to continue given that Puerto Rico Teachers Retirement System is in a relatively mature stage.

*Efforts to Address Cash Flow Shortfall and Improve Funding Ratio.* The Employees Retirement System anticipates that its future cash flow needs for disbursement of benefits to participants are likely to exceed the sum of the employer and employee contributions received and its investment and other recurring income. For fiscal year 2009-2010, the Employees Retirement System expects to have a cash shortfall of approximately \$500 million. For fiscal year 2011, the System expects to have a cash shortfall of approximately \$640. Based on the System's current funding and disbursement projections and other assumptions, it would deplete its assets by fiscal year 2019. The Employees Retirement System is evaluating measures to improve its cash flows and funding ratio. Some of these measures include, but are not limited to, the possible sale of the internally managed mortgage loan portfolio, the possible outsourcing to Puerto Rico credit unions of the issuance of benefit based loans, and stepped up collection efforts of employer contributions owed by the Commonwealth, the municipalities, and public corporations. In February 2010, the Governor of Puerto Rico established a special commission to make recommendations for improving the financial solvency of the Systems. The Commission is expected to submit a report to the Governor by the first quarter of fiscal year 2011.

*Composition and Market Value of Investment Portfolios.* As of December 31, 2009, the market value of the Employees Retirement System's investment portfolio was \$4.9 billion, compared to \$4.5 billion as of June 30, 2009.

As of December 31, 2009, the investment portfolio was comprised of approximately 39.7% of U.S. domestic and International equity investments, 13.2% of fixed-income securities, 26.5% of internally managed mortgage and personal loans portfolio, 19.3% of short term cash and 1% of other investments.

As of December 31, 2009, the market value of the Teachers Retirement System's investment portfolio was \$2.4 billion, compared to \$2.180 billion as of June 30, 2009.

As of December 31, 2009, the investment portfolio was comprised of approximately 64.3% of U.S. domestic and International equity investments, and 17.5% of fixed-income securities, 16.9% of internally managed mortgage and personal loans portfolio, 0.20% of short term cash and 1% of other investments.

The following tables present the Statement of Plan Net Assets and Statement of Changes in Plan Net Assets of the Employees Retirement System, the Judiciary Retirement System and Teachers Retirement System, in each case for fiscal years 2007, 2008 and 2009 and for the first six months of fiscal year 2010.

**The Commonwealth of Puerto Rico**  
**Employees' Retirement System**  
**Statements of Plan Net Assets\***  
**As of June 30, 2007, 2008, 2009 and December 31, 2009**  
**(in thousands)**

<b>ASSETS</b>	<b>December 31, 2009**</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
<b>CASH AND SHORT TERM INVESTMENTS</b>				
Deposits at Commercial Banks	\$ 25,709	\$ 21,792	\$ 84,439	\$ 41,365
Deposits with Treasury Department	174,171	--	23,099	--
Deposits with GDB:				
Unrestricted	76,596	79,500	54,438	266,633
Restricted	858,184	1,028,878	1515,042	2,310
Restricted Cash Bonds	250,996	193,537	--	--
Total Cash and Short Term Investment	1,385,656	1,323,707	1,677,018	310,308
<b>SECURITIES LENDING, COLLATERAL INVESTED</b>				
Marketable Securities:				
Notes and Bonds	562,997	565,366	547,414	149,638
Stocks	1,766,811	1,477,945	2,018,090	1,693,144
Master Repo	--	--	--	--
Private Equity Investments	43,671	34,922	42,294	47,784
Total Investments	2,373,479	2,078,233	2,607,798	1,890,566
<b>LOANS TO PLAN MEMBERS</b>				
Mortgage	132,262	128,365	116,022	107,680
Personal	973,199	916,934	771,367	440,167
Cultural Trips	53,781	50,317	38,344	28,933
PEC	1,835	1,827	1,098	533
Total Loans to Plan Members	1,161,077	1,097,443	926,831	577,313
Investment in PRTA Holdings	--	--	--	--
Total cash, investments and loans to plan members	4,920,212	4,499,383	5,211,647	2,778,187
<b>RECEIVABLES:</b>				
Employers	218,147	298,507	246,167	117,420
General Fund	7,833	7,833	854	4,615
Judiciary Retirement System	18,595	17,942	16,714	5,113
Investment Sales	12,468	24,509	9,800	2,470
Accrued Interest	6,158	6,939	3,279	3,119
Dividend Receivable	--	--	--	--
Other	4,069	5,081	58,210	4,527
Total Receivables	267,270	360,811	335,024	137,264
<b>CAPITAL ASSETS</b>	9,001	9,171	9,839	8,476
<b>OTHER ASSETS</b>	8,422	8,892	8,292	7,371
Prepaid Bond Cost	34,363	34,363	35,462	--
Total assets	5,239,268	4,912,620	5,600,264	2,931,298
<b>LIABILITIES</b>				
Book overdraft	--	37,961	--	1,566
Short Term Obligations	--	--	--	--
Repurchase Obligations	--	--	--	--
Funds of Mortgage Loans and Guarantee Insurance Reserve for Loans	7,473	6,372	3,863	8,914
Investment Purchases	2,571	13,926	12,694	2,172
Accounts Payable and Accrued Liabilities	11,176	14,228	9,310	10,125
Line of Credit	--	--	--	--
Bonds Payable	2,961,359	2,961,359	2,942,183	--
Other Liabilities	148,020	13,675	12,946	17,022
Bonds Interest Payable	--	13,876	12,182	--
Total Liabilities	3,130,600	3,061,397	2,993,178	39,799
<b>Net Assets Held in Trust for Pension Benefits</b>	<b>\$2,108,669</b>	<b>\$1,851,223</b>	<b>\$2,607,086</b>	<b>\$2,891,499</b>

\* Totals may not add due to rounding.

\*\* Preliminary, unaudited numbers.

**The Commonwealth of Puerto Rico**  
**Employees' Retirement System**  
**Statements of Changes in Plan Net Assets\***  
**As of June 30, 2007, 2008, 2009 and December 31, 2009**  
**(in thousands)**

<b>ADDITIONS:</b>	<b>December 31, 2009**</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Contributions:				
Employer	\$ 196,632	\$ 400,405	\$ 380,833	\$ 374,394
Participating employees	178,034	362,041	345,614	338,791
Early Retirement	3,376	47,146	141,724	69,097
Other Special Laws	17,000	17,000	16,789	17,000
Total Contributions	395,042	826,591	884,961	799,282
Investment (loss) Income:				
Realized Gain or Loss	8,888	25,129	25,129	74,304
Unrealized Gain or Loss	334,365	(238,509)	(238,509)	289,881
Dividend Income	5,703	15,774	10,347	14,494
Interest Income	91,607	198,734	115,763	68,231
Total	440,563	(344,044)	(87,270)	446,910
Less Investment Expense	(830)	(7,589)	(6,664)	(12,940)
Insurance Premium	387	6,197	6,197	2,441
Other Income	7,820	35,879	24,927	17,431
Net Investment Income	7,377	(315,756)	(62,904)	453,841
Total Additions	842,982	510,835	822,034	1,253,124
<b>DEDUCTIONS:</b>				
Annuities	454,926	970,842	932,701	793,883
Benefits Under Special Laws	17,000	17,000	16,789	17,000
Death Benefits	7,049	11,532	18,712	13,872
Refunds of Contributions:				
Employers	763	2,013	3,020	5,296
Participating Employees	19,117	32,517	37,346	28,009
Personal Loans Adjustment	--	--	--	--
Insurance Claims on Loans	9	1,092	1,092	2,118
Other Expenses	1,137	13,335	18,204	13,569
Administrative Expenses	16,150	32,590	31,610	29,207
Interest on Bonds	69,385	186,869	46,996	--
Total Deductions	585,536	1,266,699	1,106,472	902,954
Net (decrease) Increase	257,446	(755,864)	(284,415)	(350,170)
Net Assets Held in Trust for Pension				
Benefits:				
Beginning of the Year	1,851,223	2,607,086	2,891,501	2,541,331
End of Year	<b>\$2,108,669</b>	<b>\$1,851,223</b>	<b>\$2,607,086</b>	<b>\$2,891,501</b>

\* Totals may not add due to rounding.

\*\* Preliminary, unaudited numbers.

**The Commonwealth of Puerto Rico**  
**Judiciary Retirement System**  
**Statements of Plan Net Assets\***  
**As of June 30, 2007, 2008, 2009 and December 31, 2009**  
**(in thousands)**

<b>ASSETS</b>	<b>December 31, 2009**</b>	<b>2009</b>	<b>2008</b>	<b>2007</b>
Cash and Investments:				
Cash and Cash Equivalents	\$ 3,454	\$ 3,985	\$ 2,519	\$ 2,735
Cash Deposited with GDB or Treasury Department:	214	2,353	267	197
Total Cash	3,668	6,338	2,786	2,932
Receivables:				
Accrued Interest	239	215	237	237
Investment Sales	98	117	196	179
Other	28	28	25	86
Total receivables	365	360	458	502
Marketable Securities:				
Notes and Bonds	24,295	22,805	22,169	20,728
Stocks	54,620	44,634	61,377	68,654
Total Investments	78,915	67,439	83,546	89,382
Loans and Interest Receivable from Members:				
Mortgage	13	8	8	17
Personal	536	462	394	195
Cultural Trips	64	60	45	44
Total Loans to Plan Members	613	530	448	256
Total cash, investments and loans to plan members	83,561	74,667	87,239	93,072
<b>LIABILITIES</b>				
Due to Treasury Department	2,202	4,513	--	5,415
Due to the Employee's Retirement System of the Government of Puerto Rico	18,292	17,942	16,714	5,113
Escrow Funds to plan Members and Guarantee Insurance	60	59	56	53
Investment Purchases	113	867	345	180
Other Liabilities	3,612	720	812	838
Total Liabilities	24,279	24,100	17,927	11,599
<b>Net Assets Held in trust for Pension Benefits</b>	<b>\$ 59,282</b>	<b>\$ 50,566</b>	<b>\$ 69,311</b>	<b>\$ 81,473</b>

\* Totals may not add due to rounding.

\*\* Preliminary, unaudited numbers.

**The Commonwealth of Puerto Rico**  
**Judiciary Retirement System**  
**Statements of Changes in Plan Net Assets\***  
**As of June 30, 2007, 2008, 2009 and December 31, 2009**  
**(in thousands)**

	<u>December 31, 2009**</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
<b>ADDITIONS:</b>				
Contributions:				
Employer	\$ 4,108	\$9,970	\$6,705	\$6,632
Participating employees	1,256	3,138	3,076	2,828
Total Contributions	<u>5,364</u>	<u>13,108</u>	<u>9,781</u>	<u>9,460</u>
Investment Income:				
Realized Gain or Loss	216	(3,158)	1,031	1,484
Unrealized Gain	10,774	(13,583)	(8,988)	10,954
Dividend Income	111	218	267	224
Interest Income	635	1,313	1,553	1,447
Total	<u>11,736</u>	<u>(15,209)</u>	<u>(6,137)</u>	<u>14,110</u>
Less Investment Expense	--	(170)	(197)	(192)
Other Income	1	50	--	1
Net Investment Income	<u>11,737</u>	<u>(15,330)</u>	<u>(6,333)</u>	<u>13,918</u>
Total Additions	<u>17,101</u>	<u>(2,221)</u>	<u>3,448</u>	<u>23,378</u>
<b>DEDUCTIONS:</b>				
Annuities	8,185	15,538	14,419	13,461
Refunds to Participating Employees	--	--	169	38
Administrative Expenses	201	986	1,022	1,255
Total Deductions	<u>8,386</u>	<u>16,524</u>	<u>15,610</u>	<u>14,754</u>
Net Increase	8,715	(18,745)	(12,162)	8,624
Net Assets Held in Trust for Pension Benefits:				
Beginning of the Year	50,566	69,311	81,473	72,849
<b>End of Year</b>	<u><b>\$59,282</b></u>	<u><b>\$50,566</b></u>	<u><b>\$69,311</b></u>	<u><b>\$81,473</b></u>

\* Totals may not add due to rounding.

\*\* Preliminary, unaudited numbers.

**The Commonwealth of Puerto Rico**  
**Teachers Retirement System**  
**Statements of Plan Net Assets\***  
**As of June 30, 2007, 2008, 2009, and December 2009\*\***  
**(in thousands)**

	<u>December 2009</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
<b>ASSETS</b>				
Cash:				
Cash and cash equivalents	\$ 86,636	\$ 65,885	\$ 324,846	\$ 273,982
Cash with fiscal agent	-	450	297	-
Cash restricted	-	-	-	-
Cash deposited with Government Development Bank for Puerto Rico	3,278	3,276	3,255	3,123
Total Cash	<u>89,914</u>	<u>69,611</u>	<u>328,398</u>	<u>277,105</u>
Investments, at fair value:				
Bonds and notes	1,545,922	425,911	490,007	468,452
Stocks	416,011	1,259,169	1,796,817	2,218,033
Total investment at fair value	<u>1,961,933</u>	<u>1,685,080</u>	<u>2,286,824</u>	<u>2,686,485</u>
Other investments:				
Mortgage notes acquired from third parties				
Private equity investments	26,139	26,139	37,630	46,686
Total investments	<u>1,988,072</u>	<u>1,711,219</u>	<u>2,324,454</u>	<u>2,733,171</u>
Loan to plan members:				
Mortgage	115,600	109,508	103,759	102,684
Personal	290,966	288,410	271,510	260,066
Cultural trips	1,383	1,462	1,355	1,371
Total loans to plan members	<u>407,949</u>	<u>399,380</u>	<u>376,624</u>	<u>364,121</u>
Total investments and loans	<u>2,396,021</u>	<u>2,180,210</u>	<u>3,029,476</u>	<u>3,374,397</u>
Accounts receivable:				
Receivable for investments sold	408	23,231	4,693	12,242
Accrued interest and dividends receivable	5,261	5,445	6,395	6,312
Other	2,268	2,930	15,141	14,640
Total accounts receivable	<u>7,937</u>	<u>31,606</u>	<u>26,229</u>	<u>33,194</u>
Property and equipment, net	26,450	26,167	26,223	25,890
Other assets	845	876	451	700
Total Assets	<u>2,521,167</u>	<u>2,238,859</u>	<u>3,082,379</u>	<u>3,434,181</u>
<b>LIABILITIES</b>				
Investments purchased	90	18,981	7,952	11,258
Payable for securities lending	69,769	46,751	274,372	240,440
Cash overdraft in cash with fiscal agent	66,633	-	-	5,619
Accounts payable	1,037	4,188	3,688	4,152
Obligation under capital lease	-	-	12	35
Accrued expenses	5,919	5,925	5,361	4,470
Line of credit	-	-	-	4
Escrow fund of mortgage loans and guarantee insurance reserve for loans to plan members	4,838	4,580	4,641	4,916
Bonds payable	-	-	-	-
Other liabilities	584	841	1,007	567
Total liabilities	<u>148,870</u>	<u>81,266</u>	<u>297,033</u>	<u>271,461</u>
<b>Net Assets Held in Trust for Pension Benefits</b>	<u>\$2,372,297</u>	<u>\$2,157,593</u>	<u>\$2,785,346</u>	<u>\$3,162,720</u>

\* Totals may not add due to rounding.

\*\* Interim not audited numbers.

**The Commonwealth of Puerto Rico**  
**Teachers Retirement System**  
**Statements of Plan Net Assets\***  
**As of June 30, 2007, 2008, 2009 and December 2009\*\***  
**(in thousands)**

	<u>Dec. 2009</u>	<u>2009</u>	<u>2008</u>	<u>2007</u>
<b>ADDITIONS:</b>				
Contributions:				
Participating Employees	\$65,241	\$136,305	\$127,566	\$127,809
Employer	59,327	125,165	117,065	116,320
Contributions transferred from other systems**	741	1,479	4,181	12,396
Special	48,161	75,548	68,085	57,960
Total contributions	<u>173,470</u>	<u>338,497</u>	<u>316,897</u>	<u>314,485</u>
Investment Income:				
Interest income	31,121	66,927	67,825	65,367
Dividend Income	4,880	13,194	15,629	13,654
Net appreciation (depreciation) in fair value of investments	305,641	(518,862)	(276,573)	406,131
	<u>341,642</u>	<u>(438,741)</u>	<u>(193,119)</u>	<u>485,152</u>
Less investment expense	<u>2,238</u>	<u>4,660</u>	<u>6,847</u>	<u>6,217</u>
Net investment income	<u>339,404</u>	<u>(443,401)</u>	<u>(199,966)</u>	<u>478,935</u>
Other income	<u>269</u>	<u>2,444</u>	<u>1,735</u>	<u>1,299</u>
<b>Total additions</b>	<u>\$ 513,143</u>	<u>(\$ 131,794))</u>	<u>\$ 118,666</u>	<u>\$ 794,719</u>
<b>DEDUCTIONS:</b>				
Benefit paid to participants:				
Annuities and death benefits	243,312	442,542	414,334	364,998
Special benefits	38,542	51,951	49,742	45,564
Refunds of contributions	4,277	5,313	6,427	5,447
Administrative expenses	<u>12,308</u>	<u>25,485</u>	<u>25,537</u>	<u>22,877</u>
<b>Total deductions</b>	<u>298,439</u>	<u>525,291</u>	<u>496,040</u>	<u>438,886</u>
Net increase in net assets held in trust for pension benefits	<u>214,704</u>	<u>(627,753)</u>	<u>(377,374)</u>	<u>355,833</u>
<b>Net assets held in trust for pension benefits</b>				
Beginning of year	<u>2,157,593</u>	<u>2,785,346</u>	<u>3,162,720</u>	<u>2,806,887</u>
<b>End of year</b>	<u><u>\$2,372,297</u></u>	<u><u>\$2,157,593</u></u>	<u><u>\$2,785,346</u></u>	<u><u>\$3,162,720</u></u>

\* Totals may not add due to rounding.

\*\* Interim not audited numbers.



## **COMMONWEALTH AUDITED FINANCIAL STATEMENTS**

For fiscal year 2008, the basic financial statements of the Commonwealth were audited by KPMG LLP. KPMG LLP did not audit the financial statements of the Public Buildings Authority capital project fund or The Children's Trust special revenue funds (major funds), and certain activities, funds and component units identified separately in its report. Those financial statements were audited by other independent auditors whose reports were furnished to KPMG LLP, and its opinion on the basic financial statements, insofar as it relates to the amounts included in the basic financial statements pertaining to such activities, funds and component units, is based solely on the reports of the other auditors.

The Comprehensive Annual Financial Report of the Commonwealth ("CAFR") for fiscal year 2008, which includes the basic financial statements of the Commonwealth for fiscal year 2008, was filed by the Commonwealth with the Municipal Securities Rulemaking Board ("MSRB") through its Electronic Municipal Markets Access System ("EMMA") in August 2009. The Commonwealth's basic financial statements for fiscal year 2009 are being audited by Deloitte & Touche LLP and are expected to be filed with the MSRB through EMMA in July, 2010.

## **PUERTO RICO TAXES, OTHER REVENUES, AND EXPENDITURES**

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

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

### **Summary and Management's Discussion of General Fund Results**

The following table presents the actual revenues and expenditures of the General Fund on a cash basis for fiscal years 2006, 2007 and 2008. The Treasury Department is currently in the process of completing the financial statements for fiscal year 2009. Once the audited financial statements have been completed, the Commonwealth will provide the General Fund revenue and expenditure data for fiscal year 2009.

The amounts shown in the following table as expenditures may be different than those reflected in the budget or in the Commonwealth's financial statements because the table shows only cash disbursements, while the budget includes all authorized expenditures, regardless of when the related cash is actually disbursed. In addition, transfers to the Redemption Fund (used to pay debt service on the Commonwealth's bonds), which are included in the budget under "debt service," are shown as a deduction from total revenues in calculating "adjusted revenues" in the table and are not included under "expenditures." Finally, certain expenditures incurred in excess of budgeted amounts may not be reflected in the table as expenditures to the extent they are paid from reserve funds, such as moneys in the Budgetary Fund. A discussion of the budget for fiscal years 2010 and 2011 appears below under "Budget of the Commonwealth of Puerto Rico."

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

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

	2006	2007	2008
Beginning cash balance	\$ 42,933	\$ -	\$ (506,261)
Revenues:			
Income Taxes:			
Individuals	3,087,748	3,071,655	2,759,305
Corporations	1,872,458	2,002,718	1,565,534
Partnerships	2,787	2,960	1,942
Withheld from non-residents	921,260	933,728	1,087,782
Tollgate taxes	27,396	25,083	21,610
Interest	11,536	12,112	13,657
Dividends	66,721	138,859	59,770
Total income taxes	5,989,906	6,187,115	5,509,600
Sales and use tax	-	582,560	911,000
Commonwealth excise taxes:			
Alcoholic beverages	292,180	279,028	268,094
Cigarettes	135,267	132,399	119,124
Motor vehicles	533,957	396,667	366,341
Other excise taxes	682,477	314,340	110,014
Total Commonwealth excise taxes	1,643,881	1,122,434	863,573
Property taxes	1,106	800	219
Inheritance and gift taxes	9,466	4,663	6,600
Licenses	91,310	97,610	87,690
Other:			
Lottery	62,729	73,014	46,636
Electronic lottery	55,212	71,815	105,298
Miscellaneous non-tax revenues	431,803 <sup>(6)</sup>	330,064	466,741 <sup>(8)</sup>
Total Other	549,744	474,893	618,675
Total revenues from internal sources	8,285,413	8,470,075	7,997,357
Revenues from non-Commonwealth sources:			
Federal excise taxes <sup>(1)</sup>	346,272	377,872	356,827
Customs	9,553	14,504	4,846
Total revenues from non-Commonwealth sources	355,825	392,376	361,673
Total revenues	8,641,238	8,862,451	8,359,030
Other Income (refunds) <sup>(2)</sup>	76,085	(8,335)	(10,797)
(Transfer) Refunding to Redemption Fund <sup>(3)</sup>	(484,812)	(512,197)	(202,954)
Proceeds of notes and other borrowings <sup>(4)</sup>	4,115,897 <sup>(7)</sup>	1,872,096	2,710,000
Repayment of notes and other borrowings <sup>(5)</sup>	(3,005,838)	(1,926,273)	(2,580,764)
Adjusted revenues	9,342,570	8,287,742	8,274,515
Expenditures:			
Grants and subsidies	3,944,349	3,387,199	3,471,922
Personal services	4,796,382	4,590,962	4,563,192
Other services	525,377	594,345	685,112
Materials and supplies	50,227	79,186	99,486
Equipment purchases	19,378	27,965	49,498
Capital outlays and other debt service	49,789	21,576	11,222
Prior year disbursements	-	92,770	-
Total expenditures	9,385,503	8,794,003	8,880,432
Adjusted revenues less expenditures	(42,933)	(506,261)	(605,917)
Ending cash balance	0	(506,261)	(1,112,178)

<sup>(1)</sup> Excludes transfers by the Commonwealth to the Conservation Trust Fund and amounts deposited by the Secretary of the Treasury into a separate account for the promotion of Puerto Rico rums in foreign markets.

<sup>(2)</sup> Consists of net revenues from the General Fund's non-budgetary funds plus a reserve for future tax refunds reduced by estimated tax refunds.

<sup>(3)</sup> Consists of amounts to pay principal of and interest on general obligation bonds and notes of the Commonwealth. Does not include amounts deposited directly into the Redemption Fund from non-General Fund revenues.

<sup>(4)</sup> Consists of proceeds of borrowings from GDB and a syndicate of commercial banks, and proceeds from Commonwealth's Tax and Revenue Anticipation Notes, including \$741 million loan authorized by the Legislature in fiscal year 2006.

<sup>(5)</sup> Consists of repayments of borrowings from GDB and a syndicate of commercial banks, and repayments of Commonwealth's Tax and Revenue Anticipation Notes.

<sup>(6)</sup> Includes proceeds of \$100 million generated by the issuance of the Commonwealth's Public Improvement Refunding Bonds, Series 2006 A, which were privately placed.

<sup>(7)</sup> Includes \$50 million from the Emergency Fund used for operating expenses.

<sup>(8)</sup> Includes \$145 million related to the sale of properties.

Source: Treasury Department

### *Fiscal Year 2008 Compared to Fiscal Year 2007*

Preliminary total General Fund revenues for fiscal year 2008 were \$8.359 billion, representing a decrease of \$234 million, or 2.7%, from actual revenues for fiscal year 2007 (excluding the collection of \$269 million from special temporary tax measures in fiscal year 2007). The major changes from fiscal year 2007 were: (i) decreases in income taxes from individuals of \$313 million and in corporate income taxes of \$437 million, (ii) a decrease of \$259 million in excise taxes, and (iii) an increase of \$328 million in the sales and use tax revenues, which was only in effect for seven and a half months of fiscal year 2007. The decrease in 2008 revenues was principally due to the ongoing economic recession and high oil prices, which directly affected income and excise tax collections.

Total General Fund expenses for fiscal year 2008 amounted to \$9.083 billion, which were composed of \$8.880 billion of operational expenses and \$203 million transferred to the redemption fund. The difference between preliminary revenues and expenses for fiscal year 2008 of \$724 million was covered principally by cash-management procedures such as delaying payments to certain vendors and a GDB loan of \$190 million.

### *Fiscal Year 2007 Compared to Fiscal Year 2006*

General Fund total revenues for the fiscal year 2007 were \$8.862 billion, an increase of \$221 million, or 2.5%, from fiscal year 2006. This amount includes (i) \$5.074 billion in individual and corporate income taxes, (ii) \$934 million in non-resident withholding taxes, (iii) \$1.122 billion in excise taxes, (iv) \$583 million of sales and use tax revenues, and (v) \$269 million from special temporary tax measures. A decrease of \$521 million in excise taxes was offset by revenues from the sales and use tax, as the repeal of the general excise tax on imported goods and goods manufactured in Puerto Rico was replaced with the sales and use tax commencing on November 15, 2006.

General Fund expenses for fiscal year 2007 were \$9.306 billion. This amount does not include \$522 million of debt service payments on a portion of the Commonwealth's outstanding appropriation debt, which debt service was excluded from the budget based on the provisions of Act 91, which created the Dedicated Sales Tax Fund to service in part the repayment of such appropriation debt.

The difference between revenues and expenses for fiscal year 2007 of \$444 million was covered by a \$240 million transfer of funds from GDB that was originally set aside from General Fund appropriations to cover a portion of debt service payments on the Commonwealth's appropriation debt, which set-aside was no longer needed on account of the passage of Act 91. The remaining shortfall was covered principally by cash-management procedures such as delaying payments to certain vendors (carrying over into fiscal year 2008).

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

### *Income Taxes*

The Commonwealth's income tax law, the Internal Revenue Code of 1994, as amended (the "PR Code"), imposes a tax on the income of individual residents of Puerto Rico, trusts,

estates, and domestic and foreign (if engaged in a trade or business in Puerto Rico) corporations and partnerships at graduated rates. A flat tax is imposed on certain payments made to non-residents of Puerto Rico, which is collected through an income tax withholding.

*Individuals.* Resident individuals are subject to tax on their taxable income from all sources. The PR Code has four tax brackets for individuals with tax rates of 7%, 14%, 25%, and 33%. Dividend income from Puerto Rico corporations and certain qualifying foreign corporations is taxed at an income tax rate of 10%.

Gain realized from the sale or exchange of a capital asset by resident individuals, if held for more than six months, is taxed at an income tax rate of 10%.

Interest income in excess of \$2,000 on deposit with Puerto Rico financial institutions is taxed at an income tax rate of 10%; the first \$2,000 of interest income from such institutions is exempt from taxation. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to resident individuals, trusts, estates, corporations and partnerships qualifies for an income tax rate of 10%.

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

In general, the PR Code provides for six income tax brackets for corporations and partnerships, with the highest rate (39%) applicable to net taxable income in excess of \$300,000. Gains realized from the sale or exchange of a capital asset, if held for more than six months, are taxed at a maximum regular income tax rate of 15%. Dividends received by Puerto Rico corporations and partnerships from foreign corporations and partnerships engaged in trade or business in Puerto Rico are subject to general income tax rates. A dividends received credit may be available when the corporation or partnership making the distribution is organized in Puerto Rico. Interest income on certain qualifying debt obligations issued by Puerto Rico corporations and certain qualifying foreign corporations and paid to corporations and partnerships qualifies for a special tax rate of 10%.

In general, corporations and partnerships operating under a new grant of tax exemption issued under the Economic Incentives Act are subject to a maximum income tax rate of 4% during their basic exemption period. Corporations and partnerships covered by the Tourism Incentives Act are subject to a maximum tax rate of 42% on their taxable income after applying the 90% exemption granted under the Tourism Incentives Act, which results in a maximum effective tax rate of 4.2% on their net tourism development income. The PR Code also provides for an alternative minimum tax of 22%.

The PR Code generally imposes a branch profits tax on resident foreign corporations whose gross income qualifies as income effectively connected with a Puerto Rico trade or

business. The branch profits tax is 10% of an annual dividend equivalent amount, and it applies without regard to the Puerto Rico source of income rules.

Interest from Puerto Rico sources paid to non-resident non-affiliated corporate recipients is not subject to any income or withholding tax. Interest paid to certain related non-resident recipients is subject to a withholding tax of 29%. Dividends paid to non-resident corporate recipients are subject to a withholding tax of 10%. Dividends distributed by corporations operating under new grants of tax exemption issued under the Economic Incentives Act are not subject to Puerto Rico income tax. However, royalty payments made by such corporations to non-resident recipients are subject to an income tax withholding of 2% or 12%, depending on certain elections made by the grantee.

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

*Act No. 7.* Act No. 7, which was enacted on March 9, 2009 as part of the new administration's Fiscal Plan, seeks, among other things, to increase the tax revenues of the Puerto Rico government by imposing certain permanent and temporary tax increases.

With respect to income taxes, Act No. 7 includes the following temporary measures that are applicable for taxable years commenced after December 31, 2008 and before January 1, 2012:

- (i) taxable corporations and individuals whose adjusted gross income equal or exceeds \$100,000 (for single individuals) or \$150,000 (in the case of married persons filing jointly) are subject to a surtax of 5% on their total tax liability;
- (ii) international banking entities that do not operate as bank units will be subject to a 5% income tax on their entire net income computed in accordance with the PR Code (international banking entities operating as bank units are subject to this 5% tax on their net income that does not constitute excess net income);
- (iii) credit unions, their subsidiaries, and affiliates are subject to a 5% tax on the amount of net taxable income in excess of \$250,000 (these entities were totally exempt before the enactment of Act No. 7), however, if the Government of Puerto Rico collects \$690 million prior to January 1, 2012, the 5% tax will not be applicable for the remaining period;
- (iv) the Cooperative Bank, its subsidiaries, and affiliates are subject to a 5% tax on the amount of net taxable income in excess of \$250,000 (these entities were totally exempt before the enactment of Act No. 7);
- (v) insurance cooperatives are subject to a 5% tax on the amount of net taxable income in excess of \$250,000 (these entities were totally exempt before the enactment of Act No. 7); and

- (vi) international insurers and holding companies of international insurers are subject to a 5% tax on their net income (these entities were totally exempt before the enactment of Act No. 7).

Act No. 7 also provides as a permanent measure a change in the method of computing the net income subject to alternative minimum tax ("AMT") in the case of individuals by including in the computation various categories of exempt income and income subject to preferential tax rates under the PR Code, such as: (a) long-term capital gains, which enjoy a preferential tax rate of 10% under the PR Code; (b) dividends that are taxable at the rate of 10% under the PR Code; (c) interest on bank deposits and individual retirement accounts subject to the special 10% and 17% preferential income tax rates, respectively; and (d) interest from notes or bonds eligible for the special 10% tax rate provided by the PR Code.

Another change introduced by Act No. 7, for taxable years commenced after December 31, 2008 and before January 1, 2012 is an adjustment to the calculation of the net income subject to the AMT in the case of entities taxed as corporations that denies a deduction for expenses paid or accrued for services rendered outside of Puerto Rico by a related party. Lastly, different income tax credits awarded to investors under certain special laws for activities such as revitalization of urban centers (only in part), venture capital, solid waste, housing infrastructure, and rehabilitation of social-interest housing (only projects without qualification certifications as of March 9, 2009), among others, may not be claimed or granted for taxable years commenced after December 31, 2008 and before January 1, 2012. Tax credits associated to manufacturing, tourism, and cinematographic projects, however, are not affected by Act No. 7.

### *Sales and Use Taxes*

Act No. 117 of July 4, 2006 ("Act 117") amended the PR Code to provide, among other things, for a general sales and use tax of 5.5% to be imposed by the central government (the "Commonwealth Sales Tax"). Act 117 also authorized each municipal government to impose a municipal sales and use tax of 1.5% (the "Municipal Sales Tax" and, together with the Commonwealth Sales Tax, the "Sales Tax"). In general, the Municipal Sales Tax has the same tax base, exemptions (except for unprocessed foods) and limitations as those provided for the Commonwealth Sales Tax. Act 117 also provides certain income tax reductions to address the regressive effect of the Sales Tax on taxpayers in lower income tax brackets.

The Sales Tax is imposed on the sale, use, consumption and storage of taxable items, which include tangible personal property, taxable services, admission rights and certain other types of transactions covering separable and identifiable taxable items which are sold for a single price, subject to certain exceptions and limitations. The Sales Tax does not apply to, among other things: (i) motor vehicles, (ii) non-prepared food, (iii) healthcare services and prescription medicines, (iv) certain bakery goods, (v) crude oil and its derivatives, including gasoline, (vi) hotel room charges, (vii) financial services, (viii) services provided by the Commonwealth, including electricity and water, and (ix) local sales of goods to be used as content in a manufactured good, whether or not bound for export.

Act 117 also repealed the 5% general excise tax imposed on imported goods and the 3.6% general excise tax imposed on goods manufactured in Puerto Rico. Other items, such as

fuel, crude oil and petroleum products, and vehicles, however, remain subject to the excise tax previously applicable to such items, and are not subject to the Sales Tax.

The Sales Tax became effective on November 15, 2006 and the effective date of the repeal of the 5% general excise tax was October 16, 2006. Municipalities were authorized to implement the Municipal Sales Tax starting on July 1, 2006. The revenues derived from the Sales Tax are distributed as follows: 5.5% goes to the central government and 1.5% to Puerto Rico's municipalities. One half of the 5.5% Commonwealth Sales Tax is transferred to the Dedicated Sales Tax Fund, created by Act 91, as amended, and the balance goes to the General Fund. The 1.5% Municipal Sales Tax is divided as follows: (i) 1% goes to the municipalities, and (ii) 0.5% goes to the Municipal Improvements Fund. The increase in revenues generated by the Sales Tax has been partly offset by the elimination of the 5% general excise tax and the effect of the income tax reduction measures included in Act 117.

The Treasury Department has reported and recorded Commonwealth Sales Tax revenues on a "modified cash basis." This means that the figures for each month represent the sales taxes corresponding to sales made by merchants and retailers and sales tax collected by such merchants and retailers during that month, but reported and remitted to the Treasury Department during the following month.

Effective fiscal year 2010, the Treasury Department will begin reporting Commonwealth Sales Tax revenues on a cash basis in order to report these revenues on the same basis and at the same time as it reports all other tax revenues. Accordingly, Commonwealth Sales Tax revenues will be reported in the month in which such revenues are received by the Treasury Department. The new reporting method will be effective as of July 1, 2009. Thus, the figures for sales tax collections previously reported in June 2009 will now be reported in July 2009.

The Sales Tax generated total annual gross revenues for the General Fund of approximately \$807.6 million (taking into account a one time accounting adjustment) for fiscal year 2009.

The Treasury Department has also sponsored legislation to limit or close certain gaps that existed in Act 117, as amended. In this regard, one of the amendments incorporated in Act No. 7 of March 9, 2009, as amended, require a merchant or retailer to file his or her Commonwealth Sales Tax monthly return on or prior to the tenth day of the following month, rather than the twentieth day (as originally required in Act 117). Such amendment also provides that the Commonwealth Sales Tax exemption applicable to resellers applies only to merchants and retailers (i) with gross sales greater than or equal to \$500,000 or (ii) that do not meet the \$500,000 sales threshold but meet certain other requirements imposed by the Treasury Department. A merchant or retailer that meets neither the \$500,000 threshold nor the other requirements imposed by the Treasury Department would still be entitled to a credit on sales tax paid on merchandise acquired for resale that must be claimed in each monthly filing. This measure is intended to enable responsible taxpayers to take advantage of the exemption while preventing non-compliant merchants and retailers from abusing the exemption.



### *Excise Taxes*

The PR Code imposes an excise tax on certain articles and commodities, such as cigarettes, alcohol, sugar, cement, motor vehicles and certain petroleum products, which are taxed at different rates.

Under Act No. 7, the excise tax was increased on certain articles (cigarettes and certain alcoholic beverages) and was expanded with respect to others (motor vehicles). With respect to cigarettes, the increase was approximately 81% per taxable unit. For certain alcoholic beverages, the increase ranges between \$0.30 and \$0.70 per standard gallon. In the case of motor vehicles, motorcycles, all terrain vehicles and “scooters,” which used to be subject to the Sales Tax, will now be subject to an excise tax of 10%.

### *Property Taxes*

Personal property, which accounts for approximately 46% of total collections of taxable property, is self-assessed. Real property taxes are assessed based on 1958 property values. No real property reassessment has been made since 1958, and construction taking place after that year has been assessed on the basis of what the value of the property would have been in 1958. Accordingly, the overall assessed valuation of real property for taxation purposes is substantially lower than the actual market value. Also, an exemption on the first \$15,000 of assessed valuation in owner-occupied residences is available.

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

One of the amendments incorporated in Act No. 7 was that, for fiscal years 2010 through 2013, the appraisal values of real property in Puerto Rico were increased tenfold and the real personal property tax rates applicable to such values were reduced tenfold so as to offset any increased tax that would have otherwise been applicable due to the increase in appraisal values. This temporary amendment, which is expected to be revenue neutral, was intended to increase the borrowing capacity of Puerto Rico’s municipalities.

Act No. 7 did impose, however, an additional real property tax on residential real properties with appraised values in excess of approximately \$210,000. This tax will apply during fiscal years 2010, 2011, 2012 and 2013, or until \$690 million is collected. The additional real property tax, to be collected by the Treasury Department, will be equal to 0.591% of such properties’ appraised value as determined by CRIM.

The following table presents the assessed valuations and real and personal property taxes collected for fiscal years 2005 to 2009.

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

<b>Fiscal Years Ended June 30,</b>	<b>Assessed Valuations<sup>(1)</sup></b>	<b>Taxes Levied</b>	<b>Collections of Current Year</b>	<b>Collections of Previous Years</b>	<b>Total Collections<sup>(2)</sup></b>
2005	25,277,795	899,893	738,074	50,751	788,825
2006	25,606,121	925,618	801,497	70,908	872,405
2007	26,898,519	982,400	813,700	79,720	893,420
2008	27,941,285	1,031,277	788,364	119,062	907,426
2009	28,903,996	1,032,570	634,040	244,411	878,451

<sup>(1)</sup> Valuation set as of July 1 of each fiscal year.

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

*Source:* Municipal Revenues Collection Center.

### *Other Taxes and Revenues*

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

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

### *Revenues from Non-Commonwealth Sources*

Revenues from non-Commonwealth sources include customs duties collected in Puerto Rico and excise taxes on shipments of rum from the island to the United States mainland. The customs duties and excise taxes on shipments are imposed and collected by the United States and returned to the Commonwealth. The excise tax on shipments of rum from Puerto Rico and other rum producing countries is \$13.50 per gallon. Of this amount, the lesser of \$13.25 per proof gallon and the actual excise tax imposed is currently returned to the Commonwealth.

### **Measures to Increase Collections of Income, Sales, and Excise Taxes**

The Treasury Department has elaborated a strategic plan designed to improve tax collections. The plan includes initiatives to foster tax compliance, implement effective enforcement measures, and attack tax evasion. To promote taxpayers' compliance, the Treasury Department has liberalized the procedures to enter into payment plans, offers-in-compromise agreements, and encourage voluntary disclosures agreements.

In addition, the Treasury Department has developed initiatives focused on effective enforcement methods, such as improving the efficiency of its audit selection process, the creation of technological solutions to improve collections, and the establishment of cooperation agreements with federal and local governmental agencies. The Treasury Department is also integrating its databases and establishing a tax intelligence project to identify tax evasion and improve its audit selection process.

Specifically, the Treasury Department has developed various initiatives directed towards increasing the Commonwealth sales tax collections through the implementation of various enforcement and compliance programs. Among these initiatives is a voluntary disclosure program, which began on July 1, 2009 and has since then allowed for the review of more than 53 cases and collection of approximately \$3.9 million, by providing certain taxpayers the opportunity to pay taxes and interest owed on unreported income and to avoid the payment of surcharges and penalties.

Other programs are geared towards the use of technology to detect noncompliance. The Treasury Department is in the process of procuring a new point of sale system to strengthen its enforcement efforts. The system would be designed to capture a greater percentage of cash sales through the implementation of a special lottery using sales receipts as lottery tickets and deposit credit and debit card transactions directly into the Treasury Department's account. Although the original procurement of the system was delayed by a legal challenge presented by a losing bidder, the Treasury Department expects the procurement process to resume in the first quarter of 2010. The Treasury Department is also in process of integrating its general computer systems with the sales tax database in order to better detect non-compliance and has implemented a program whereby officers from the Treasury Department use hand held scanning devices to cross-check merchant licenses with sales tax receipts.

Another initiative has focused on strengthening the Treasury Department's enforcement workforce. It has equipped a call center to be staffed by 150 tax collection agents, which began operations during the first quarter of calendar year 2010. The Treasury Department is also increasing staffing levels in its Enforcement and Compliance Bureaus by approximately 500 employees, therefore allowing an increase in unannounced field audits of businesses and merchants. The Treasury Department currently makes approximately 2,000 visits per month.

Other initiatives include the enforcement of a provision of Act No. 7 that allows the Treasury Department to revoke a certificate of exemption held by a merchant or retailer that fails to pay sales taxes collected in full by the 10<sup>th</sup> day of the month. Also, the Treasury Department will begin to seize the assets of businesses that are delinquent on their sales tax payments. In addition, the Treasury Department has entered into agreements with various municipalities to conduct simultaneous field visits and joint audits in order to increase the effectiveness of sales tax enforcement efforts as the ones described above.

### **Transfers to General Obligation Redemption Fund**

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

### **Components of General Fund Expenditures**

#### *Grants and Subsidies*

This category includes grants and contributions to municipalities, public corporations with independent treasuries, and charitable institutions. It also includes items for or included in

court awards, damage awards for personal injury or property damage, and payment of taxes and payments in lieu of taxes.

#### *Personal Services*

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

#### *Other Services*

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

#### *Materials and Supplies*

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

#### *Equipment Purchases*

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

#### *Capital Outlays and Other Debt Service*

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

#### *Transfers to Agencies*

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

#### *Other Expenditures*

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

## *Federal Grants*

Puerto Rico receives grants under numerous federal programs. Federal grants to the agencies and instrumentalities of the Commonwealth government are estimated to be \$5.020 billion for fiscal year 2011, a decrease of \$869 million, or 15%, from fiscal year 2010. The following table presents revenues from federal grants by broad program areas, which are accounted in the central accounting system of the Treasury Department. The figures for fiscal years 2007 through 2009 are actual figures. The figures for fiscal year 2010 are the amounts included in the approved budget.

Puerto Rico expects to receive approximately \$6.4 billion in stimulus funds from ARRA, of which \$1.203 billion, \$1.256 billion and \$537 million are expected to be received by the government during fiscal years 2009, 2010, and 2011, respectively. Such amounts are reflected in the table below.

### **The Commonwealth of Puerto Rico**

#### **Federal Grants\* (in thousands)**

	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010<sup>(1)</sup></b>	<b>2011<sup>(2)</sup></b>
Education	\$ 986,574	\$ 992,087	\$1,032,387	\$1,779,542	\$1,313,153
Social Services	1,923,845	2,054,897	3,033,365	2,536,021	2,473,611
Health	436,892	465,466	593,925	605,896	485,263
Labor and Human Resources <sup>(3)</sup>	183,228	140,186	277,267	216,189	128,080
Crime	29,631	20,319	21,377	74,197	29,238
Housing <sup>(4)</sup>	375,581	363,589	574,196	522,765	464,911
Drug and Justice	35,321	19,394	26,350	48,995	23,355
Agriculture and Natural Resources	12,484	11,054	12,625	30,043	38,171
Contributions to Municipalities	48,531	49,543	47,656	60,559	47,806
Other	17,095	15,782	17,803	15,068	16,355
<b>TOTAL</b>	<b>\$4,049,182</b>	<b>\$4,132,317</b>	<b>\$5,636,951</b>	<b>\$5,889,275</b>	<b>\$5,019,943</b>

\* Does not include grants received by agencies whose accounting systems are not centralized in the Treasury Department.

<sup>(1)</sup> Approved budget.

<sup>(2)</sup> Estimated.

<sup>(3)</sup> Amounts include grants to the Right to Work Administration and the Occupational Development and Human Resources Council.

<sup>(4)</sup> Amounts include grants to the Public Housing Administration.

Source: Office of Management and Budget

## **BUDGET OF THE COMMONWEALTH OF PUERTO RICO**

### **Office of Management and Budget**

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

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

### **Budgetary Process**

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

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

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

## **Financial Control and Adjustment Procedures**

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

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

A Budgetary Fund was created by Act No. 147 of June 18, 1980, as amended (the “Budgetary Fund”), to cover the appropriations approved in any fiscal year in which the revenues available for such fiscal year are insufficient, to secure the payment of public debt, and to provide for unforeseen circumstances in the provision of public service. An amount equal to one percent of the General Fund net revenues of the preceding fiscal year is required to be deposited annually into the Fund. In addition, other income (not classified as revenues) that is not assigned by law to a specific purpose is also required to be deposited in the Budgetary Fund. The maximum balance of the Budgetary Fund may not exceed 6% of the total appropriations included in the budget for the preceding fiscal year. During the last two fiscal years, the Legislative Assembly approved joint resolutions to halt temporarily the deposit of funds into the Budgetary Fund, and such funds were used instead to cover the budgetary deficits. As of December 31, 2009, the balance in the Budgetary Fund was \$103,373.

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

emergency and disaster needs. As of December 31, 2009, the balance in the Emergency Fund was \$2.7 million and \$4.0 million was available to be borrowed from GDB.

## **Appropriations**

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

(i) General Fund appropriations for recurring ordinary operating expenses of the central government and of the Legislative Assembly are made by a single annual law known as the Joint Resolution of the General Budget.

(ii) General Fund appropriations for special operating expenses, for contributions to municipalities, the University of Puerto Rico and the Judicial Branch and for capital expenditures are authorized by separate law for one or more years for special programs or activities, which may be permanent or transitory.

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

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

In Puerto Rico, the central government performs many functions, which in the fifty states are the responsibility of local governments, such as providing public education, police and fire protection. The central government also provides significant annual grants to the University of Puerto Rico and to the municipalities. In addition, the Commonwealth appropriates annually to the Judicial Branch an amount equal to 4% of the average annual revenue from internal sources for each of the two preceding fiscal years. This percentage may be increased upon review, with scheduled reviews every five years.

For fiscal year 2010, approximately 34% of the General Fund was committed to the payment of fixed charges such as municipal subsidies, grants to the University of Puerto Rico, mandated funding for the Judicial Branch, rent payments to the Public Buildings Authority, and debt service on the direct debt of the Commonwealth. This proportion is expected to decrease to 30% in fiscal year 2011.

For fiscal year 2009, over 60% of the controllable funds portion of the General Fund was committed for the payment of the central government payroll (not including the University of Puerto Rico and the Judicial Branch). In fiscal year 2010 and 2011, the Commonwealth decreases this proportion to an average of 47% due mainly to the savings in operational expenses expected from the implementation of the Fiscal Plan. The following table shows a breakdown between controllable and non-controllable General Fund expenses for fiscal years 2010 and 2011.



**General Fund Expenses Breakdown**  
(in millions)

	<b>2009<sup>(1)</sup></b>	<b>2010<sup>(1)</sup></b>	<b>2011<sup>(2)</sup></b>
<b>Non-Controllable Expenses</b>			
Mandated Expenses (Formula)			
Contributions to Municipalities	\$368	\$335	\$355
University of Puerto Rico	835	729	691
Judicial Branch	348	348	348
Rent Payments to Public Buildings Authority	206	297	217
General Obligation Debt Service	288	521	201
Other Debt Service	105	373	632
Total of Non-Controllable Expenses	<u>\$2,150</u>	<u>\$2,603</u>	<u>\$2,444</u>
Percent of Total General Fund Expenses	<u>23%</u>	<u>34%</u>	<u>30%</u>
<b>Controllable Expenses</b>	7,334	\$5,067	\$5,751
Payroll and Related Costs <sup>(3)</sup>	4,695	2,309	2,767
Payroll as a Percentage of Controllable Expenses	<u>64%</u>	<u>46%</u>	<u>48%</u>
<b>Total General Fund Expenses</b>	<u><u>\$9,484</u></u>	<u><u>\$7,670</u></u>	<u><u>\$8,195</u></u>
<b>Other Expenses</b>			
Total Non-Budgeted Expenses	\$1,766 <sup>(4)</sup>	-	-
COFINA Stabilization Fund	-	\$2,500	\$1,000
<b>Total Expenses</b>	\$11,250	\$10,170	\$9,195

<sup>(1)</sup> Preliminary.

<sup>(2)</sup> Estimated.

<sup>(3)</sup> Excludes University of Puerto Rico and Judicial Branch.

<sup>(4)</sup> Represents non-budgeted operating expenses that have been identified and that were paid for with proceeds of COFINA bond issues.

Source: Office of Management and Budget

## Budget for Fiscal Year 2010

The following table presents a summary of the Commonwealth's central government budget for fiscal year 2010.

### Commonwealth of Puerto Rico Summary of Central Government Annual Budget Fiscal Year Ending June 30, 2010 (in thousands)\*

	General Fund	Bond Fund	Special Funds	Total
Revenues from internal sources:				
Property taxes	\$230,000	-	\$115,657	\$345,167
Personal income taxes	2,614,000	-	-	2,614,000
Retained non-resident income tax	878,000	-	-	878,000
Corporate income taxes	1,556,000	-	-	1,556,000
Partnership income taxes	2,000	-	-	2,000
Tollgate taxes	11,000	-	-	11,000
17% withholding tax on interest	16,000	-	-	16,000
10% withholding tax on dividends	34,000	-	-	34,000
Inheritance and gift taxes	5,000	-	-	5,000
Sales and use taxes	545,000	-	-	545,000
Excise taxes:				
Alcoholic beverages	279,000	-	-	279,000
Motor vehicles and accessories	334,000	-	-	334,000
Cigarettes	177,000	-	-	177,000
Other (excise taxes)	86,000	-	638,453	724,453
Licenses	94,000	-	-	94,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	46,000	-	-	46,000
Electronic lottery	76,000	-	-	76,000
Registration and document certification fees	128,000	-	-	128,000
Other	203,000	-	403,920	606,920
Total revenues from internal sources	7,314,000	-	1,157,540	8,471,540
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	356,000	-	-	356,000
Federal grants <sup>(1)</sup>	0	-	5,889,275	5,889,275
Customs	0	-	-	0
Total revenues from non-Commonwealth sources	356,000	-	5,889,275	6,245,275
Total revenues	7,670,000	-	7,046,815	14,716,815
Other:				
Balance from previous year	0	-	1,648,236	1,648,236
Bonds authorized	0	0	-	-
Total other sources	0	0	1,648,236	1,648,236
Total resources	7,670,000	0	8,695,051	16,365,051
Appropriations:				
Current expenses:				
General government	714,269	-	57,640	771,909
Education	3,038,896	-	1,889,044	4,927,940
Health	1,361,284	-	603,533	1,964,817
Welfare	253,149	-	2,977,834	3,230,983
Economic development	127,305	-	108,436	235,741
Public safety and protection	490,235	-	133,066	623,301
Transportation and communication	93,294	-	83,724	177,018
Housing	9,975	-	312,892	322,867
Contributions to municipalities	369,727	-	13,709	383,436
Special pension contributions	313,626	-	0	313,626
Debt service	520,600	-	115,167	635,767
Other debt service (appropriations)	373,140	-	682,708	1,055,848
Total appropriations – current expenses	7,665,500	-	6,977,753	14,643,253
Capital improvements	4,500	-	250,278	254,778
Total appropriations	7,670,000	-	7,228,031	14,898,031
Year-end balance	0	-	1,467,020	1,467,020
Total appropriations and year-end balance	\$7,670,000	-	\$8,695,051	\$16,365,051

\* Totals may not add due to rounding.

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

Sources: Treasury Department and Office of Management and Budget

Projected revenues for fiscal year 2010 total \$16.4 billion and projected General Fund Revenues total \$7.7 billion. The principal changes in general fund revenues are accounted mainly by increases in property taxes (up \$229 million), corporate income tax (up \$191.7 million), excise taxes on motor vehicles and accessories (up to \$19.6 million), cigarettes and alcoholic beverages (up \$49.2 million), and decreases in sales and use taxes (down \$349.9 million, due principally to the increase in the portion of the tax transferred to COFINA), retained non-resident income taxes (down \$203.3 million), federal excise taxes on offshore shipments (down \$39.7 million), and 10% withholding taxes on dividends (down \$14.7 million).

Estimated expenses and capital improvements for the central government of all budgetary funds total \$14.9 billion, a decrease of \$2.0 billion from fiscal year 2009. The principal changes in general fund expenditures by program in fiscal year 2010 are mainly due to increases in general obligation bonds debt service (up \$255.4 million), and decreases in general government (down \$1.5 billion), public safety and protection (down \$1.2 billion), education (down \$409.9 million), welfare (down \$243.4 million), other debt service appropriations (down \$195.8 million), health (down \$194.2 million), economic development (down \$55.6 million), transportation and communication (down \$22.2 million), contributions to municipalities (down \$18.5 million), and housing (down \$17.7 million).

For fiscal year 2010, the government expects to incur an additional \$2.5 billion in expenses, for a total of \$10.2 billion in expenses. Approximately \$2 billion of this amount is related to (i) transitory expenses related to the implementation of the expense-reduction measures included in the Fiscal Plan (\$1 billion) and (ii) additional expenses (\$1 billion) to be incurred only in fiscal year 2010 (these expenses, which will not be incurred in subsequent fiscal years, are a result of the expense reduction plan being implemented under Act No. 7). These additional expenses are included in the consolidated budget of the Commonwealth and are expected to be covered from the proceeds of COFINA bond issues.

## Proposed Budget for Fiscal Year 2011

The following table presents a summary of the Commonwealth's central government proposed budget for fiscal year 2011.

### Commonwealth of Puerto Rico Summary of Central Government Annual Budget Fiscal Year Ending June 30, 2011 (in thousands)\*

	General Fund	Bond Fund	Special Funds	Total
Revenues from internal sources:				
Property taxes	\$319,000		\$115,743	\$434,743
Personal income taxes	2,812,000			2,812,000
Retained non-resident income tax	800,000			800,000
Corporate income taxes	1,657,000			1,657,000
Partnership income taxes	3,000			3,000
Tollgate taxes	5,000			5,000
17% withholding tax on interest	12,000			12,000
10% withholding tax on dividends	34,000			34,000
Inheritance and gift taxes	5,000			5,000
Sales and use taxes	593,000			593,000
Excise taxes:				
Alcoholic beverages	283,000			283,000
Motor vehicles and accessories	349,000			349,000
Cigarettes	166,000			166,000
Other (excise taxes)	86,000		606,500	692,500
Licenses	77,000			77,000
Miscellaneous non-tax revenues:				
Contributions from lottery fund	52,000			52,000
Electronic lottery	104,000			104,000
Video Lottery	220,000			220,000
Registration and document certification fees	131,000			131,000
Other	143,125		373,940	517,065
Total revenues from internal sources	7,851,125		1,096,183	8,947,308
Revenues from non-Commonwealth sources:				
Federal excise taxes on off-shore shipments	344,000		0	344,000
Federal grants <sup>(1)</sup>	0		5,019,943	5,019,943
Customs	0		0	0
Total revenues from non-Commonwealth sources	344,000		5,019,943	5,363,943
Total revenues	8,195,125		6,116,126	14,311,251
Other:				
Balance from previous year	0		1,467,020	1,467,020
Bonds authorized	0		0	0
Total other sources	0		1,467,020	1,467,020
Total resources	8,195,125	0	7,583,146	15,778,271
Appropriations:				
Current expenses:				
General government	723,885	-	49,387	773,272
Education	2,926,087	-	1,753,995	4,680,082
Health	1,510,730	-	517,592	2,028,322
Welfare	226,889	-	2,701,258	2,928,147
Economic development	186,491	-	117,019	303,510
Public safety and protection	996,828	-	85,937	1,082,765
Transportation and communication	88,849	-	64,312	153,161
Housing	4,188	-	351,451	355,639
Contributions to municipalities	363,538	-	956	364,494
Special pension contributions	334,553	-	0	334,553
Debt service	200,813	-	115,743	316,556
Other debt service (appropriations)	632,074	-	652,035	1,284,109
Total appropriations – current expenses	8,194,925	-	6,409,685	14,604,610
Capital improvements	200	0	219,439	219,639
Total appropriations	8,195,125	0	6,629,124	14,824,249
Year-end balance	0	-	954,022	954,022
Total appropriations and year-end balance	\$8,195,125	\$0	\$7,583,146	\$15,778,271

\* Totals may not add due to rounding.

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

Sources: Treasury Department and Office of Management and Budget

Projected revenues for fiscal year 2011 total \$15.8 billion and projected General Fund Revenues total \$8.2 billion. The principal changes in General Fund revenues are accounted mainly by increases in personal income taxes (up \$198 million), video lottery (up \$220 million), property taxes (up \$89 million), corporate income tax (up \$101 million), excise taxes on motor vehicles and accessories (up \$15 million), sales and use taxes (up \$48 million), and decreases in retained non-resident income taxes (down \$78 million), and federal excise taxes on offshore shipments (down \$12 million).

Estimated expenses and capital improvements for the central government of all budgetary funds total \$14.8 billion, a decrease of \$73.8 million from fiscal year 2010. The principal changes in general fund expenditures by program in fiscal year 2011 are mainly due to increases in public safety and protection (up \$506.6 million), other debt service appropriations (up \$258.9 million), health (up \$149.4 million), special pension contributions (up \$20.9 million), economic development (up \$59.2 million), and decreases in general obligation bonds debt service (down \$319.8 million), education (down \$112.8 million), and welfare (down \$26.3 million).

For fiscal year 2011, the government expects to incur an additional \$1.0 billion in expenses, for a total of \$9.2 billion. This additional amount of expenses is included in the consolidated budget of the Commonwealth and expected to be covered from the proceeds of COFINA bond issues.

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

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

- (i) The budgetary accounts are on a cash basis, while financial statements prepared by the Treasury Department include accruals and other adjustments as required by government accounting standards.
- (ii) Expenditures for current purposes in a particular fiscal year may include amounts appropriated for earlier periods but not previously expended or amounts not budgeted for a particular fiscal year, but expended during that year, and, conversely, may exclude amounts appropriated for such fiscal year but not expended until later periods.
- (iii) Bonds are authorized by the Commonwealth in accordance with a four-year capital improvement program. Since bond sales are determined by bond market conditions and other factors, the amounts of bonds sold for these improvements are financed by advances from the General Fund to the Capital Projects Fund, which are later reimbursed from proceeds of bond or notes sales.

### **LITIGATION**

*General.* The Commonwealth is a defendant in numerous legal proceedings pertaining to matters incidental to the performance of routine governmental operations. Under Act No. 104 of June 25, 1955, as amended (“Act 104”), persons are authorized to sue the Commonwealth only for causes of actions specified in said Act. The Commonwealth may be liable under Act 104 for

damages up to a maximum amount of \$75,000, or \$150,000 if the suit involves actions for damages to more than one person or where a single injured party is entitled to several causes of action.

Under certain circumstances, as provided in Act No. 9 of November 26, 1975, as amended, the Commonwealth may provide its officers and employees, including directors of public corporations and government instrumentalities and mayors of the municipalities of the Commonwealth, with legal representation, as well as assume the payment of any judgment that may be entered against them. There is no limitation on the amount of the judgment that may be paid under the Act in cases before federal court, but in all other cases the Puerto Rico Secretary of Justice may determine whether, and to what extent, the Commonwealth will assume payment of such judgment.

With respect to pending and threatened litigation, as of June 30, 2008, the Commonwealth has included in its financial statements reported liabilities of approximately \$1.2 billion for awarded and anticipated unfavorable judgments. While amounts claimed exceed \$6 billion, such amount represents the amount estimated at the time as a probable liability or a liability with a fixed or expected due date, which would require future available financial resources for its payment. The Commonwealth believes that the ultimate liability in excess of amounts provided in the financial statements, if any, would not be significant.

*Constitutionality of Act 7.* On April 13, 2009, a group of government employees along with labor organizations that represent governmental employees filed a complaint in the U.S. District Court for the District of Puerto Rico against the Governor of Puerto Rico and several agency heads. In the complaint, the plaintiffs challenge the constitutionality of Act 7 and seek, among other relief, an injunction to stop the Government of Puerto Rico from implementing the cost-cutting provisions of Act 7, described above in “Fiscal and Economic Reconstruction—Expense Reduction Measures” under “The Economy.”

On August 5, 2009, the U.S. District Court for the District of Puerto Rico denied the requested preliminary injunction and, on December 14, 2009, the court dismissed the complaint. Plaintiffs have appealed the Court’s decision. The Government will continue to vigorously defend this case. As discussed under “The Economy- Fiscal Stabilization and Economic Reconstruction”, the Supreme Court of Puerto Rico has upheld the constitutionality of the provisions of Act 7 relating to employee dismissals and the administration continues with its implementation.

*Recovery of Medicaid Funds.* The Commonwealth is a defendant in two lawsuits filed, one in Commonwealth court and one in the U.S. District Court for the District of Puerto Rico, by an association of primary care health centers seeking to recover from the Commonwealth \$800 million of Medicaid funds retained by the Department of Health since 1997. In June 2004, the Superior Court of the Commonwealth in San Juan determined that the Commonwealth must make Medicaid “wraparound” payments to the health centers to cover the difference between the reimbursement they are owed and what they are paid by managed care organizations. The Supreme Court of Puerto Rico, however, upheld a partial ruling allowing the Commonwealth to deduct from the payments due to the centers certain payments received by the centers from the federal government. Currently, audits are being carried out on the health centers.

With respect to the federal case, in February 2005, the U.S. Court of Appeals (First Circuit) upheld a preliminary injunction issued by the U.S. District Court for the District of Puerto Rico requiring the Commonwealth to make Medicaid “wraparound” payments to the health centers. In December 2008, the U.S. Court of Appeals determined that the U.S. District Court erred when it vacated the preliminary injunction and determined that the Department of Health had met its obligations to establish and implement payment system to health centers in compliance with federal Medicaid statute. The U.S. Court of Appeals reversed the District Court’s order vacating the preliminary injunction and remanded the case for further proceedings. Since mid-2009, the parties have been presenting evidence before a Special Master in order to determine the precise amounts of payments due to the health centers.

As of June 30, 2008, the Commonwealth had accrued \$150 million in its financial statements for this legal contingency.

*Special Education Students.* The Commonwealth is also a defendant in a class action presented in 1980 by parents of special-education students before Commonwealth courts alleging that the Puerto Rico Department of Education had failed to provide legally required special education and related services. In February 2002, the court issued a judgment approving the stipulations reached by the parties regarding the manner special education services should be provided. Since December 2002, the Department of Education has paid fines for not complying with the stipulations reached. The fines were originally set in the amount of \$1,000 daily, and were raised to \$2,000 daily in January 2006. In February 2010, the court issued a resolution advancing its intention to establish a new scheme of fines ranging from \$25,750 to \$77,250 daily. Said resolution also creates a new scheme of monitoring compliance with the stipulations. that would be effective by July 1, 2010.

The February 2002 judgment only disposed of the injunctive relief sought by plaintiffs. Still pending before the court are the claims for damages regarding the failure to provide adequate services. In October 2006, the San Juan Court of Appeals decided in favor of the parents’ request to include damage claims in the same class-action case, and the court may now award damages to the members of the class. When awarding damages, the court may consider the claims in groups or each case individually, and the parents must prove the damages suffered. The Commonwealth plans to defend vigorously each case.

As of June 30, 2008, the Commonwealth had accrued \$600 million in its financial statements for this legal contingency.

*Other.* The Commonwealth and various component units are defendants in other lawsuits alleging violations of civil rights, breach of contract, and other damage claims. Preliminary hearings and discovery proceedings are in progress. The amounts claimed exceed \$5 billion; however, the ultimate liability cannot be presently determined. It is the opinion of the Commonwealth that the claims are excessive. No provision for any liability that may result upon adjudication of these lawsuits has been recognized by the Commonwealth. The Commonwealth believes that the ultimate liability, if any, would not be significant.