FINANCIAL STATEMENTS
AND REQUIRED SUPPLEMENTARY
INFORMATION

Puerto Rico Electric Power Authority
Years Ended June 30, 2008 and 2007
With Report of Independent Auditors

ERNST & YOUNG

Puerto Rico Electric Power Authority

Financial Statements and Required Supplementary Information

Years Ended June 30, 2008 and 2007

Contents

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Report of Independent Auditors

To the Governing Board of the
Puerto Rico Electric Power Authority

We have audited the accompanying financial statements of the Puerto Rico Electric Power Authority (the Authority), a component unit of the Commonwealth of Puerto Rico, as of and for the years ended June 30, 2008 and 2007, as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of PREPA Networks, Inc. (PREPA.Net) (a blended component unit), which financial statements reflect total assets constituting approximately .2% and .05% of total assets as of June 30, 2008 and 2007, and revenues constituting .1% and .04% of revenues for the years then ended. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for PREPA.Net, is based solely on the report of the other auditors.

We conducted our audits in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Authority’s internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority’s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Authority as of June 30, 2008 and 2007, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the financial statements, effective July 1, 2007, the Authority changed its accounting policy related to accounting for its Other Post Employment Benefits to comply with the provisions of Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*.

In accordance with *Government Auditing Standards*, we have also issued our report, dated December 23, 2008, on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Management's Discussion and Analysis on pages 3 through 12 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

The required supplementary information disclosed on page 70 is not a required part of the audited financial statements, but is supplementary information required by the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures which consisted principally of inquires of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Ernst & Young LLP

December 23, 2008

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original of
this report.

This section of the financial report of Puerto Rico Electric Power Authority (the Authority) presents the analysis of the Authority's financial performance during the fiscal years ended June 30, 2008, 2007 and 2006. As management of the Authority, we offer readers of the financial statements this narrative overview and analysis of the financial activities. We encourage readers to consider the information presented here in conjunction with the financial statements that follow this section.

FINANCIAL HIGHLIGHTS

- The Authority's net assets decreased by $284.7 million (or 60.4 percent), decreased by $39.8 million (or 7.8 percent) and increased by $16.4 million (or 3.3 percent) as a result of operations during fiscal years ended June 30, 2008, 2007 and 2006, respectively.

- Operating income was $181.1 million, 370.9 million and $403.0 million for the fiscal years ended June 30, 2008, 2007 and 2006, respectively, representing 51.2 percent decrease, 8.0 percent decrease and 13.9 percent increase when compared to fiscal years ended June 30, 2008, 2007 and 2006, respectively.

- Ratios of fuel and purchased power adjustment revenues to total operating revenues were 73.8 percent for 2007-2008, 67.6 percent for 2006-2007 and 68.4 percent for 2005-2006.

- Operating expenses increased by $871.7 million, decreased by $3.6 million and increased by $623.1 million for the fiscal years ended June 30, 2008, 2007 and 2006, representing a 26.3 percent increase, .1 percent decrease and 23.2 percent increase, when compared to previous fiscal years.

- Ratios of fuel oil and purchased power expenses to total operating expenses (excluding depreciation expense) were 76.3 percent for 2007-2008, 77.4 percent for 2006-2007 and 74.6 percent for 2005-2006.

- The increase in the fuel adjustment revenues and fuel expense for 2007 and 2008 of $695.0 million and $586.1 million, respectively, was mainly due to an increase in fuel oil price per barrel of $26.63 (or 46.3%). The decrease in the fuel adjustment revenues of for 2006 and 2007 ($90.3 million) was mainly due to the excess of fuel expenses of $123 million associated with alternate generation capacity as a result of the Palo Seco Steam Plant fire, which it is expected to be recovered from insurance companies. The increase in fuel expenses for 2006 and 2007 ($51.1 million) was mainly due to an increase in fuel oil price per barrel of $1.17 (or 2.1 percent). In addition, the increase in the fuel adjustment revenues and fuel expense for 2005 and 2006 ($539.5 million and $482.9 million, respectively) was mainly due to an increase in fuel oil price per barrel of $17.16 (or 43.7 percent).

- The increase in the purchased power adjustment revenue and expense of $36.8 million and $36.4 million, respectively, was mainly due to an increase of 312,676 MWh (or 4.5 percent) purchase power for 2007 and 2008. The increase in the purchased power adjustment revenue and expense of $34.5 million and $21.5 million, respectively, was mainly due to an increase of 311,279 MWh (or 4.6 percent) purchase power for 2006 and 2007. In addition, the increase in the purchased power adjustment revenue and expense of $122.6 million and $110.5 million, respectively, was mainly due to an increase of .77 cents (or 9.3 percent) per kWh in average price of purchase power and an increase of 713,149 MWh (or 12.0 percent) purchase power for 2005 and 2006.

- The Authority's Net Utility Plant increased by $419.4 million, $316.9 million and $348.2 million or 7.3 percent, 5.8 percent and 6.8 percent, respectively, for the fiscal years ended June 30, 2008, 2007 and 2006. Total assets increased by $989.9 million, $823.6 million and $347.1million or 12.0 percent, 11.1 percent and 4.9 percent, respectively, for the fiscal years ended June 30, 2008, 2007 and 2006.

- For the fiscal year ended June 30, 2008, as compared to the fiscal year ended June 30, 2007, accounts receivable increased from $994.6 million on June 30, 2007 to $1,272.8 million on June 30, 2008, representing a 28.0 percent increase. The increase was mainly due to a claim to insurance companies related to the costs associated with alternate generation capacity in connection with two fires on the Authority's generating units. Accounts receivable from the governmental sector increased from $316.6 million on June 30, 2007 to $357.3 million on June 30, 2008, representing a 12.8 percent increase.

- For the fiscal year ended June 30, 2007, as compared to the fiscal year ended June 30, 2006, accounts receivable increased from $837.3 million on June 30, 2006 to $994.6 million on June 30, 2007, representing an 18.8 percent increase. The increase was mainly due to a claim to insurance companies related to the costs associated with alternate generation capacity in connection with two fires on the Authority's generating units. Accounts receivable from the governmental sector increased from $265.9 million on June 30, 2006 to $316.6 million on June 30, 2007, representing a 19.1 percent increase.

- For the fiscal year ended June 30, 2006, as compared to the fiscal year ended June 30, 2005, accounts receivable increased from $736.0 million on June 30, 2005 to $837.3 million on June 30, 2006, representing a 13.8 percent increase. Accounts receivable from the governmental sector increased from $176.0 million on June 30, 2005 to $265.9 million on June 30, 2006, representing a 51.1 percent increase, due to the Commonwealth's budget deficit for fiscal year 2005-2006. The Commonwealth enacted legislation for the fiscal and tax reform, starting collection of its new sales tax of 7% on November 15, 2006.

OVERVIEW OF FINANCIAL REPORT

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

REQUIRED FINANCIAL STATEMENTS

The financial statements of the Authority report the financial position and operations of Puerto Rico Electric Power Authority and its blended component units, Puerto Rico Irrigation Systems and PREPA Networks Corp., which include a Balance Sheet, Statement of Revenues, Expenses and Changes in Net Assets, Statement of Cash Flows and the notes to financial statements.

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

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

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

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

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

FINANCIAL ANALYSIS

The Authority's net assets decreased by $284.7 million, decreased by $39.8 million and increased by $16.4 million for the fiscal years ended June 30, 2008, 2007 and 2006, respectively. Our analysis below focuses on the Authority's net assets and changes in net assets during the year.

Authority's Net Assets
(*In thousands*)

	2008	2007	2006
Current, non-current and other assets	**$ 3,057,603**	$ 2,487,122	$ 1,980,450
Capital assets	**6,173,993**	5,754,568	5,437,661
Total assets	**$ 9,231,596**	$ 8,241,690	$ 7,418,111
Long-term debt outstanding	**$ 6,842,778**	$ 6,115,493	$ 5,247,716
Other liabilities	**2,202,136**	1,654,789	1,659,211
Total liabilities	**$ 9,044,914**	$ 7,770,282	$ 6,906,927
Net assets:			
Invested in capital assets, net of related debt	**$ 55,101**	$ 168,307	$ 269,241
Restricted	**307,666**	315,154	206,748
Unrestricted	**(176,085)**	(12,053)	35,195
Total net assets	**$ 186,682**	$ 471,408	$ 511,184

A significant portion of the Authority's net assets is restricted and represents resources that are subject to external restrictions on how they may be used. An additional portion of the Authority's net assets reflects its investment in capital assets, less any related debt used to acquire those assets that is still outstanding.

Net assets invested in utility plant, net of related debt decreased from $168.3 million as of June 30, 2007 to $55.1 million as of June 30, 2008 (or 67.3%) mainly due to the increase in lines of credits by $213.6 million to finance a portion of the cost of various projects under the capital improvement program and the increases in net utility plant by $419.4 million and Power Revenues Bonds by $306.5 million (excluding the non-expended portion).

Restricted for capital and debt service decreased from $315.2 million as of June 30, 2007 to $307.6 million as of June 30, 2008 by $7.6 million (or 2.4%).

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

Authority's Changes in Net Assets
(In thousands)

	Year Ended June 30		
	2008	**2007**	**2006**
Operating revenues	**$ 4,362,209**	$ 3,680,390	$ 3,716,082
Other income	**25,874**	20,942	24,475
Total revenues	**4,388,083**	3,701,332	3,740,557
Operating expenses	**4,181,143**	3,309,445	3,313,064
Interest expense, net	**312,269**	296,209	286,742
Total expenses	**4,493,412**	3,605,654	3,599,806
(Loss)/Income before contribution in lieu of taxes and other and contributed capital	**(105,329)**	95,678	140,751
Contribution in lieu of taxes and other	**(218,379)**	(192,591)	(180,733)
Loss before contributed capital	**(323,708)**	(96,913)	(39,982)
Contributed capital	**38,982**	57,137	56,378
Change in net assets	**(284,726)**	(39,776)	16,396
Net assets, beginning of year	**471,408**	511,184	494,788
Net assets, end of year	**$ 186,682**	$ 471,408	$ 511,184

For the fiscal year ended June 30, 2008, as compared to June 30, 2007, operating revenues and expenses increased by $681.8 million (or 18.5%) and $871.7 million (or 26.3%), respectively, resulting in a decrease in net assets of $284.7 million. The decrease in net assets was mainly due to the recognition of the Other Postemployment Benefit (OPEB) expense of $189.5 million. The Authority implemented Statement No. 45 of the Governmental Accounting Standard Board (GASB), *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*. GASB 45 establishes standards for the measurement, recognition of Other Postemployment Benefits (OPEB), related liabilities and disclosures. In addition, other reasons for the decrease in net assets were the decrease in sales of energy by 1,070 MhW (5.2%), representing $52.3 million on basic rate revenues, and the increases on the total interest charge, net, and reserve for uncollectible accounts of $16.1 million and $20.1 million, respectively.

For the fiscal year ended June 30, 2007, as compared to June 30, 2006, operating revenues and expenses decreased by $35.7 million (or 1%) and $35.7 million (or 1%), respectively, resulting in a decrease in net assets of $39.8 million. The decrease in net assets was mainly due to an increase in the reserve for uncollectible accounts of $29.4 million and $19.4 million related to the portion of the loss the Authority observed in connection of the Palo Seco Steam Plant fire, net of other operating income. The Authority holds a 30-day waiting period as a deductible on each occurrence in the extra expenses clause of Business Interruption Insurance Policy. The Authority assumed the cost of such retention instead of recovering it from the clients through the fuel and purchased power adjustment clauses. In addition, there was an increase on the total interest charge, net, of $9.4 million for 2006-2007.

For the fiscal year ended June 30, 2006, as compared to June 30, 2005, operating revenues and expenses increased by $672.2 million (or 22.1%) and $623.1 million (or 23.2%), respectively, resulting in an increase in net assets of $16.4 million. The increase in operating revenues and expenses was mainly due to an increase in fuel oil price per barrel of $17.16 (or 43.7 percent), an increase of .77 cents (or 9.3 percent) per kWh in average price of purchase power and an increase of 713,149 MWh (or 12.0 percent) of purchase power for 2005-2006.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets

The Authority's investment in capital assets as of June 30, 2008, 2007 and 2006, amounts to approximately $6,174 million, $5,755 million and $5,438 million (net of accumulated depreciation), respectively. This investment in capital assets includes land, generation, transmission and distribution systems, buildings, fixed equipment, furniture, fixtures and equipment. The total increases in the Authority's investment in capital assets (net of accumulated depreciation) were 7.3 percent, 5.8 percent and 6.8 percent for 2007-2008, 2006-2007 and 2005-2006, respectively.

A substantial portion of the capital expenditures for production plant in fiscal year ended June 30, 2008, 2007 and 2006, was spent on the rehabilitation and life extension of generating plants in order to achieve and maintain higher levels of availability, reliability and efficiency.

Major capital asset events during fiscal years 2007 and 2008 included the following:

- The Authority is replacing the two 44 MW San Juan Units No. 5 and 6, removed from service in fiscal year 1997, with 464 MW of combined-cycle capacity. The plant is comprised of two combined-cycle units, each consisting of one combustion turbine rated at 165 MW with a heat recovery steam generator (HRSG) feeding a single 67 MW steam turbine-generator.

- The Authority is working in the replacement of the four 21 MW combustion turbines at Mayagüez with new four 55 MW dual fuel aero-derivative combustion turbines, which represent a net increase in capacity of approximately 136 MW over the replaced combustion turbines and they will generate electricity more efficiently. The first two combustion turbines were installed in fiscal year 2008 and the remainder two will be installed and in service on fiscal year 2009.

- The Authority is modifying the eight 50 MW combustion turbines of Aguirre Combined Cycle Plant to enable them to burn either natural gas or light distillate. This conversion to dual fuel capability is scheduled for completion on fiscal year 2009. The 40 mile long natural gas pipeline from the EcoEléctrica Facility in Guayanilla to the Aguirre Combined Cycle Plant is also scheduled for completion during the second half of fiscal year 2009.

- The Authority is constructing a new 50-mile long 230 kV transmission line between its South Coast Steam Plant and the Transmission Center at Aguas Buenas. This new transmission line is expected to be operating in fiscal year 2012. Once in operation, this major infrastructure project will enhance the reliability of the transmission system, and will permit the increase of power transfers from the south coast of Puerto Rico to the northern and central regions.

- The second priority 230 kV line project is a new 38-mile long 230 kV transmission line connecting the South Coast Steam Plant and the Cambalache Plant. Currently, the line is scheduled for completion in fiscal year 2014.

- An aggressive program to improve the 38 kV sub-transmission systems is in effect. This program includes the construction of underground 38 kV lines in Mayagüez, Carolina and San Juan. In addition, most 38 kV lines in the central part of the island are being replaced. These projects will improve the reliability of the sub-transmission system.

- The Authority is constructing an underground 115 kV transmission circuit line around the San Juan metropolitan area in order to reduce the incidents of loss of power in the aftermath of hurricanes and other major storms, which strike Puerto Rico from time to time. The estimated cost for this project, which is expected to be completed in fiscal year 2009, is $135 million. The Federal Emergency Management Agency provided $75 million for the investment in construction for this project through grants to the Authority. Other projects related to the load growth forecast of the San Juan metropolitan area are the new gas-insulated switchgear (GIS) 115/38 kV transmission centers of Isla Grande, San Juan and Palo Seco Steam Plants.

- In addition, major expansions to 115/38 kV transmission centers in the municipalities of Aguadilla, Isabela and Canóvanas will increase the power transfer and improve the voltage regulation of the 38 kV system under emergency conditions.

  The Authority installed a 90 MVARS Static Var Compensator (SVC) at the 38 kV bus of Bayamón Transmission Center to improve the voltage stability margins of the electric system by regulating this 115 kV bus. This SVC will help to improve the system dynamic reactive power response to major contingencies and outages in the generation or transmission system.

- The Authority installed a new 115 kV capacitor banks in the transmission center of Dorado and Sabana Llana to improve the system power factor and to reduce the reactive power losses at transmission level.

- The Authority has three new substations under construction in the distribution system. These substations are: Mora PDS 115/13.2 kV (33.6 MVA) in Isabela, Factor 38/13.2 kV (22.4 MVA) in Arecibo and Juan Martín 115/13.2 kV (33.6 MVA) in Yabucoa. The construction of these new substations increases the distribution capacity, provides service to new clients, and improves the reliability of the distribution system.

- The Authority is repairing steam turbines generators and replacing transformers and major electrical equipments of Palo Seco Steam Plant unit, which have a 85 MW capacity. In addition, the Authority is replacing the control room for all Palo Seco Steam Plant units and switch gear for Palo Seco Steam Plant units two, three and four. The estimated cost of repairing the Palo Seco Steam Plant units is of approximately $106 million.

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

Additional information on the Authority's capital assets can be found in Note 6 to the financial statements.

Long-Term Debt

At the end of the fiscal year 2008, 2007 and 2006, the Authority had total long-term debt outstanding of $6,856.9 million, $6,127.8 million and $5,261.4 million, respectively, comprised of revenue bonds and other borrowings.

Authority's Outstanding Debt
(In thousands)

	2008	2007	2006
Power revenue bonds, net	**$ 6,162,987**	$ 5,647,709	$ 5,156,531
Notes payable	**693,884**	480,061	104,835
	6,856,871	6,127,770	5,261,366
Current portion	**(341,335)**	(363,358)	(391,182)
Long-term debt excluding current portion	**$ 6,515,536**	$ 5,764,412	$ 4,870,184

The Authority maintains ratings of "A3" by Moody's, "BBB+" by S&P and "A-" by Fitch for its bonds.

Additional information on the Authority's long-term debt can be found in Notes 8 and 11 to the financial statements.

ECONOMIC FACTORS AND NEW YEAR'S BUDGETS AND RATES

The economy of Puerto Rico must be analyzed as a region within the U.S. economy, since it is part of the U.S. monetary and banking system, as well as within its territorial boundaries. The main drive of the Puerto Rico economy is a huge external sector closely tied to the flow of merchandise, tourists, and capital between Puerto Rico and the Mainland. In the second quarter of fiscal year 2008 U.S. Real GDP increased at an annual rate of 2.8% after a 0.9% increase in the first quarter.

The economy of Puerto Rico is expected to decrease in fiscal year 2008, at a rate of 2.1% in real terms, according to the latest forecast prepared by the Puerto Rico Planning Board (JP).

The Authority adopted the 2009 fiscal year budget on June 18, 2008. The electric revenues for fiscal year 2008-2009 are projected to approximately $4,539.5 million. In addition, the Capital Improvement Program amounted to approximately $446.0 million. The 2009 consolidated budget increased by $435.3 million (or 9.6 percent) from fiscal year 2007-2008, due mainly to the increase of projected fuel oil prices.

REQUEST FOR INFORMATION

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

Puerto Rico Electric Power Authority

Balance Sheets

	June 30	
	2008	**2007**
	(In thousands)	
Assets		
Current assets:		
Cash and cash equivalents	**$ 40,920**	$ 40,441
Receivables, net	**1,171,112**	895,990
Fuel oil, at average cost	**212,026**	147,132
Materials and supplies, at average cost	**192,554**	161,607
Prepayments and other assets	**2,510**	6,177
Total current assets	**1,619,122**	1,251,347
Other non-current receivables	**101,734**	98,577
Restricted assets:		
Cash and cash equivalents held by trustee for payment of principal and interest on bonds	**281,624**	287,183
Investments held by trustee	**338,918**	347,864
Construction fund and other special funds	**567,834**	374,166
Total restricted assets	**1,188,376**	1,009,213
Utility plant:		
Plant in service	**8,001,401**	7,570,186
Accumulated depreciation	**(4,383,884)**	(4,128,229)
	3,617,517	3,441,957
Construction in progress	**2,556,476**	2,312,611
Total utility plant, net	**6,173,993**	5,754,568
Deferred expenses:		
Unamortized debt issue costs	**68,461**	57,085
Other	**79,910**	70,900
Total deferred expenses	**148,371**	127,985
Total assets	**$ 9,231,596**	$ 8,241,690

(Continue)

	June 30	
	2008	**2007**
	(In thousands)	
Liabilities and net assets		
Current liabilities:		
Notes payable	**$ 652,508**	$ 436,766
Accounts payable and accrued liabilities	**854,882**	749,044
Customers' deposits	**164,475**	159,104
Total current liabilities	**1,671,865**	1,344,914
Current liabilities payable from restricted assets:		
Current portion of long-term debt	**327,242**	351,081
Accrued interest	**137,497**	102,935
Other current liabilities payable from restricted assets	**79,767**	78,226
Total current liabilities payable from restricted assets	**544,506**	532,242
Noncurrent liabilities:		
Long-term debt, excluding current portion	**6,515,536**	5,764,412
Sick leave benefits to be liquidated after one year	**123,515**	128,714
Accrued unfunded other post-employment benefits liability	**189,492**	–
Total noncurrent liabilities	**6,828,543**	5,893,126
Total liabilities	**9,044,914**	7,770,282
Net assets:		
Invested in utility plant, net of related debt	**55,101**	168,307
Restricted for capital activity and debt service	**307,666**	315,154
Unrestricted	**(176,085)**	(12,053)
Total net assets	**186,682**	471,408
Total liabilities and net assets	**$ 9,231,596**	$ 8,241,690

See accompanying notes.

Puerto Rico Electric Power Authority

Statements of Revenues, Expenses and Changes in Net Assets

	Year Ended June 30 2008	2007
	(In thousands)	
Operating revenues	**$ 4,362,209**	$ 3,680,390
Operating expenses:		
Operations:		
Fuel	**2,303,036**	1,716,965
Purchased power	**661,097**	624,653
Claim for extra fuel expense	**(96,273)**	(114,261)
Other production	**58,035**	56,722
Transmission and distribution	**177,692**	163,555
Customer accounting and collection	**118,485**	109,589
Administrative and general	**225,693**	216,015
Maintenance	**248,569**	252,444
Depreciation	**295,317**	283,763
Other post-employment benefit (OPEB)	**189,492**	–
Total operating expenses	**4,181,143**	3,309,445
Operating income	**181,066**	370,945
Interest income and other	**25,874**	20,942
Income before interest charges, contribution in lieu of taxes and contributed capital	**206,940**	391,887
Interest charges:		
Interest on bonds	**271,016**	262,616
Interest on other long-term debt	**44,291**	38,922
Other interest	**3,963**	1,434
Amortization of debt discount, issuance costs and refunding loss	**14,124**	15,467
Allowance for funds used during construction	**(21,125)**	(22,230)
Total interest charges, net	**312,269**	296,209
(Loss)/Income before contribution in lieu of taxes and contributed capital	**(105,329)**	95,678
Contribution in lieu of taxes and other	**(218,379)**	(192,591)
Loss before contributed capital	**(323,708)**	(96,913)
Contributed capital	**38,982**	57,137
Change in net assets	**(284,726)**	(39,776)
Net assets, beginning balance	**471,408**	511,184
Net assets, ending balance	**$ 186,682**	$ 471,408

See accompanying notes.

Puerto Rico Electric Power Authority

Statements of Cash Flows

	Year Ended June 30 2008	2007
	(In thousands)	
Cash flows from operating activities		
Cash received from customers	**$ 4,095,297**	$ 3,635,637
Cash paid to suppliers and employees	**(3,981,056)**	(3,285,525)
Net cash flows provided by operating activities	**114,241**	350,112
Cash flows from noncapital financing activities		
Proceeds from notes payable	**226,450**	358,100
Principal paid on notes payable	**(62,277)**	(247,727)
Interest paid on notes payable	**(18,754)**	(14,144)
Proceeds on fuel line of credit	**100,000**	–
Payments on fuel line of credit	**(50,000)**	–
Interest paid on fuel line of credit	**(9,452)**	(9,770)
Net cash flows provided by noncapital financing activities	**185,967**	86,459
Cash flows from capital and related financing activities		
Construction expenditures	**(673,207)**	(574,981)
Proceeds received from contributed capital	**17,379**	44,015
Allowance for funds used during construction	**21,125**	22,230
Power revenue bonds:		
Proceeds from issuance of bonds, net of original discount	**706,199**	675,362
Principal paid on revenue bonds maturities	**(197,583)**	(191,872)
Interest paid on revenue bonds	**(242,765)**	(297,811)
Proceeds from issuance of refunding bonds, net of original discount	**–**	1,951,140
Defeased bonds, net of original discount or premium	**–**	(1,955,158)
Proceeds from bond anticipation notes	**215,229**	409,675
Payment of bond anticipation notes	**–**	(200,000)
Interest paid on notes payable	**(23,189)**	(22,815)
Net cash flows used in capital and related financing activities	**(176,812)**	(140,215)
Cash flows from investing activities		
Purchases of investment securities	**(1,180,735)**	(1,573,424)
Proceeds from sale and maturities of investment securities	**1,385,132**	1,366,090
Interest on investments	**35,856**	17,910
Transfer from restricted funds to general fund	**25,438**	9,387
Transfer from general fund to restricted funds	**(5,000)**	(5,000)
Net cash flows provided by (used in) investing activities	**260,691**	(185,037)
Net increase in cash and cash equivalents	**384,087**	111,319
Cash and cash equivalents at beginning of year	**467,677**	356,358
Cash and cash equivalents at end of year	**$ 851,764**	$ 467,677

(Continue)

Statements of Cash Flows (continued)

	Year Ended June 30 2007	2006
	(In thousands)	
Cash and cash equivalents		
Unrestricted	**$ 40,920**	$ 40,441
Restricted:		
Cash and cash equivalents held by trustee for payment of principal and interest bonds	**281,624**	287,183
Cash and cash equivalents within construction and other special funds	**529,220**	140,053
	$ 851,764	$ 467,677
Reconciliation of net operating revenues to net cash provided by operating activities		
Operating income	**$ 181,066**	$ 370,945
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	**295,317**	283,763
Amortization of asbestos removal	**2,634**	3,133
Provision for uncollectible accounts and other	**30,021**	41,584
Changes in assets and liabilities:		
Receivables	**(582,615)**	(405,581)
Fuel oil	**(55,442)**	(17,391)
Materials and supplies	**(30,350)**	(3,593)
Prepayments and other assets	**3,667**	(771)
Other deferred debits	**(21,242)**	590
Noncurrent liabilities, excluding revenue bonds and notes payable	**184,293**	(9,592)
Accounts payable and accrued liabilities	**101,521**	83,287
Customers' deposits	**5,371**	3,738
Total adjustments	**(66,825)**	(20,833)
Net cash flows provided by operating activities	**$ 114,241**	$ 350,112

See accompanying notes.

1. Reporting Entity

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

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

On August 18, 2003, the Commonwealth of Puerto Rico approved Act No. 189, which authorizes the Authority to create, acquire and maintain corporations, partnerships or subsidiary corporations, profit or non-profit entities.

Basis of Presentation – Blended Component Units

The financial statements of the Authority include the financial position and operations of the Puerto Rico Irrigation Systems (Irrigation Systems) and PREPA Networks Corp. (PREPA.Net). The Irrigation Systems operate pursuant to the provisions of the Act, and Acts No. 83 and 84, approved on June 20, 1955, regarding the Puerto Rico Irrigation Service, South Coast, and Isabela Irrigation Service, respectively, and the Lajas Valley Public Irrigation Law, approved on June 10, 1953, as amended.

The Irrigations Systems and PREPA.Net conform to the requirements of Governmental Accounting Standards Board (GASB) No. 39, *Determining Whether Certain Organizations are Component Units,* on its stand-alone financial statements. GASB No. 39 establishes standards for defining and reporting on the financial reporting entity. It also establishes standards for reporting participation in joint ventures. It applies to financial reporting by primary governments, and other stand-alone governments; and it applies to the separately issued financial statements of governmental component units. In addition, this Statement should be applied to governmental and nongovernmental component units when they are included in a governmental financial reporting entity.

1. Reporting Entity (continued)

Basis of Presentation – Blended Component Units (continued)

Condensed financial information as of June 30, 2008 and 2007 and for the years then ended for the Irrigation Systems is as follows:

	2008	**2007**
	(*In thousands*)	
Balance sheets:		
Assets:		
Receivables, net	**$ 16,725**	$ 12,902
Prepayments and other assets	**2,185**	2,185
Utility Plant, net of depreciation	**19,376**	21,140
Total assets	**$ 38,286**	$ 36,227
Liabilities:		
Accounts payable, net	**$ 997**	$ 974
Statements of revenues, expenditures and changes in net assets:		
Operating revenues	**$ 5,985**	$ 7,681
Operating expenses	**(3,949)**	(3,916)
	2,036	3,765
Net assets, beginning balance	**35,253**	31,488
Net assets, ending balance	**$ 37,289**	$ 35,253

PREPA.Net is a subsidiary of the Authority created to develop strategies for commercializing the surplus capacity of the installed Optical Fiber Network (OFN), adding flexibility and diversification to its operations. PREPA.Net was created on April, 2004 and started commercial operations during fiscal year 2005-2006.

PREPA.Net provides Optical Infrastructure to carriers, ISPs and enhanced services providers – with a highly reliable Island wide fiber optic network.

1. Reporting Entity (continued)

Basis of Presentation – Blended Component Units (continued)

PREPA.Net entered into a long-term lease with PREPA for the Indefeasible Right of Use (IRU) of all PREPA's Optical Infrastructure. PREPA.Net's network features state of the art optical technology that is being used by service providers to reach undersea cable landing stations, wireless network towers, and island wide locations.

In February 2008, PREPA.Net acquired Telecomunicaciones Ultramarinas de Puerto Rico (Ultracom). Ultracom is one of the three submarine cable station administrators in Puerto Rico. This acquisition provides PREPA.Net with International fiber optic capacity and satellite teleport facilities.

Condensed financial information as of June 30, 2008 and 2007 and for the years then ended for PREPA.Net is as follows:

	2008	**2007**
	(In thousands)	
Balance sheets:		
Assets:		
Cash and cash equivalents	**$ 8,737**	$ 526
Receivables, net	**1,116**	554
Prepayments and other assets	**130**	–
Utility plant, net of depreciation	**8,660**	2,918
Total assets	**$ 18,643**	$ 3,998
Liabilities:		
Accounts payable, net	**$ 18,059**	$ 4,865
Statements of revenues, expenditures and changes in net assets:		
Operating revenues	**$ 5,678**	$ 1,758
Operating expenses	**(4,227)**	(2,244)
	1,451	(486)
Net assets, beginning balance	**(867)**	(381)
Net assets, ending balance	**$ 584**	$ (867)

2. Summary of Significant Accounting Policies

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

Basis of Accounting

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

The Authority follows the provisions of GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting*, as amended by GASB Statement No. 34, which requires proprietary activities to apply all applicable GASB pronouncements as well as all Financial Accounting Standards Board (FASB) Statements and Interpretations, and Accounting Principles Board Opinions and Accounting Research Bulletins issued on or before November 30, 1989, unless the pronouncements conflict or contradict GASB pronouncements.

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

GASB Statement No. 45

During fiscal year 2008, the Authority adopted the provisions of GASBoard Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. This Statement improves the relevance and usefulness of financial reporting by (a) requiring systematic, accrual-basis measurement and recognition of OPEB cost (expense) over a period that approximates employees' years of service and (b) providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan. Effects on the financial statements of the adoption of Statement No. 45 are disclosed in Note 12.

2. Summary of Significant Accounting Policies (continued)

Cash and Cash Equivalents

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

Receivables

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

Materials, Supplies and Fuel Oil

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

Investments

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

The funds under the 1974 Agreement may be invested in:

- Government obligations, which are direct obligations of, or obligations whose principal and interest is guaranteed by the U.S. Government, or obligations of certain of its agencies or instrumentalities.

- Investment obligations of any of the states or territories of the United States or political subdivisions thereof (other than obligations rated lower than the three highest grades by a nationally recognized rating agency) and repurchase agreements with commercial banks fully secured by U.S. Government obligations.

2. Summary of Significant Accounting Policies (continued)

Investments (continued)

- Time deposits with Government Development Bank for Puerto Rico (GDB) or the Authority's Trustee under the 1974 Agreement or any bank or trust company member of the Federal Deposit Insurance Corporation having a combined capital and surplus of not less than $100 million.

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

Utility Plant

Utility plant is carried at cost, which includes labor, materials, overhead, and an allowance for the cost of funds used during construction (AFUDC). AFUDC represents the cost of borrowed funds used to finance construction work in progress. AFUDC is capitalized as an additional cost of property and as a reduction of interest expense. Capitalized interest expense is reduced by interest income earned on related investments acquired with proceeds of tax-exempt borrowings. Such costs are recovered from customers as a cost of service through depreciation charges in future periods. Capitalized interest during the years ended June 30, 2008 and 2007 amounted to $21.1 million and $22.2 million, respectively. These amounts are net of interest income earned on investments amounting to $375,117 and $2.6 million, respectively.

Capital expenditures of $1,200 or more are capitalized at cost at the date of acquisition. Maintenance, repairs, and the cost of renewals of minor items of property units are charged to operating expenses. Replacements of major items of property are charged to the plant accounts. The cost of retired property, together with removal cost less salvage, is charged to accumulated depreciation with no gain or loss recognized.

2. Summary of Significant Accounting Policies (continued)

Depreciation

Depreciation is computed on the straight-line method at rates considered adequate to allocate the cost of the various classes of property over their estimated service lives. The annual composite rate of depreciation, determined by the Authority's consulting engineers, was approximately 4.25% for 2008 and 2007.

Unamortized Debt Issuance Expense

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

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

Asbestos Containment Deferred Costs

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

Pension Plan

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

Other Postemployment Benefits

Other postemployment Benefits (OPEB) cost for healthcare is measured and disclosed using the accrual basis of accounting (see Note 12).

2. Summary of Significant Accounting Policies (continued)

Accounting for Compensated Absences

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

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

Revenue Recognition, Fuel Costs and Purchase Power

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

Contributions in Lieu of Taxes and Governmental Subsidies

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

Municipalities

To the extent net revenues, as defined, are available, the Authority is required under the Act to make a contribution in lieu of taxes of 11% to the Commonwealth and the Municipalities of gross electric sales.

The Authority is also required under the Act to make a contribution in lieu of taxes of the greater of:

a) Twenty percent of the Authority’s Adjusted Net Revenues (Net Revenues, as defined in the 1974 Agreement, less the cost of the Commonwealth rate subsidies);
b) The cost collectively of the actual electric power consumption of the municipalities; or

2. Summary of Significant Accounting Policies (continued)

Contributions in Lieu of Taxes and Governmental Subsidies (continued)

Municipalities (continued)

c) The prior five-year moving average of the contributions in lieu of taxes paid to the municipalities collectively.

If the Authority does not have sufficient funds available in any year to pay the contributions in lieu of taxes then difference will be accrued and carried forward for a maximum of three years. The contribution in lieu of taxes to Municipalities can be used to offset accounts receivable balance owed by the Municipalities to the Authority as permitted by law.

Commonwealth of Puerto Rico

To the extent net revenues are available, the Authority is also required under the Act to set aside the remainder of contribution in lieu of taxes of gross electric sales for the purpose of (i) financing capital improvements, (ii) offsetting other subsidies (other than cost of fuel adjustments to certain residential clients) of the Commonwealth, and (iii) any other lawful corporate purpose. Amounts assigned to (ii) above, are classified as a contribution in lieu of taxes in the accompanying statements of revenues, expenses and changes in net assets and reduce the related accounts receivable in the balance sheets.

Contributed Capital

The Authority records contributed capital as income in the year earned. The Authority receives contributed capital in the form of cash and property from residential projects developed by third parties during recent years and local and federal agencies.

Interest Rate Swap Agreements

The interest rate swaps are used in the area of debt management to take advantage of favorable market interest rates and to limit interest rate risk associated with variable rate debt exposure. Under the interest rate swap programs, the Authority pays a fixed rate of interest for the term of the variable interest rate Power Revenue Bonds and receives a variable rate of interest, which is based on various indices. These indices are affected by changes in the market. The net amount received or paid under the swap agreements are recorded as an adjustment to interest accrued on the statements of balance sheets.

3. Cash and Cash Equivalents

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

At June 30, 2008 and 2007, the carrying amount and bank balance of cash deposits held by the Authority and restricted cash deposits held by the Trustee under the 1974 Agreement are as follows (in thousands):

	2008		**2007**	
	Carrying Amount	**Bank Balance**	**Carrying Amount**	**Bank Balance**
Unrestricted	**$ 40,920**	**$ 47,464**	$ 40,441	$ 50,496
Restricted:				
Held by the Trustee	**281,624**	**281,624**	287,183	287,183
Held by the Authority	**529,220**	**529,220**	140,053	140,053
	$ 851,764	**$ 858,308**	$ 467,677	$ 477,732

Custodial Credit Risk - Deposits

Custodial credit risk is the risk that in the event of a bank failure, the Bank's deposits may not be returned. The Authority's policy is to deposit funds with either institutions which provide insurance or securities as collateral. Such collateral is held by the Department of the Treasury of the Commonwealth, or with GDB, another component unit of the Commonwealth, which are uninsured and uncollateralized.

All moneys deposited with the Trustee or any other Depositary hereunder in excess of the amount guaranteed by the Federal Deposit Insurance Corporation or other Federal agency are continuously secured by lodging with a bank or trust company approved by the Authority and by the Trustee as custodian, or, if then permitted by law, by setting aside under control of the trust department of the bank holding such deposit, as collateral security, Government Obligations or other marketable securities.

4. Accounts Receivable

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

	2008	2007
Electric and related services:		
Government agencies and municipalities	**$ 357,257**	$ 316,620
Residential, industrial, and commercial	**611,773**	460,387
Recoveries under fuel adjustment clause under (over) billed	**5,487**	(38,989)
Unbilled services	**230,578**	186,077
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	**18,980**	18,980
Miscellaneous accounts and others	**22,021**	23,978
	1,246,096	967,053
Allowance for uncollectible accounts	**(143,756)**	(88,228)
	1,102,340	878,825
Recovery from insurance companies and other	**167,733**	109,261
Accrued interest on investments	**2,773**	6,481
Less other non-current receivables, mostly related to the Commonwealth	**(101,734)**	(98,577)
	$ 1,171,112	$ 895,990

On October 29, 1991, the Authority entered into an agreement with the Commonwealth for the payment of the outstanding fuel adjustment subsidy receivable amounting to approximately $94 million. Under this agreement, the Commonwealth was paying that amount over a fifteen-year period in installments of approximately $6.3 million per year, without interest. As of June 30, 2004, the outstanding fuel adjustment subsidy receivable amounted to approximately $31.6 million. In June 2004, the Legislature of the Commonwealth of Puerto Rico superseded the 1991 agreement with a revised agreement containing an eight-year payment schedule that totals $55.7 million. The amount owed to the Authority under the 2004 agreement includes an allocation for past due government account receivables in addition to the unpaid balance of the fuel adjustment subsidy. As of June 30, 2008 and 2007, the outstanding receivable amounted to approximately $18.9 and $43.1 million, respectively, of which the fuel adjustment subsidy receivable amounted to $18.9 million.

4. Accounts Receivable (continued)

In addition, the Authority has other subsidies and reimbursable costs receivable from the Commonwealth, which are reduced by means of charges (accounted for as a contribution in lieu of taxes and to the extent net revenues, as defined, are available) against a portion of the 11% of gross electric sales, after the contribution in lieu of taxes to municipalities, it is required to set aside under the Act. The portion of such receivables and other governmental receivables not expected to be collected during the next fiscal year are reflected in the accompanying balance sheets as other noncurrent receivables.

5. Restricted Assets

At June 30, 2008 and 2007, certain investments and cash deposits of the Authority were restricted to comply with long-term principal and interest debt service requirements (sinking funds) as well as for self-insurance. These restricted assets are held by the Trustee under the 1974 Agreement (see Note 3) in the following funds:

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

1974 Self-Insurance Fund – Fund to pay the cost of repairing, replacing or reconstructing any property damaged or destroyed from, or extraordinary expenses incurred as a result of a cause, which is not covered by insurance required under the 1974 Agreement. The 1974 Self-Insurance Fund also serves as an additional reserve for the payment of the principal of and interest on the Power Revenue Bonds, and meeting the amortization requirements to the extent that moneys in the Bond Service Account, the Redemption Account and the 1974 Reserve Account are insufficient for such purpose. During fiscal year 2007-2008, the Authority withdrew $25.4 million from 1974 Self-Insurance Fund to cover uninsured losses associated with the Palo Seco Steam Plant fires. In addition, the Authority deposited $5 million to 1974 Self-Insurance Fund.

Bond Service Account and Redemption Account (1974 Sinking Fund) – Current year requirements for principal of and interest on Power Revenue Bonds. As of June 30, 2008 and 2007, cash and cash equivalents in this account amounted to $281.6 million and $287.2 million, respectively.

5. Restricted Assets (continued)

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

	2008	**2007**
1974 Reserve Account	**$ 287,832**	$ 273,108
1974 Self-insurance Fund	**51,086**	68,922
1974 Sinking Fund	**–**	5,834
	$ 338,918	$ 347,864

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

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

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

Reserve Maintenance Fund – Fund to pay the cost of unusual or extraordinary maintenance or repairs, not recurring annually, and renewals and replacements, including major items of equipment. The Reserve Maintenance Fund also serves as an additional reserve for the payment of principal of and interest on the Power Revenue Bonds and meeting the amortization requirements to the extent that moneys in the 1974 Sinking Fund, including money in the 1974 Reserve Account, are insufficient for such purpose. During fiscal year 2007-2008 and 2006-2007, the Authority withdrew $58.3 million and $9.4 million, respectively, from 1974 Reserve Maintenance Fund to finance the recovery of the Palo Seco Steam Plant. In addition, the Authority deposited $9.7 million and $5.0 million, respectively, to 1974 Reserve Maintenance Fund to replenish using the proceeds from insurance companies.

5. Restricted Assets (continued)

At June 30, the 1974 Construction Fund and Reserve Maintenance Fund consist of (in thousands):

	2008		2007	
	Cash and Cash Equivalents	**Investments**	**Cash and Cash Equivalents**	**Investments**
1974 Construction Fund	**$ 529,220**	**$ 38,045**	$ 140,005	$ 185,921
Reserve Maintenance Fund	**–**	**569**	48	48,192
	$ 529,220	**$ 38,614**	$ 140,053	$ 234,113

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

	2008	**2007**
U.S. Government obligations	**$ 924**	$ 49,105
Certificate of deposit	**37,690**	185,008
	$ 38,614	$ 234,113

5. Restricted Assets (continued)

Investments

The following table provides a summary of the Authority's investments by type at June 30, 2008 (in thousands):

	Coupon Rate	Maturity Dates	Face Value	Fair Value	% of Total Portfolio
1974 Reserve Maintenance Fund					
Certificate of Deposits	1.35%	07/2008	$ 569	$ 569	100.0%
			Total Portfolio	**569**	
1974 Self Insurance Reserve Fund					
Federal Home Loan Mortgage Corp.	3.60 to 5.05%	08/2010 to 02/2011	20,000	20,359	39.9%
Federal Home Loan Bank	3.13 to 3.38%	06/2010 to 05/2011	30,000	30,068	58.8%
Certificates of Deposit	2.050%	07/2008	659	659	1.3%
			Total Portfolio	**51,086**	
1974 Reserve Account					
Federal Home Loan Mortgage Corporation	3.50 to 4.75%	11/2011 to 01/2013	60,000	60,116	20.9%
Federal Home Loan Bank	3.375 to 4.40%	07/2008 to 02/2012	51,410	51,683	18.0%
Federal National Mortgage Association	3.125 to 5.085%	06/2010 to 03/2013	100,000	100,903	35.1%
Federal Farm Credit Bank	3.80 to 3.90%	03/2012 to 02/2013	40,000	40,170	13.9%
Certificates of Deposit	2.05 to 2.30%	07/2008	34,960	34,960	12.1%
			Total Portfolio	**287,832**	
1974 Construction Fund					
Other – Rural Electrification Administration (REA) Investment			924	924	2.4%
Certificate of Deposit	3.00%	12/2008	37,121	37,121	97.6%
			Total Portfolio	**38,045**	
				$377,532	

5. Restricted Assets (continued)

Credit Risk

Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. This is measured by the assignment of a rating by a nationally recognized statistical rating organization. The 1974 Trust Agreements limits investments in:

- Government obligations, which are direct obligations of, or obligations whose principal and interest is guaranteed by the U.S. Government, or obligation of certain of its agencies or instrumentalities.

- Investment obligation of any of the states or territories of the United States or political subdivisions therefore (other than obligations rated lower than the three highest grades by a nationally recognized rating agency) and repurchase agreements with commercial banks fully secured by U.S. Government Obligations.

- Time deposits with GDB or the Authority's Trustee under the 1974 Agreement or any bank or trust company member of the Federal Deposit Insurance Corporation having a combined capital and surplus of not less than $100 million.

As of June 30, 2008, the Authority's investments in Federal Home Loan Mortgage, Federal Home Loan Bank, Federal National Mortgage Association and Federal Farm Credit Bank were rated AAA by Standard & Poor's and Aaa by Moody's Investors Service.

Concentration Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of investment in a single issuer by five percent or more of total investment. The Authority's investment policy does not contain a limitation to invest in the securities of single issuer. As June 30, 2008, more than 5% of the Authority's total investments are in Federal Home Loan Mortgage, Federal Home Loan Bank, Federal National Mortgage Association, Federal Farm Credit Bank, and Certificate of Deposits.

5. Restricted Assets (continued)

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. In accordance with the 1974 Trust Agreement, the Authority manages its exposure to declines in fair values by limiting the maturity of its investment portfolio up to 5 years. Information about the sensitivity of the fair values of the Authority's investment to market interest fluctuations is provided by the following table that shows the distribution of the investments by maturity as of June 30, 2008 (in thousands):

		Investment Maturities		
Investment Type	**Fair Value**	**Less than 1 year**	**1-5 years**	**Total**
Federal Home Loan Mortgage	$ 80,475	$ –	$ 80,475	$ 80,475
Federal Home Loan Bank	81,751	11,627	70,124	81,751
Federal National Mortgage	100,903	–	100,903	100,903
Federal Farm Credit Bank	40,170	–	40,170	40,170
Certificate of Deposits	73,309	73,309	–	73,309
Other – REA Investment	924	–	924	924
				$ 377,532

6. Utility Plant

As of June 30, utility plant consists of:

	2008	2007
	(In thousands)	
Distribution	**$ 2,491,417**	$ 2,410,780
Transmission	**1,305,372**	1,174,126
Production	**1,799,070**	1,753,574
Other production	**691,083**	680,850
Hydroelectric	**107,593**	102,499
General	**1,558,640**	1,410,763
Irrigation systems	**31,898**	33,880
Fiber Network	**16,328**	3,714
	8,001,401	7,570,186
Less accumulated depreciation	**(4,383,884)**	(4,128,229)
	3,617,517	3,441,957
Construction in progress	**2,556,476**	2,312,611
	$ 6,173,993	$ 5,754,568

Utility plant activity for the years ended June 30, 2008 and 2007 was as follows (in thousands):

	2007 Beginning Balance	**Increases**	**Decreases**	**Transfers**	**2008 Ending Balance**
Utility plant	$ 7,570,186	$ –	$ (39,662)	$ 470,877	**$ 8,001,401**
Construction work in progress	2,312,611	714,742	–	(470,877)	**2,556,476**
Total utility plant	9,882,797	714,742	(39,662)	–	**10,557,877**
Less:					
Accumulated depreciation	(4,128,229)	(295,317)	39,662	–	**(4,383,884)**
Total utility plant, net	$ 5,754,568	$ 419,425	$ –	$ –	**$ 6,173,993**

6. Utility Plant (continued)

	2006 Beginning Balance	Increases	Decreases	Transfers	2007 Ending Balance
Utility plant	$ 7,235,232	$ –	$ (20,489)	$ 355,443	$ 7,570,186
Construction work in progress	2,067,384	600,670	–	(355,443)	2,312,611
Total utility plant	9,302,616	600,670	(20,489)	–	9,882,797
Less:					
Accumulated depreciation	(3,864,955)	(283,763)	20,489	–	(4,128,229)
Total utility plant, net	$ 5,437,661	$ 316,907	$ –	$ –	$ 5,754,568

Construction work-in-progress at June 30, 2008 and 2007 consists principally of expansions and upgrades to the electric generation, distribution and transmission systems.

7. Defeasance of Debt

In prior years, the Authority has refunded in advance certain Power Revenue Bonds and other obligations by placing the proceeds of new debt in an irrevocable trust to provide for future debt service payments on such bonds. Accordingly, the trust accounts, assets, and liabilities for the defeased bonds are not included in the Authority's financial statements. At June 30, 2008, $3,199 million of Power Revenue Bonds which remain outstanding are considered defeased.

8. Notes Payable

On July 2, 2003, the Authority and GDB entered into an agreement for a line of credit of $68 million to fund payments required under a settlement agreement relating to certain litigation with the municipalities of Puerto Rico. On December 22, 2006, this line of credit was refinanced with a term loan of $64.2 million between the Authority and certain commercial banks. As of June 30, 2008, the balance outstanding is $57 million, of which $48.1 million is considered long term.

On March 26, 2004, the Authority and GDB entered into an agreement for a line of credit of $25.3 million to be used for financing the improvements of Isabela irrigation system. The Authority expects that this line of credit will be paid by the Commonwealth of Puerto Rico from the proceeds of future bond issues. As of June 30, 2008, $10.2 million have been drawn on this line of credit and the outstanding balance is $6.1 million.

8. Notes Payable (continued)

On April 23, 2004, the Authority and GDB entered into an agreement for a line of credit of $57 million for electric infrastructure projects in the Municipalities, which is outstanding as of June 30, 2008.

On December 30, 2004, the Authority and a commercial bank entered into an agreement for selling at discount the funds assigned by the Legislature of Puerto Rico through Joint Resolution 1290 of August 24, 2004, to pay the amount owed by the Commonwealth regarding the subsidy to qualified clients and certain accounts receivables from the government agencies. The proceeds of the transaction were $41.5 million. The note bears interest between 2.6% to 4.44%. The Authority expects that this note will be paid by annual appropriation by the Commonwealth of Puerto Rico of $6.3 million until fiscal year 2012 and a final payment of $5.1 million on fiscal year 2013, according to Joint Resolution 1290. As of June 30, 2008, the outstanding balance is $26.9 million of which $21.7 million is considered long-term.

On July 1, 2005, the Authority and certain commercial banks entered into an agreement for a revolving line of credit to be used for financing fuel purchases. Under the agreement, the Authority borrowed $125 million. On October 31, 2005 and June 30, 2008, the line of credit was amended to increase the amount to $175 million and $225 million, respectively, which is outstanding. The average effective interest rate during each year and at year-end was 4,46% and 4.26%, respectively, for 2008; and 5.52% and 5.50%, respectively, for 2007.

On November 15, 2005, the Authority and GDB entered into an agreement for a line of credit of $200 million to be used as interim financing for a portion of the cost of various projects under its capital improvement program. As of June 30, 2007, this line of credit was refinanced with a bridge loan of $200 million between the Authority and JP Morgan Chase Bank National Association. As of June 30, 2008, the outstanding balance is $200 million.

On September 13, 2007, the Authority and GDB entered into an agreement for a line of credit of $100 million to be used in the recovery of Palo Seco Steam Plant. As of June 30, 2008, the outstanding balance is $50 million.

On December 19, 2007, the Authority and Banco Bilbao Vizcaya Argentaria (BBVA) entered into an agreement for a line of credit of $100 million to be used in the recovery of Palo Seco Plant. As of June 30, 2008, the outstanding balance is $100 million.

As of June 30, 2008, PREPA.Net has a revolving line of credit of $2 million for working capital purposes and the outstanding balance is $350,000.

8. Notes Payable (continued)

Short-term debt activity for the years ended June 30, 2008 and 2007 was as follows:

	2008	2007
	(In thousands)	
Balance at beginning of year	**$ 436,766**	$ 493,316
Proceeds and transfers from long-term debt	**329,672**	114,434
Payments of short-term debt	**(113,930)**	(170,984)
Balance at end of year	**$ 652,508**	$ 436,766

9. Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities for the years ended June 30, 2008 and 2007 was as follows:

	2008	2007
	(In thousands)	
Accounts payable, accruals, and withholdings in process of payment	**$ 630,960**	$ 515,539
Additional accruals and withholdings:		
Injuries and damages and other	**22,373**	24,931
Accrued vacation and payroll benefits	**57,396**	54,647
Accrued sick leave and payroll benefits - exclusive of benefits to be liquidated after one year of approximately $123.5 million in 2008 and $128.7 in 2007	**32,111**	23,639
Accrued compensation	**24,240**	17,596
Accrued pension plan contribution and withholding from employees:		
Employees' Retirement System	**13,432**	36,049
Employees health plan	**20,125**	20,815
Contribution in lieu of taxes	**40,613**	34,539
Other accrued liabilities	**13,632**	21,289
	$ 854,882	$ 749,044

10. Other Current Liabilities Payable from Restricted Assets

	2008	2007
	(In thousands)	
Contract retainage	**$ 26,642**	$ 29,966
Other liabilities	**53,125**	48,260
	$ 79,767	$ 78,226

11. Long-Term Debt

At June 30, long-term debt consists of:

	2008	2007
	(In thousands)	
Power Revenue Bonds payable:		
Publicly offered at various dates from 1992 to 2005, interest rates ranging from 3.0% to 7.0%, maturing to 2035	**$ 6,167,780**	$ 5,667,265
Rural Utility Services (RUS) issues - interest rate of 5%, maturing through 2028	**27,422**	28,175
	6,195,202	5,695,440
Less unamortized discount and debt reacquisition costs	**(32,215)**	(47,731)
Revenue bonds payable, net	**6,162,987**	5,647,709
Notes payable	**693,884**	480,061
	6,856,871	6,127,770
Less current portion of long-term debt	**(341,335)**	(363,358)
	$ 6,515,536	$ 5,764,412

11. Long-Term Debt (continued)

Long-term debt activity for the years ended June 30, 2008 and 2007 was as follows:

	2008	**2007**
	(In thousands)	
Long-term debt excluding current portion	**$ 6,127,770**	$ 5,261,366
New issues:		
Power revenue bonds	**697,345**	643,530
Power revenue refunding bonds	**–**	1,857,445
Debt discount on new bond issues – net	**4,905**	125,527
Defeasance of bonds	**–**	(1,860,025)
Debt discount and excess reacquisition costs on cancelled bonds – net	**–**	(95,133)
Notes payable	**226,100**	448,100
	7,056,120	6,380,810
Payments:		
Power revenue bond – July 1	**(197,202)**	(191,509)
Power revenue bond – January 1	**(381)**	(363)
Notes payable	**(12,277)**	(72,874)
Total payments	**(209,860)**	(264,746)
Amortization of debt discount and excess reacquisition costs	**10,611**	11,706
Balance at end of year	**$ 6,856,871**	$ 6,127,770
Current portion of Notes Payable	**$ 14,093**	$ 12,277
Current portion of Power Revenue Bonds	**327,242**	351,081
Total current portion	**$ 341,335**	$ 363,358

11. Long-Term Debt (continued)

Power Revenue Bonds Payable

During fiscal year 2008, the Authority issued its Power Revenue Bonds, Series WW for the purpose of paying a portion of the cost of its Capital Improvements Program (CIP).

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

Principal amount of the Bonds	$ 697,345,000
Plus:	
Net original issue premium	8,853,673
Proceeds	$ 706,198,673
Application of net proceeds:	
Deposit to 1974 Construction Fund	$ 650,004,640
Capitalized interest on Bonds through July 1, 2009	37,120,672
Underwriting discount and estimated legal, printing and other financing expenses	19,073,361
Application of proceeds	$ 706,198,673

Maturities of the Power Revenue Refunding Bonds Series WW issued during fiscal year 2008 range from July 1, 2010 to July 1, 2038. The Series WW Bonds bear fixed interest rates ranging from 5% to 5.5%. Interest on the Series WW Bonds is payable on each January 1 and July 1.

11. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

During fiscal year 2007, the Authority issued its Power Revenue Bonds, Series TT, UU and VV. In addition, the Authority issued the Series, UU and VV Bonds pursuant to Section 210 of the 1974 Agreement to refund blocks of the following previous bond issues summarized below:

Series	**Principal Amount Refunded**
	(In thousands)
Series AA	$ 62,335
Series DD	318,480
Series FF	24,035
Series HH	342,180
Series II	493,960
Series NN	345,780
Series RR	273,255
Total refunded	$1,860,025

The refunding permitted the Authority to realize savings on its debt service requirements on bonds outstanding under the 1974 agreement. Reduction of the total debt service payments over the next 29 years is $146,197,241. This will generate an economic gain (difference between present value of the old and new debt service payments) of $105,563,509. The Authority deposited the net proceeds of the Series UU and VV Power Revenue Refunding Bonds with the 1974 trustee, as escrow agent. The net proceeds were invested in Government Obligations, the principal of and interest on which when due, will provide moneys sufficient to pay the redemption price of the Refunded Power Revenue Bonds on and the interest coming due on the Refunded Power Revenue Bonds through their respective dates of redemption.

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

The Authority issued the Power Revenue Bonds, Series TT for the purpose of paying a portion of the cost of its CIP.

11. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

A summary of the net proceeds of the Power Revenue Bonds, Series TT, Series UU, and Series VV application of the proceeds follows:

Principal amount of Series TT Bonds	$ 643,530
Principal amount of Series UU Refunding Bonds	1,300,035
Principal amount of Series VV Refunding Bonds	557,410
Plus:	
Net original issue premium	139,202
Other available moneys	34,397
Proceeds	$ 2,674,574
Application of net proceeds:	
Deposit to Escrow Fund for Refunded Power Revenue Bonds	$ 1,966,281
Deposit to 1974 Construction Fund	450,001
Repayment of Government Development Bank Line of credit	200,000
Capitalized interest on Series TT Bonds through January 1, 2008	20,581
Underwriting discount, municipal bond issuance premium and estimated legal, printing and other financing expenses	37,711
Costs of Issuance	$ 2,674,574

Maturities of the Power Revenue Refunding Bonds Series TT issued during fiscal year 2007 range from July 1, 2017 to July 1, 2037. The Series TT Bonds bear fixed interest rates ranging from 4.20% to 5%. Interest on the Series TT Bonds is payable on each January 1 and July 1.

11. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

Maturities of the Power Revenue Bonds Series UU issued during fiscal year 2007 range from July 1, 2010 to July 1, 2031. The Series UU Bonds bear fixed and variable interest rates ranging from 4.00% to 5.00%. The fixed rate bonds are payable on each January 1 and July 1. The variable rate bonds are payable on each January 1, April 1, July 1 and October 1.

Maturities of the Power Revenue Refunding Bonds Series VV issued during fiscal year 2007 range from July 1, 2020 to July 1, 2035. The Series VV Bonds bear fixed interest rates ranging from 5.25% to 5.50%. Interest on the Series VV Bonds is payable on each January 1 and July 1.

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

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

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

Interest Rate Swap Agreements

To protect against the potential of rising interest rates, the Authority entered into quarterly separate pay-fixed, receive-variable interest rate swaps at a cost anticipated to be less than what the Authority would have paid to issue fixed-rate debt.

11. Long-Term Debt (continued)

Interest Rate Swap Agreements (continued)

The terms, fair values and credit ratings of the outstanding swaps as of June 30, 2008, were as follows:

Associated Power Revenue Bonds	Notional Amount	Effective Date	Maturity Date	Fixed Rate	Fair Value
LIBOR Bonds, Series UU	$169,531,850	May 3, 2007	July 2, 2029	4.080%	$ (7,705,022)
LIBOR Bonds, Series UU	123,762,250	May 3, 2007	July 1, 2025	4.232%	(5,413,437)
LIBOR Bonds, Series UU	225,597,150	May 3, 2007	July 1, 2031	4.286%	(11,150,044)
LIBOR Bonds, Series UU	61,107,750	May 3, 2007	July 1, 2025	4.232%	(2,706,495)
LIBOR Bonds, Series UU	83,343,150	May 3, 2007	July 2, 2029	4.080%	(3,841,877)
LIBOR Bonds, Series UU	111,092,850	May 3, 2007	July 1, 2031	4.286%	(5,549,240)
Muni-BMS Bonds, Series UU	25,525,000	May 3, 2007	July 3, 2017	4.014%	(324,395)
Muni-BMS Bonds, Series UU	17,000,000	May 3, 2007	July 2, 2018	4.054%	(230,805)
Muni-BMS Bonds, Series UU	29,055,000	May 3, 2007	July 1, 2020	4.124%	(446,297)
Total	$846,015,000				$(37,367,612)

The notional amounts of the swaps match the principal amounts of the associated Power Revenue Bonds.

During fiscal year 2007-2008, the payments of fixed rate interest from the Authority exceeded the amount received as variable interest rate from swap counter parties by $4.8 million.

11. Long-Term Debt (continued)

Interest Rate Swap Agreements (continued)

Using rates as of June 30, 2008, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same for their term, were as follows. These debt service requirements are included in the scheduled maturities of long-term debt disclosed further on this note. As rates very, variable-rate bond interest payments and net swap payments will vary.

Fiscal Year Ending June 30	Principal	Interest	Interest Rate Swap, Net	Total
2009	$ –	$ 20,932,163	$ 14,551,351	$ 35,483,514
2010	–	20,932,163	14,551,351	35,483,514
2011	–	20,932,163	14,551,351	35,483,514
2012	–	20,932,163	14,551,351	35,483,514
2013	–	20,932,163	14,551,351	35,483,514
2014-2031	846,015,000	245,608,840	174,578,313	420,187,153
Total	$846,015,000	$350,269,655	$247,335,068	$597,604,723

As of June 30, 2008, the swaps had a negative fair value of approximately $37.4 million. The negative fair value of the swaps may be countered by reduction in future net interest payments required on the variable-rate Power Revenue Bonds, creating higher synthetic rates.

As of June 30, 2008, the Authority was not exposed to credit risk because the swaps had a negative fair value in the amount of the swaps' fair value. However, should interest rates change and the fair value of the swap become positive, the Authority would be exposed to credit risk in the amount of the derivative's fair value. The swaps counterparties were rated Aa2 and Aaa as issued by Moody's Investor Services (Moody's), AA- and AA by Standard & Poors (S&P), and AA- by Fitch Ratings.

11. Long-Term Debt (continued)

Interest Rate Swap Agreements (continued)

The derivative contract uses the International Swaps and Derivatives Association, Inc. master agreement, which includes standard termination events, such as failure to pay bankruptcy. The Authority or the counterparties may terminate the swaps if the other party fails to perform under the terms of the contracts. Also, the swaps may be terminated by the Authority if the counterparties' credit quality rating falls below Baa1 as issued by Moody's or BBB+ as determined by S&P. If at the time of termination the swap has a negative fair value, the Authority would be liable to the counterparty for a payment equal to the swap's fair value.

Forward Swap Agreements

On September 5, 2007, the Authority entered into two forward floating-to-fixed interest-rate swap transaction relating to the bonds (Forward Swap Agreement) with UBS AG and Goldman Sachs Capital Markets for two thirds and one third, respectively, of a notional amount of $600 million in Power Revenue Bonds to be issued by the Authority. The transaction will expire on September 1, 2008 or the date before the bonds will be issued, if earlier than September 1, 2008. The transactions fixed rate was established a 3.652 percent per annum.

On June 26, 2008, the Authority paid to the aggregate amount of $13.5 million to the counterparties to terminate the Forward Swap Agreement with the proceeds of Power Revenue Bonds, Series WW.

Notes Payable

On September 13, 2006, the Authority and Citibank, N.A., as Administrative Agent, entered into an agreement for a revolving line of credit of $400 million to be used for interim finance of a portion of the cost of various projects under its Capital Improvement Program. As of June 30, 2008, the outstanding balance of line of credit is $400 million.

On December 22, 2006, the Authority and certain commercial banks entered into an agreement for a revolving line of credit of $200 million to be used for operational purposes. As of June 30, 2008, the outstanding balance is $200 million.

On February 28, 2008, PREPA Net and a financial institution entered into an agreement for a loan of $10.1 million to be used in the acquisition of a subsidiary, Ultramarinas de P.R. (ULTRACOM). As of June 30, 2008, the outstanding balance is $10.1 million.

11. Long-Term Debt (continued)

Scheduled Maturities of Long-Term Debt

The scheduled maturities of long-term debt with interest thereon at June 30, 2008, are as follows:

Fiscal Year Ending June 30	Principal	Interest	Total
		(In thousands)	
2009	$ 951,136	$ 430,434	$ 1,381,570
2010	196,102	293,675	489,777
2011	193,739	283,521	477,260
2012	201,163	273,889	475,052
2013	231,023	263,429	494,452
2014-2018	1,170,700	1,141,131	2,311,831
2019-2023	1,294,923	843,868	2,138,791
2024-2028	1,253,445	525,748	1,779,193
2029-2033	930,690	254,242	1,184,932
2034-2038	466,165	64,365	530,530
Total	6,889,086	4,374,302	11,263,388
Less:			
Unamortized discount and premium	197,418	–	197,418
Excess reacquisition costs	(229,633)	–	(229,633)
Interest	–	(4,374,302)	(4,374,302)
Total long-term debt	6,856,871	–	6,856,871
Current portion, net of discount and excess reacquisition costs of bonds	(327,242)	–	(327,242)
Current portion of notes payable	(14,093)	–	(14,093)
Total current portion	(341,335)	–	(341,335)
Long-term debt, excluding current portion	$ 6,515,536	$ –	$ 6,515,536

12. Employees' Retirement Benefits

Pension Plan

Plan Description

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

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

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

Funding Policy and Annual Pension Cost

The contribution requirements of plan members and the Authority are established and may be amended by the Authority. The Annual Pension Cost (APC) and the Annual Required Contribution (ARC) were computed as part of an actuarial valuation performed as of June 30, 2006 and projected to June 30, 2008, based on current year demographic data.

12. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System

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

Supplemental Pension Obligations Exchanged for Forfeited Sick Leave Benefits

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

The Authority’s annual pension cost for the year ended June 30, 2008 and related information for the Plan and supplemental benefits follows:

	Pension Plan
Contribution rates:	
Authority	21. 75%
Plan members	10.00%
Annual pension cost (thousands)	$76,290
Contributions made and accruals (thousands)	$75,995
Actuarial valuation date	6/30/2006
Actuarial cost method	Entry age
Amortization method	Level percentage of pay, closed (4% payroll increases per year)

12. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System (continued)

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

	Pension Plan
Remaining amortization period	30 years
Asset valuation method	3-year smoothed market
Actuarial assumptions:	
Investment rate of return (net of administrative expenses)*	8.5%
Projected salary increases*	5.0%
*Includes inflation at	3.0%
Cost-of-living adjustments	8% per year for yearly pension up to $3,600 and 4% per year for yearly pension between $3,600 and $7,200, 2% per year for yearly pension in excess of $7,200. The minimum adjustment is $300 per year. The maximum is $600 per year.

12. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System (continued)

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

Trend Information
(In millions)

Fiscal Year Ending	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
Pension Plan			
06/30/00	39.9	100%	$0.0
06/30/01	35.0	100%	0.0
06/30/02	43.0	100%	0.0
06/30/03	50.6	100%	0.0
06/30/04	65.0	81%	12.3
06/30/05	69.9	100%	12.6
06/30/06	74.8	100%	12.9
06/30/07	74.6	100%	13.2
06/30/08	76.3	100%	13.5

The annual required contribution amounted to $76.0 million in 2008 and $74.3 million in 2007.

Other Post-Employment Benefits (OPEB)

Postemployment Health Plan

Plan Description – PREPA Retired Employees Healthcare Plan (Health Plan) is a single-employer defined benefit healthcare plan administered by the Authority. The Health Plan provides hospital, surgical, regular medical, supplementary major medical (organ transplant, nuclear medicine test and others), dental and prescription drug coverage to eligible retirees and their spouse.

12. Employees' Retirement Benefits (continued)

Other Post-Employment Benefits (OPEB) (continued)

Postemployment Health Plan (continued)

Membership – All retired employees, their legal spouses, and certain disable dependents are eligible to participate in the Postretirement Health Plan. To remain eligible for participation, Medicare eligible retired participants and their spouses must enroll in Medicare Part B at age 65, or whenever eligible, at their own expenses. The benefit provisions to retired employees are established and may be amended by the Authority.

Funding Policy and Annual OPEB Cost – The required contribution is based on projected pay-as-you-go financing requirements. The contribution requirements of plan members and the Authority are established and may be amended by the Authority. The contribution requirements of members and the Authority are established and may be amended by the Authority.

The Annual OPEB Cost is calculated based on the Annual Required Contribution of the employer (ARC), an amount actuarially determined in accordance with the provisions of GASB Statement No. 45. The ARC represents a level of funding that, if paid on ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities over a period not to exceed thirty years. The following table shows the components of the Authority's annual OPEB cost for the fiscal year 2007-2008, the amount actually contributed of the health plan, and change in the Authority's net OPEB obligation to Health Plan (in thousands):

Annual OPEB cost (or ARC)	$ 259,266
Actuarial Accrued Liability (AAL)	$3,375,046
Unfunded AAL	$3,375,046
Funded Ratio	0%
Annual Covered Payroll	$ 348,929

For the fiscal year ended June 30, 2008, the Authority's annual OPEB expense of $189.5 million is not equal to the Annual Required Contribution of $259.3 million. For this amount, the payment to medical plan for retirees and their beneficiaries, which totaled $69.8 million, is included in Administrative and General Expenses.

12. Employees' Retirement Benefits (continued)

Other Post-Employment Benefits (OPEB) (continued)

Postemployment Health Plan (continued)

OPEB Actuarial Valuation – The Authority's other Post-Employment Benefits Program actuarial valuation was conducted by Buck Consultants, LLC as of September 5, 2008, members of the American Academy of Actuaries. The valuation was performed in accordance with GASB Statement No. 45 requirements.

Actuarial Methods and Assumptions

Actuarial Valuation Date	September 5, 2008
Actuarial Cost Method	Projected Unit Credit
Amortization method	Level Dollar Amortization over 30 years
Remaining Amortization Period	29 years
Actuarial Assets Valuation Method	Not applicable
Healthcare Inflation Rate:	
Medical	Start at 9% decreasing by 1% to an ultimate rate of 5%
Prescription drug	Start at 10% decreasing by 1% to an ultimate rate of 5%
Dental	Fixed 4%
Investment Rate of Return	4% (unfunded rate)
Projected Salary Increases	4%
Employee Contribution	$372 annual average

The required schedule of funding progress included as supplementary information (Schedule I) presents multiyear trend information about whether the actuarial value of plan assets is increasing or decreasing over time relative to the actuarial accrued liability for benefits.

12. Employees' Retirement Benefits (continued)

Other Post-Employment Benefits (OPEB) (continued)

Postemployment Health Plan (continued)

Calculations are based on the types of benefits provided under the terms of the substantive plan at the time of each valuation and on the pattern of sharing of costs between the employer and plan members to that point. The projection of benefits for financial reporting purposes does not explicitly incorporate the potential effects of legal or contractual funding limitations on the pattern of cost sharing between the employer and plan members in the future.

The actuarial calculations reflect a long-term perspective. Consistent with that perspective, actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets

13. Revenues from Major Clients and Related Parties

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

	2008	**2007**
	(In thousands)	
Governmental sector, principally instrumentalities, agencies and corporations of the Commonwealth of Puerto Rico	**$ 505,991**	$ 444,410
Municipalities	**187,365**	159,912
	$ 693,356	$ 604,322

14. Net Assets

Restricted assets at June 30, 2008 and 2007 include $307.6 million and $315.2 million, respectively, which have been appropriated principally to comply with long-term principal and interest debt services requirements and a reserve for damaged or destroyed property of the Authority not fully covered by insurance as required by the 1974 Agreement. Funds set aside for self-insurance purposes are deposited in the Self-Insurance Fund held by the Trustee (see Note 5).

15. Claim for Extra Fuel Expense

The Authority expects insurance companies to cover higher fuel price and other costs associated with alternate generation capacity in connection with two fires on the Authority's generating units (see Note 17). The Authority holds a self-insured retention of the first 30 days after the date of the fires for extra expenses amounting to $19.4 million for the fiscal year ended June 30, 2007.

16. Contribution in Lieu of Taxes

	2008	**2007**
	(In thousands)	
Municipalities	**$ 187,365**	$ 159,912
Commonwealth:		
Hotels	**6,689**	5,634
Fuel adjustment subsidy	**24,299**	26,969
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	**26**	76
	$ 218,379	$ 192,591

17. Commitments and Contingencies

Environmental Matters

Facilities and operations of the Authority are subject to regulations under numerous Federal and Commonwealth environmental laws, including the Clean Air Act, Clean Water Act, Oil Pollution Act (OPA), Resource Conservation Recovery Act (RCRA), Comprehensive Environmental, Response, Compensation and Liability Act (CERCLA) and Underground Storage Tanks, among others. In February 1992, the Environmental Protection Agency (EPA) performed an inspection of various facilities of the Authority and became aware of deficiencies in different areas, principally air opacity; water quality; spill prevention control and countermeasures; and underground storage tanks.

The Authority and EPA undertook negotiations to resolve the issues regarding the deficiencies observed during the inspection and to ensure future compliance with all applicable laws and regulations. As a result of the negotiations, the Authority and EPA reached an agreement that resulted in a Consent Decree approved by the United States District Court for the District of Puerto Rico on March 19, 1999. In the Consent Decree, the Authority agreed to pay a civil penalty of $1.5 million, which has already been paid, and to implement environmental supplemental projects amounting to $4.5 million, which have already been funded to the full extent required by the Consent Decree. In addition, the Consent Decree requires that the Authority improves and implements compliance programs and operations in order to assure compliance with environmental laws and regulations.

Since the Consent Decree became effective, several Notices of Dispute Resolution were filed with the United States District Court for the District of Puerto Rico to contest EPA’s interpretation of the applicable method to determine visible emission from the generating units, EPA’s determination that the Costa Sur power plant was a repetitious violator of the visible emission requirements of the Consent Decree, and several other notices of violation issued by EPA regarding the applicable method to determine visible emission.

The parties reached an agreement to settle such Notices and lodged a Consent Decree Modification at the United States District Court for the District of Puerto Rico on June 24, 2004. A major program within the agreement was the reduction in two steps of the sulfur content in No. 6 fuel oil at the Authority’s southbound power plants to 0.75% or less by March 1, 2005 and to 0.50% or less by March 1, 2007. Currently, the requirements under this program have been fulfilled. The Authority believes that the agreement enables the Authority to take additional measures that will enhance its ability to comply with the Consent Decree.

17. Commitments and Contingencies (continued)

Environmental Matters (continued)

In general, the Authority is consistently achieving a level of compliance with in-stack opacity requirements and the Clean Water Act regulations equal or greater of 99%. Also, as of today the Authority had finished with the requirements of the Spill Prevention, Control and Countermeasures regulation under the Consent Decree.

Efforts are on-going to complete pending cooling seawater thermal discharge under the Clean Water Act “National Pollutant Discharge Elimination System” operating permits program, for the four Thermoelectric Power Plants. Specifically for South Coast Power Plant, extensive negotiations led to a cooperative effort as to which alternative should be develop under a Detail Evaluation Engineer Review (DEER). Meetings have been conducted at different stages of the work plan to address and keep informed the Guayanilla Community Group. Conversations are still in progress to determine the specific route through the two corridors identified for an Offshore Submerged Discharge. Draft National Pollutant Discharge Elimination System (NPDES) permit for South Coast Power Plant was issued by EPA in September 30, 2008. As expected, it included a work plan for the alternative development and its permitting process. Conversations with the Army Corps of Engineer as part of the permitting process required are in its initial stages.

The fieldwork of the Aguirre 316 Demonstration Study finished in May 2004 and the Final Report was submitted by May 2005.

The Authority submitted to EPA the reports and waiver requests, pursuant to the Clean Water Act-Section 316(a) Thermal Waiver, for the San Juan and Palo Seco power plants on July 11, 1997 and November 18, 1997, respectively. EPA issued a new NPDES Permit for the San Juan Power Plant in April 2007, including the approval of the 316(a) Waiver

Commitments to Purchase Power

In October 1994, the Authority signed a contract with AES Puerto Rico, L.P. (AES) to purchase power of approximately 454 megawatts generated from a coal fluidized bed combustion facility. The term of the agreement is for twenty-five (25) years. This project commenced operations in November 2002.

17. Commitments and Contingencies (continued)

Commitments to Purchase Power (continued)

In March 1995, the Authority also signed a contract with EcoEléctrica, L.P. (EcoEléctrica) to purchase power of approximately 507 megawatts from a gas-fired combined cycle power plant. The term of the agreement is for twenty-two (22) years. This project has been in operation since 2000.

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

Risk Management

The Authority is exposed to various risks of losses related to torts; thefts of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. The Authority obtains insurance policies covering all-risk property (excluding transmission and distribution lines), boiler and machinery and public liability. The all-risk property and boiler and machinery policies have a combined coverage of $750 million per occurrence. The policies' self-retention in case of earthquake and windstorm losses is $25 million, $2 million for all other covered risks and $10 million for Boiler and Machinery. The public general liability policy covers property damage and bodily injury to third parties with a $75 million aggregate limit in excess of the self-retention limit of $1 million per occurrence.

The Authority considers its Self-insurance Fund sufficient to provide for its self-insurance risk (see Note 5). Claims expenditures and liabilities are recorded when it is probable that a loss has occurred and the amount of that loss can be reasonably estimated.

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

17. Commitments and Contingencies (continued)

Risk Management (continued)

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

Changes in the balances of the health insurance program (self-insurance risk) incurred but no recorded (IBNR) during fiscal years 2008 and 2007 were as follows:

	Liability Beginning Balance	Expenses	Payments	Liability Ending Balance
		(In thousands)		
2007	$ 25,329	$ 119,978	$ 134,034	$ 11,273
2008	**$ 11,273**	**$ 132,358**	**$ 136,477**	**$ 7,154**

Contingencies

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

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

17. Commitments and Contingencies (continued)

Contingencies (continued)

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

On April 14, 2003, the Authority made a settlement offer consisting of a payment in cash of $68 million and $57 million for electric infrastructure projects in the municipalities. As part of the settlement agreement, the municipalities supported an amendment to the Act that was proposed by the Authority, that the amount payable to municipalities is calculated based on a percentage of the net revenues defined on the 1974 Agreement.

During fiscal year ended June 30, 2003, 37 municipalities accepted this settlement, receiving an amount of $26.1 million. During fiscal year ended June 30, 2004, 38 additional municipalities accepted the settlement as well, receiving $37.5 million. During fiscal year ended June 30, 2006, the last two municipalities accepted the settlement offer, receiving $4.4 million.

The settlement provided for the Authority to changes its legislation on CILT calculation, which the Authority did. The new law signed in August 2004 included a transitory clause regarding the $68 million payment, stating that this amount was a special CILT that the accepting municipalities would received, with monies provided by Government Development Bank for Puerto Rico (GDB), while the Authority would repay to GDB and guarantee with monies to be allocated as special CILT in an 8-year term. The settlement was retroactive starting in 2003.

17. Commitments and Contingencies (continued)

Contingencies (continued)

In connection with the same litigation, GDB approved a line of credit of $57 million for electric infrastructure projects on municipalities, which is outstanding as of June 30, 2008.

In June 2004, the Office of the Comptroller of the Commonwealth of Puerto Rico (the Comptroller) issued a report stating that the Authority overcharged its clients by approximately $49.8 million, and should reimburse this amount to such clients. After this report was made public, two lawsuits were filed by clients of the Authority against the Authority demanding the reimbursement of such alleged overcharges. The Authority's position is that the Comptroller incorrectly based his conclusion on data that is not relevant to the calculation of the Authority's rates, and that the Authority's rates were properly established in the year 2000 in accordance with applicable laws and regulations. In particular, the Authority notes that its rates properly take into consideration the cost of the fuel used by the Authority's generating facilities and the cost of the electricity purchased from the two co-generating facilities that sell power to the Authority.

On December 2006, two fires damaged one of the Authority's generating units and the control room, which controls all four units located at Palo Seco Plant. As a result, 602 MW of oil-fired capacity, representing 11% of the Production Plant installed dependable capacity was unavailable. On November 4, 2007, Unit No. 2 of Palo Seco Plant was synchronized and in operation and on April 24, 2008, Unit No. 1 was synchronized and in operation, with a combine production of 170 MW, representing 3% of the Production Plant installed dependable capacity.

The Authority submitted claims to insurance companies for $315.2 million, including extra fuel expenses, and has received payments of $5 million during the fiscal year ended June 30, 2007 and $142.6 million during the fiscal year ended June 30, 2008, for a total amount of $147.6 million. As of June 30, 2008, receivable for this concept amounts to approximately $167.6 million.

17. Commitments and Contingencies (continued)

Construction and Other Commitments

As of June 30, 2008, the Authority has commitments of approximately $465.1 million on active construction, maintenance and engineering services contracts.

18. Significant New Accounting Pronouncement

In September 2006, the GASB issued Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfers of Assets and Future Revenues.* This Statement establishes criteria that governments will use to ascertain whether certain transactions should be regarded as a sale or a collateralized borrowing. Such transactions are likely to comprise the sale of delinquent taxes, certain mortgages, student loans, or future revenues such as those arising from tobacco settlement agreements.

In addition to clarifying guidance on accounting for sales and pledges of receivables and future revenues, the Statement:

- Requires enhanced disclosures pertaining to future revenues that have been pledged or sold,
- Provides guidance on sales of receivables and future revenues within the same financial reporting entity,
- Provides guidance on recognizing other assets and liabilities arising from the sale of specific receivables or future revenues.

The requirements of this Statement are effective for financial statements for periods beginning after December 15, 2006.

In November 2006, the GASB issued Statement No. 49, *Accounting for Financial Reporting for Pollution Remediation Obligations.* The Statement identifies the circumstances under which a governmental entity would be required to report a liability related to pollution remediation. According to the Statement, a government would have to estimate its expected outlays for pollution remediation if it knows a site is polluted and any of the following recognition triggers occur:

- Pollution poses an imminent danger to the public or environment and a government has little or no discretion to avoid fixing the problem,

18. Significant New Accounting Pronouncement (continued)

- A government has violated a pollution prevention-related permit or license,
- A regulator has identified (or evidence indicates a regulator will do so) a government as responsible (or potentially responsible) for cleaning up pollution, or for paying all or some of the cost of the clean up,
- A government is named in a lawsuit (or evidence indicates that it will be) to compel it to address the pollution,
- A government begins to clean up pollution or conducts related remediation activities (or the government legally obligates itself to do so).

Liabilities and expenses would be estimated using an "expected cash flows" measurement technique, which will be employed for the first time by governments. Statement No. 49 also would require governments to disclose information about their pollution remediation obligations associated with clean-up efforts in the notes to the financial statements.

Statement No. 49 is effective for financial statements for periods beginning after December 15, 2007.

In May 2007, the GASB issued Statement No. 50, *Pension Disclosures*, which more closely aligns current pension disclosure requirements for governments with those that governments are beginning to implement for retiree health insurance and other post-employment benefits.

Specifically, Statement 50 amends GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans,* and No. 27, *Accounting for Pensions by State and Local Governmental Employers,* by requiring:

- Disclosure in the notes to the financial statements of pension plans and certain employer governments of the current funded status of the plan—in other words, the degree to which the actuarial accrued liabilities for benefits are covered by assets that have been set aside to pay the benefits—as of the most recent actuarial valuation date.
- Governments that use the aggregate actuarial cost method to disclose the funded status and present a multi-year schedule of funding progress using the entry age actuarial cost method as a surrogate; these governments previously were not required to provide this information.
- Disclosure by governments participating in multi-employer cost-sharing pension plans of how the contractually required contribution rate is determined.

18. Significant New Accounting Pronouncement (continued)

The provisions of Statement No. 50 generally are effective for periods beginning after June 15, 2007, with early implementation encouraged. The requirements relating to governments using the aggregate actuarial cost method are effective for financial statements and required supplementary information that contains information from actuarial valuations as of June 15, 2007, or later.

In June 2007, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets,* to provide guidance regarding how to identify, account for, and report intangible assets.

The new standard characterizes an intangible asset as an asset that lacks physical substance, is nonfinancial in nature, and has an initial useful life extending beyond a single reporting period. Examples of intangible assets include easements, computer software, water rights, timber rights, patents, and trademarks.

Statement No. 51 requires that intangible assets be classified as capital assets (except for those explicitly excluded from the scope of the new standard, such as capital leases). Relevant authoritative guidance for capital assets should be applied to these intangible assets.

Statement No. 51 provides additional guidance that specifically addresses the unique nature of intangible assets, including:

- Requiring that an intangible asset be recognized in the statement of net assets only if it is considered identifiable
- Establishing a specified-conditions approach to recognizing intangible assets that are internally generated (for example, patents and copyrights)
- Providing guidance on recognizing internally generated computer software
- Establishing specific guidance for the amortization of intangible assets.

The requirements Statement 51 are effective for financial statements for periods beginning after June 15, 2009. The GASB made significant changes to the transition provisions, based on constituent response to the proposed version of the standards, to make it easier for governments to implement.

18. Significant New Accounting Pronouncement (continued)

In June 2008, GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. Statement 53 is intended to improve how state and local governments report information about derivative instruments—financial arrangements used by governments to manage specific risks or make investments—in their financial statements. The Statement specifically requires governments to measure most derivative instruments at fair value in their financial statements that are prepared using the economic resources measurement focus and the accrual basis of accounting. The guidance in this Statement also addresses hedge accounting requirements and is effective for financial statements for reporting periods beginning after June 15, 2009, with earlier application encouraged.

19. Subsequent Events

In March 2008 (with effective date of July 1, 2008), the Authority entered into a Basis-Swap Agreement in the notional amount of $1.375 billion with an amortization schedule matching certain maturities of the Authority's outstanding power revenue and revenue refunding bonds issued in various years from 2027 to 2037. Under the terms of a master swap agreement, the Authority will receive from its counterparty (an affiliate of Goldman, Sachs & Co.) commencing on October 1, 2008 a floating amount applied to said notional amount at a rate equal to 62% of the taxable London Inter-Bank Offering Rate (LIBOR) index reset each week plus 29 basis points (hundredths of a percent) and a fixed rate payment of 0.4669% per annum (the "basis annuity"), quarterly for the term of swaps in return for quarterly payments by the Authority, commencing also on October 1, 2008, on such notional amount at a rate based on the Securities Industry and Financial Markets Association (SIFMA) municipal swap index. This basis swap provides the Authority the cash flow benefit of the basis annuity in exchange for the Authority taking other basis risks tied to the change in the relationship between LIBOR and the SIFMA municipal swap index.

On September 5, 2008, the line of credit used for financing fuel purchases was amended to increase its amount from $225 to $275 million.

On November 26, 2008, the Authority and GDB entered into an agreement for a line of credit of $150 million to comply with cash collateral requirements related to the Basis Swap Agreement between the Authority and Goldman Sachs.

19. Subsequent Events (continued)

As of December 22, 2008, the Authority received $56.8 million from insurance companies related to its Palo Seco Plant claim.

The recent events in the financial marketplace and the downturn of the economy, both from a worldwide and United States perspective has, and will continue to have, and impact on the Authority. The Authority is currently evaluating its alternatives to mitigate these factors and improve its financial condition.

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

To the Governing Board
Puerto Rico Electric Power Authority

We have audited the financial statements of Puerto Rico Electric Power Authority (the Authority) as of and for the year ended June 30, 2008, and have issued our report thereon dated December 23, 2008. Our report was modified to include a reference to other auditors. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

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Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

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

We noted certain matters that we reported to management of the Authority in a separate letter dated December 23, 2008.

This report is intended solely for the information and use of the Authority's Governing Board, others with the Authority, federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

Ernst + Young LLP

December 23, 2008

Stamp No. 2368408
affixed to
original of
this report.

Required Supplementary Information

Puerto Rico Electric Power Authority

Supplementary Schedule of Funding Progress

June 30, 2008

(In millions)

Actuarial Valuation Date	Actuarial Value of Assets (a) Note 1	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b) - (a)	Funded Ratio (a)/(b)	Covered Payroll (c)	UAAL Percentage Of Covered Payroll [(b) - (a)]/(c)
Pension Plan:						
6/30/97	$1,084	$1,333	$249	51%	$271	92%
6/30/98*	1,268	1,495	227	85%	274	83%
6/30/99**	1,443	1,538	95	94%	277	34%
6/30/00	1,550	1,799	250	86%	278	90%
6/30/01	1,547	1,964	417	79%	290	144%
6/30/02	1,441	2,012	572	72%	298	192%
6/30/03	1,337	2,137	799	63%	306	262%
6/30/04	1,294	2,139	846	60%	335	252%
6/30/05	1,338	2,203	866	61%	249	248%
6/30/06	1,403	2,280	877	62%	349	251%
6/30/2007	1,488	2,313	826	64%	349	237%
Postemployment Health Plan:						
6/30/07	–	3,375	3,375	0%	349	967%

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

***** Estimated valuation, projected from actual 6/30/98 valuation.

****** Estimated valuation, projected from actual 6/30/99 valuation. Does not reflect benefit improvements effective January 1, 2000.