

# **PUERTO RICO ELECTRIC POWER AUTHORITY**

**Combined Financial Statements and  
Supplementary Information  
June 30, 1998 and 1997**

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## **Report of Independent Accountants**

*October 2, 1998, except with respect to  
Note 18 d, as to which the date is  
December 1, 1998*

To the Governing Board of  
Puerto Rico Electric Power Authority:

In our opinion, the accompanying combined balance sheets and the related combined statements of income, changes in capitalization, and of cash flows present fairly, in all material respects, the financial position of Puerto Rico Electric Power Authority (a component unit of the Commonwealth of Puerto Rico) at June 30, 1998 and 1997, and the results of their operations and their cash flows for each of the two years then ended, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Authority's management; our responsibility is to express an opinion on these combined financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

As discussed in Note 2-L to the combined financial statements, the Authority adopted in 1998 the provisions of Governmental Accounting Standard Board Statement No. 27 "Accounting for Pensions by State and Local Governmental Employers".

Our audits were made for the purpose of forming an opinion on the basic combined financial statements taken as a whole. The supplementary information listed in the preceding table of contents is not a required part of the basic combined financial statements but is supplementary information required by the Government 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 supplementary information. However, we did not audit the information and express no opinion on it.

CERTIFIED PUBLIC ACCOUNTANTS (of Puerto Rico)  
Licensed No 216 Expires Dec. 1, 1998  
Stamp 1534233 of the P.R. Society of  
Certified Public Accountants has been  
Affixed to the file copy of this report

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**COMBINED BALANCE SHEETS**  
**June 30, 1998 and 1997**  
**(In Thousands)**

	1998	1997
<b>ASSETS</b>		
Utility plant:		
Plant in service	\$ 4,673,454	\$ 4,198,595
Accumulated depreciation	<u>(2,035,286)</u>	<u>(1,866,919)</u>
	2,638,168	2,331,676
Construction in progress	<u>837,015</u>	<u>919,290</u>
Utility plant, net	3,475,183	3,250,966
Other properties	<u>-</u>	<u>12,141</u>
Total utility plant and other properties	<u>3,475,183</u>	<u>3,263,107</u>
Restricted assets:		
Cash and investments held by trustees for payment of certain liabilities and other specific purposes	216,993	202,957
Investments held by trustees	311,552	303,364
Construction fund and other special funds	<u>367,542</u>	<u>161,948</u>
Total restricted assets	<u>896,087</u>	<u>668,269</u>
Current assets:		
Cash and cash equivalents	82,237	81,533
Receivables - net	367,664	325,859
Fuel oil - at average cost	36,175	49,544
Materials and supplies - at average cost	149,000	137,430
Prepayments and other assets	<u>10,699</u>	<u>12,024</u>
Total current assets	<u>645,775</u>	<u>606,390</u>
Other non-current receivables	<u>87,011</u>	<u>104,797</u>
Deferred debits:		
Unamortized debt expense	24,970	23,846
Other	<u>15,932</u>	<u>14,890</u>
Total deferred debits	<u>40,902</u>	<u>38,736</u>
Total assets	<u>\$ 5,144,958</u>	<u>\$ 4,681,299</u>

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**COMBINED BALANCE SHEETS, Continued**  
**June 30, 1998 and 1997**  
**(In Thousands)**

<b>CAPITALIZATION AND LIABILITIES</b>		
	<b>1998</b>	<b>1997</b>
Capitalization:		
Contributed capital	\$ 139,983	\$ 139,983
Retained earnings	<u>241,264</u>	<u>203,720</u>
	381,247	343,703
Long-term debt, excluding current portion	<u>3,710,045</u>	<u>3,311,349</u>
Total capitalization	<u>4,091,292</u>	<u>3,655,052</u>
Noncurrent liabilities:		
Sick leave benefits to be liquidated after one year	129,143	129,028
Supplemental spouse survivor benefits	47,676	42,069
Pension benefits exchanged for forfeited sick leave	<u>4,975</u>	<u>13,724</u>
Total noncurrent liabilities	<u>181,794</u>	<u>184,821</u>
Current portion of long-term debt and notes payable which will be paid from restricted assets	<u>226,721</u>	<u>210,932</u>
Current liabilities:		
Notes payable - Government Development Bank	5,000	5,000
Notes payable - banks	125,000	125,000
Accounts payable and accrued liabilities	310,491	312,968
Accrued Interest	101,681	90,575
Customers' deposits	101,745	95,012
Current portion of obligations under capital leases	<u>1,234</u>	<u>1,939</u>
Total current liabilities	<u>645,151</u>	<u>630,494</u>
Total capitalization and liabilities	<u>\$ 5,144,958</u>	<u>\$ 4,681,299</u>

The accompanying notes are an integral part of these financial statements.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**COMBINED STATEMENTS OF INCOME**  
For the years ended June 30, 1998 and 1997  
(In Thousands)

	<b>1998</b>	<b>1997</b>
Operating revenues	<u>\$ 1,695,845</u>	<u>\$ 1,637,802</u>
Operating expenses:		
Operations:		
Fuel	625,346	648,900
Other production	44,114	37,888
Transmission and distribution	89,671	78,650
Customer accounting and collection	74,133	68,587
Administrative and general	141,024	149,339
Maintenance	216,298	218,469
Depreciation	<u>187,156</u>	<u>164,030</u>
Total operating expenses	<u>1,377,742</u>	<u>1,365,063</u>
Operating income	318,103	271,939
Other income, net - principally interest	<u>48,210</u>	<u>37,112</u>
Income before interest charges and contribution in lieu of taxes	<u>366,313</u>	<u>309,051</u>
Interest charges:		
Interest on bonds	216,384	196,551
Interest on other long-term debt	1,348	1,025
Other interest	1,501	5,975
Amortization of debt discount and issuance costs	14,083	13,290
Allowance for funds used during construction	<u>(10,301)</u>	<u>(8,266)</u>
Total interest charges, net	<u>223,615</u>	<u>208,575</u>
Income before contribution in lieu of taxes	142,698	100,476
Contribution in lieu of taxes	<u>105,154</u>	<u>91,686</u>
Net income	<u><u>\$ 37,544</u></u>	<u><u>\$ 8,790</u></u>

The accompanying notes are an integral part of these financial statements.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**COMBINED STATEMENTS OF CHANGES IN CAPITALIZATION**  
*For the years ended June 30, 1998 and 1997*  
(In Thousands)

	<b>Contributed Capital</b>	<b>Retained Earnings</b>	<b>Long-term debt, excluding current portion</b>	<b>Total capitalization</b>
Balance as of June 30, 1996	\$ 120,714	\$ 211,085	\$ 2,947,607	\$ 3,279,406
Transfers to current liabilities			(110,684)	(110,684)
Proceeds from issuance of bonds, net of defeased bonds, original discounts and including accretion of capital appreciation bonds			474,426	474,426
Combination of Irrigation System	19,269	(16,155)		3,114
Net income	<u>          </u>	<u>8,790</u>	<u>          </u>	<u>8,790</u>
Balance as of June 30, 1997	139,983	203,720	3,311,349	3,655,052
Transfers to current liabilities			(118,823)	(118,823)
Proceeds from issuance of bonds, net of defeased bonds, original discounts and including accretion of capital appreciation bonds			517,519	517,519
Net income	<u>          </u>	<u>37,544</u>	<u>          </u>	<u>37,544</u>
Balance as of June 30, 1998	<u>\$ 139,983</u>	<u>\$ 241,264</u>	<u>\$ 3,710,045</u>	<u>\$ 4,091,292</u>

The accompanying notes are an integral part of these financial statements.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**COMBINED STATEMENTS OF CASH FLOWS, Continued**  
**For the years ended June 30, 1998 and 1997**  
**(In Thousands)**

	<b>1998</b>	<b>1997</b>
Cash flows from operating activities:		
Operating income	\$ 318,103	\$ 271,939
Adjustment to reconcile operating income to net cash provided by operating activities:		
Depreciation	187,156	164,030
Amortization of asbestos removal costs	1,843	1,567
Provision for uncollectible accounts	3,800	1,781
Contribution in lieu of taxes	(105,154)	(91,686)
Changes in assets and liabilities:		
Receivables	(25,726)	4,361
Fuel oil	13,369	(20,153)
Materials and supplies	(11,570)	(11,085)
Prepayment and other assets	1,325	(1,728)
Other deferred debits	(2,885)	206
Noncurrent liabilities	(3,027)	8,158
Accounts payable and accrued liabilities	(2,477)	22,897
Customers' deposits	6,733	6,001
Net cash flows provided by operating activities	<u>381,490</u>	<u>356,288</u>
Cash flows from noncapital financing activities:		
Restricted cash and investments held by trustee, net	(14,036)	3,825
Principal paid on general obligation notes	(5,000)	(5,000)
Interest paid on general obligation notes	(615)	(923)
Proceeds from note payable	5,000	-
Principal paid on fuel line of credit	(750,000)	(880,000)
Proceeds from fuel line of credit	750,000	880,000
Interest paid on fuel line of credit	(7,117)	(8,344)
Net cash flows used for noncapital financing activities	<u>(21,768)</u>	<u>(10,442)</u>
Cash flows from capital and related financing activities:		
Construction expenditures	(399,232)	(398,428)
Allowance for funds used during construction	10,301	8,266
Construction funds, net	(205,594)	(146,693)
Power revenue bonds:		
Proceeds from issuance of bonds, net of original discount	992,307	551,337
Principal paid on revenue bonds maturities	(110,139)	(102,970)
Interest paid on revenue bonds	(197,100)	(177,194)
Defeased bonds, net of original discount	(483,490)	(99,085)
Proceeds from bond anticipation notes - GDB	71,300	230,000
Payment of bond anticipation notes	(71,300)	(230,000)
Interest paid on bond anticipation notes	(2,054)	(3,002)
Principal paid on lease obligation	(1,940)	(1,841)
Net cash flows used for capital and related financing activities	<u>(396,947)</u>	<u>(369,610)</u>

The accompanying notes are an integral part of these financial statements.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**COMBINED STATEMENTS OF CASH FLOWS, Continued**  
For the years ended June 30, 1998 and 1997  
(In Thousands)

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	<b>1998</b>	<b>1997</b>
Cash flows from investing activities:		
Purchases of investment securities	\$ (166,738)	\$ (67,136)
Proceeds from sale and maturities of investment securities	158,550	76,649
Interest on investments	<u>46,117</u>	<u>35,969</u>
Net cash flows provided by investing activities	<u>37,929</u>	<u>45,482</u>
Net increase in cash and cash equivalents	704	21,718
Cash and cash equivalents at beginning of year	<u>81,533</u>	<u>59,815</u>
Cash and cash equivalents at end of year	<u>\$ 82,237</u>	<u>\$ 81,533</u>

The accompanying notes are an integral part of these financial statements.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**Notes to Combined Financial Statements**  
**June 30, 1998 and 1997**

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**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's financial statements. The Authority produces, transmits, and distributes substantially all of the electric power consumed in Puerto Rico.

The Authority has broad powers, including, among others, to issue bonds for any of its corporate purposes. The Authority is required under the terms of a Trust Agreement, dated January 1, 1974, as amended ("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 financing obligations, as defined.

On July 1, 1996, the Authority decided to combine the financial operations of the Puerto Rico irrigation systems ("Irrigation Systems") as of and for the years ended after June 30, 1996. For prior years the Authority did not combine the financial position and operations of the Irrigation Systems because of its immateriality.

The Irrigation Systems is a division of the Authority pursuant the provisions of Section 4(b) of the Puerto Rico Water Resources Authority Act, the power vested by Section 24 of said Act, and by Acts Nos. 83 and 84, approved on June 20, 1955 regarding the Puerto Rico Irrigation Service, South Coast, and Isabela Irrigation Service, respectively, and the power vested in the Authority by the Lajas Valley Public Irrigation Law, approved on June 10, 1953, as amended.

**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:

**a. Basis of Accounting:**

The accounting and reporting policies of the Authority conform with the accounting rules prescribed by the Governmental Accounting Standard Board (GASB). Although the Authority is not under Federal Energy Regulatory Commission (FERC) regulations, the Authority has adopted the uniform system of accounts prescribed by FERC.

**b. Utility Plant, Depreciation, and Allowance for Funds Used During Construction (AFUDC):**

Utility plant is carried at cost, which includes labor, materials, overhead, and an allowance for the cost of funds used during construction (AFUDC).

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**June 30, 1998 and 1997**

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Maintenance, repairs, and the cost of renewals of minor items of property units are charged to expense. Replacements of major items of property are charged to the plant accounts. The cost of retired property, together with removal cost, less salvage, is charged to accumulated depreciation with no gain or loss recognized. Depreciation 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 3.91% for 1998 and 1997. AFUDC represents the cost of borrowed funds used to finance the portion of construction work in progress not financed through internally generated funds. 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.

**c. Unamortized Debt Expense:**

Debt expenses and discounts incurred in the issuance of bonds are deferred and amortized using the straight-line method which approximates the interest method. The excess of reacquisition cost over the carrying value of long-term debt is deferred and amortized to expense using the straight-line method over the remaining life of the old debt or the life of the new debt, whichever is shorter.

**d. Materials and Supplies:**

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

**e. Cash Equivalents:**

For purposes of the statements of cash flows, the Authority considers all highly liquid debt instruments purchased with original maturities of three months or less to be cash equivalents. Cash and cash equivalents included in the restricted funds are not included as such in the statements of cash flows.

**f. Asbestos Containment Deferred Costs:**

Maintenance costs incurred in the containment of asbestos are deferred and included in other deferred debits. Such costs are amortized as recovered in billings over an estimated life of 12 years. The Authority estimates future asbestos containment costs of approximately \$30 to \$40 million.

**g. Revenue Recognition and Fuel Costs:**

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

**h. Contribution 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:

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**Notes to Combined Financial Statements**  
**June 30, 1998 and 1997**

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**Municipalities:**

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

**Commonwealth of Puerto Rico:**

To the extent net revenues are available, the Authority is required under the Act, as amended, to set aside 5% of gross electric sales for the purpose of (i) financing of 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 contributions in lieu of taxes in the accompanying statements of income and reduce the related accounts receivables in the balance sheets.

In July 1989, an amendment to the Act was approved which, among other things, changed the amount of the Authority's required contributions in lieu of taxes to the Municipalities. The amendment increased the Authority's contribution in lieu of taxes to the Municipalities by 1%, subject to the Authority's obligation under the 1974 Agreement. The amendment requires an annual payment to the Secretary of the Treasury who is required to distribute the amount so received in each year among the various Municipalities in addition to the year's contribution in lieu of taxes.

As required by the Act, certain residential clients of the Authority are granted a credit for all or part of the cost of fuel adjustments up to a maximum stipulated amount of \$105 million per year.

The Authority, as allowed by the Act, has reduced substantially the number of residential clients who qualify for a fuel adjustment subsidy. The Authority eliminated the subsidy for residential customers other than public housing residents, lifeline customers, university students, the elderly, and the handicapped.

The Act was further amended to provide that (i) an additional 20% of the 5% electric energy sales set aside for the Commonwealth discussed above would be applied against the cost of fuel oil subsidy program arising after June 30, 1991 (with any balance remaining used to reduce the above receivable balance owed to the Authority as of June 30, 1991) (see Note 6), (ii) the regulations of the Authority regarding fuel adjustment subsidy would no longer be subject to the Governor's approval, and (iii) the cost or subsidy amounts arising after June 30, 1991 will be incurred by the Authority and not the Commonwealth.

**i. 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 the rates in effect at the balance sheet date.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**Notes to Combined Financial Statements**  
**June 30, 1998 and 1997**

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The amount accumulated for vacations is the amount adjusted to current salary costs which is expected to be liquidated.

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

**j. Investments:**

The Authority implemented GASB Statement No. 31 "Accounting and Financial Reporting for Certain Investments and for External Investment Pools", which requires that investments should be reported at fair value in the balance sheet for the year ended June 30, 1998. All changes in the fair value of investments, which were not significant for 1998, are charged to operations.

The Authority carried noncurrent investments at amortized cost for the year ended June 30, 1997. If the market value of any of these investments declined below cost and the decline was considered permanent, the investments were written down to the market value and the losses were charged to operations. Realized gains and losses on the sale of investments were charged to operations.

**k. Contributions in Aid of Construction:**

Contributions received in aid of construction are recorded as a reduction of the cost basis of the related property.

**l. Accounting and Financial Reporting:**

The Authority implemented the provisions of GASB Statement No. 20 "Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities that Use Proprietary Fund Accounting", which requires proprietary activities to apply all applicable GASB pronouncements as well as all Financial Accounting Standard Board Statements (FASB) and Interpretations, Accounting Principle Board Opinions and Accounting Research Bulletins issued on or before November 30, 1989, unless the pronouncements conflict or contradict GASB pronouncements. This pronouncement permits the adoption of all FASB Statements and Interpretations issued after November 30, 1989, except for those that conflict or contradict GASB pronouncements. The Authority, as allowed by the GASB, decided not to implement any FASB or Interpretation issued after November 30, 1989.

The Authority also implemented the provisions of GASB Statement No. 27 "Accounting for Pensions by State and Local Governmental Employers", which establishes standards for the measurement, recognition, and display of pension expenditure/expense and related liabilities, assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The adoption of GASB No. 27 resulted in a decrease in liabilities and expenses of \$30.5 million for the year ended June 30, 1998.

**m. Reclassifications:**

Certain reclassifications have been made to the 1997 financial statements to conform with the 1998 financial statements presentation.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**Notes to Combined Financial Statements**  
**June 30, 1998 and 1997**

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**3. UTILITY PLANT:**

As of June 30, utility plant consist of:

	<b>1998</b>	<b>1997</b>
	<b>(In Thousands)</b>	
Production plant	\$ 1,330,785	\$ 1,272,739
Other production plant	481,161	267,099
Hydroelectric plant	82,227	82,090
Distribution plant	1,476,982	1,399,444
Transmission plant	725,659	654,990
General plant	547,252	492,944
Irrigation systems plant	29,388	29,289
	<u>4,673,454</u>	<u>4,198,595</u>
Less accumulated depreciation	<u>2,035,286</u>	<u>1,866,919</u>
	<u><u>\$ 2,638,168</u></u>	<u><u>\$ 2,331,676</u></u>

**4. OTHER PROPERTIES:**

As of June 30, other properties which are carried at cost, not in excess of their estimated net realizable value, consist of:

	<b>1998</b>	<b>1997</b>
	<b>(In Thousands)</b>	
Generating units, construction materials and supplies		
and other properties available for sale and future use	\$ -	\$ 588
Generator held for sale (net of a reserve of \$11,553 in 1998)	<u>-</u>	<u>11,553</u>
	<u><u>\$ -</u></u>	<u><u>\$ 12,141</u></u>

**5. CASH AND INVESTMENTS:**

**a. Cash Deposits:**

At June 30, 1998 and 1997, the carrying amount of cash deposits held by the Authority was \$410.7 million and \$125.1 million, respectively

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

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
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**June 30, 1998 and 1997**

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Pursuant to present statutes, deposits of the Authority shall be in banks designated by the Secretary of the Treasury as depository institutions of public funds. Such deposits shall be guaranteed by sufficient collateral under the name and custody of the Secretary.

**b. Investments:**

Investments are held by the trustee under the 1974 Agreement for 1998 and 1997. The Authority is authorized to invest in:

- Government obligations, which are direct obligations of, or principal and interest thereon is guaranteed by, the United States Government, or obligations of certain of its agencies or instrumentalities.
- Investment obligations, which are U.S. Government Obligations, obligations of any of its states or territories or political subdivisions (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 Government Development Bank ("GDB") or the trustee under the 1974 Agreement or any bank or trust company which is a member of the Federal Deposit Insurance Corporation having a combined capital and surplus of not less than \$100 million

The Authority's investment securities at June 30, 1998 and 1997, were held by the trustee in the Authority's name. Cash deposits, except for minor amounts, are uninsured and uncollateralized, and are held by the trustee primarily for debt service to be made on January 1 and July 1 of each year.

Investments of \$66.2 million in 1998 and \$51.5 million in 1997 have substantially all current maturities but are classified as restricted investments held by the trustee as they are restricted to comply with long-term principal, interest debt service requirements and for self-insurance. Additionally, during the year the Authority invested in various repurchase agreements.

At June 30, cash and investments held by the trustee consist of:

	1998	1997
	(In Millions)	
Cash deposits	\$ 217.2	\$ 190.0
Government and investment obligations (market value was \$311.5 million in 1998 and \$313 million in 1997)	<u>311.3</u>	<u>316.3</u>
	<u>\$ 528.5</u>	<u>\$ 506.3</u>

The Authority has issued bonds pursuant to the 1974 Agreement for 1998 and 1997. Under the provisions of the 1974 Agreement the Authority is required to establish certain fund accounts consisting of cash and investments whose use is limited. The investments, primarily U.S. Government securities, are stated at market value for 1998 and amortized cost for 1997. Interest accruing on investments is credited to the respective accounts when collected. A brief description of the significant funds and limitations on use is as follows:

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**Notes to Combined Financial Statements**  
**June 30, 1998 and 1997**

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**General Purpose Funds:**

General fund, revenue fund, and other general purpose funds received by the Authority, except construction funds obtained through financing, are first deposited in general purpose funds and any balance after payment of current expenses, as defined, is used to fund specific account requirements. Unrestricted balance at June 30, 1998 and 1997 amounted to approximately \$82,237,000 and \$81,533,000, respectively.

**Sinking Funds - Restricted:**

Principal and interest - Current year requirements for principal and interest on Power Revenue Bonds for 1998 and 1997.

1974 Reserve Account Fund - Reserve for payment of principal and interest of serial bonds in the event 1974 sinking funds for such purpose are insufficient and for transfer to the redemption account to meet amortization requirements of term bonds if 1974 sinking funds 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 and interest on the Power Revenue bonds, and meeting the amortization requirements to the extent that moneys in the 1974 Bond Service Account, the 1974 Redemption Account and the 1974 Reserve Account are insufficient for such purpose.

At June 30, investments held by the trustee consist of:

	1998	1997
	(In Thousands)	
Restricted assets:		
1974 Reserve Account Fund	\$ 222,872	\$ 219,120
1974 Self-Insurance Fund	<u>88,680</u>	<u>84,244</u>
	<u>\$ 311,552</u>	<u>\$ 303,364</u>

1974 Construction Fund - A special fund is created by the 1974 Agreement and designated the "Puerto Rico Electric Power Authority Power System Construction Fund" (the "1974 Construction Fund"). The proceeds of any Power Revenue Bonds issued for the purpose of paying the cost of acquiring or constructing improvements, together with the moneys received from any other source for such purpose, except proceeds which are (i) applied to the repayment of advances, (ii) deposited in the 1974 Reserve Account Fund, (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.

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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 the principal of and the interest on the Power Revenue Bonds and meeting the amortization requirements to the extent that moneys in the 1974 Sinking Fund, including moneys in the 1974 Reserve Account Fund, are insufficient for such purpose.

Cogeneration Fund – Fund created on December 15, 1997 pursuant an agreement between the Authority and EcoEléctrica for the purpose of enabling the Authority to pay certain expenses in connection with the Authority's activities concerning cogeneration planning and implementation.

**6. ACCOUNTS RECEIVABLE:**

At June 30, receivables consist of:

	<b>1998</b>	<b>1997</b>
	<b>(In Thousands)</b>	
Electric and related services:		
Government	\$ 164,872	\$ 159,903
Residential, industrial, and commercial	176,929	145,499
Recoveries under fuel adjustment clause under (over) billed	(544)	438
Unbilled services	78,999	82,630
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	56,940	63,294
Other subsidies receivable from the Commonwealth	113	1,679
Accrued interest on investments	6,792	4,699
Miscellaneous accounts and others	4,007	5,044
Allowance for uncollectible accounts	<u>(34,313)</u>	<u>(32,530)</u>
	454,675	430,656
Less other non-current receivables	<u>87,011</u>	<u>104,797</u>
	<u><u>\$ 367,664</u></u>	<u><u>\$ 325,859</u></u>

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 \$94,900,500. Under this agreement, the Commonwealth will pay the outstanding receivable over a fifteen year period in installments of approximately \$6,326,700 per year, without interest. As of June 30, 1998 the outstanding fuel adjustment subsidy receivable amounted to approximately \$56.9 million.

In addition, the Authority has other subsidies and reimbursable costs receivable from the Commonwealth which are reduced by means of charges (accounted for as a contribution in lieu of taxes and to the extent net revenues, as defined, are available) against a portion of the 5% of gross electric sales it is required to set aside under the Act (see Note 2h). 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.

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**7. DEFEASANCE OF DEBT:**

During 1998 and in prior years the Authority has advance refunded certain Power Revenue Bonds and Electric Revenue Bonds by placing the proceeds of new debt in various irrevocable trusts 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, 1998, \$978,833 million of Power Revenue Bonds series M, N, O, P, R and T which remain outstanding, are considered defeased.

**8. LONG-TERM DEBT:**

At June 30, long-term debt consists of:

	1998	1997
	(In Thousands)	
Revenue bonds payable:		
Power revenue bonds:		
Publicly offered, interest ranging from 4.0% to 8.7% maturing to 2024	\$ 3,996,902	\$ 3,536,518
RUS issues - interest of 5%; maturing to 2028	178,802	184,316
	4,175,704	3,720,834
Less unamortized discount and debt reacquisition costs	(248,938)	(209,732)
Revenue bonds payable, net	3,926,766	3,511,102
Notes payable to GDB interest of 6.15%; due in equal installments of \$5,000,000 maturing to 2000	10,000	15,000
Note payable	5,000	-
Obligations under capital leases	1,234	3,118
	3,943,000	3,529,220
Less current portion of long-term debt	232,955	217,871
	<u>\$ 3,710,045</u>	<u>\$ 3,311,349</u>

**a. Revenue Bonds Payable:**

The Authority issued the 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 agreement, and subject to the conditions and limitations set forth therein.

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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 and (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 revenue bonds principal and interest (see Note 5).

On May 8, 1997 the Authority issued \$100.8 million in Power Revenue Bonds with an average interest rate of 5.54% to advance refund \$100 million of outstanding Series A, Power Revenue Bonds. The net proceeds of \$101.3 million, (after a premium of \$2.7 million and payment of \$2.2 in underwriting fees, insurance, and other issuance costs) plus additional moneys of \$2.0 million were used to purchase U.S. securities. Those securities were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments. As a result, the advance refunded bonds are considered defeased and the liability for those bonds has been removed from the accounting records.

Although the advance refund resulted in the recognition of a deferred accounting loss of \$2.5 million for the year ended June 30, 1997, the Authority reduced its aggregate debt service payments by almost \$6.8 million over the next 17 years and obtained an economic gain (difference between the present value of the old and new debt service payments) of \$5.2 million.

In addition, on May 8, 1997, the Authority issued \$464.8 million (gross of original issue discount and financing expenses of \$14.8 million) in Power Revenue Bonds with an average interest rate of 5.74% to finance a portion of the cost of various projects under its capital improvement program and to pay Bond Anticipation Notes.

On July 10, 1997, the Authority issued \$128.7 million Power Revenue Bonds with an average interest rate of 5.13% to advance refund \$127.1 million of outstanding Series N and O. The net proceeds of \$129.7 million (after a premium of \$2 million and payment of \$1 million in underwriting fees, insurance and other issuance costs) were used to purchase U.S. securities. Those securities were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments. As a result, the advance refunded bonds are considered defeased and the liability for those bonds has been removed from the accounting records. The Authority defeased the bonds to reduce its total debt service payments over the next 13 years by almost \$9.6 million, and incurred a deferred accounting loss of \$17.6 million but obtained an economic gain (difference between the net present value of the old and new debt service payments) of \$7.5 million.

On March 26, 1998, the Authority issued \$889.1 million in Power Revenue Bonds with an average interest rate of 5.19% to advance refund \$342.3 million of outstanding P, R and T Power Revenue Bonds and to finance its capital improvement program and to retire bond anticipation notes of the Authority. From the total net proceeds of \$861 million, \$367.4 million (after a discount of \$20.2 and payment of \$11.8 million in underwriting fees, insurance and other issuance costs) were used to purchase U.S. securities. Those securities were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments. As a result, the advance refunded bonds are considered defeased and the liability for those bonds has been removed from the accounting records.

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Although the advance refund resulted in the recognition of a deferred accounting loss of \$33.8 million for the year ended June 30, 1998, the Authority reduced its aggregate debt service payments by almost \$39.8 million over the next 26 years and obtained an economic gain (difference between the present value of the old and new debt service payments) of \$24.8 million.

The remainder proceeds of \$493.6 million of Revenue Bonds were deposited in the Construction Fund and were used to pay Bond Anticipation Notes.

**b. Notes Payable:**

The Authority borrowed \$45,000,000 from GDB pursuant to a nine year notes payable agreement. Proceeds from the notes were used to pay contributions payable to the Employees' Retirement System of the Authority. The principal and interest payments are subordinated to funding requirements of the 1974 Agreement. As of June 30, 1998, the notes had an outstanding balance of \$10,000,000.

On December 15, 1997, the Authority borrowed \$5,000,000 from EcoEléctrica for the purpose of enabling the Authority to pay certain expenses (the "Note") in connection with Authority's activities concerning cogeneration planning and implementation.

The Note bears interest at a rate per annum equal to LIBOR minus three percent (3%) and will be paid at the earliest of various events as described in the Note. As of June 30, 1998, the interest rate was 2.625%.

**c. Obligations Under Capital Leases:**

On February 1, 1995, the Authority entered into various capital lease agreements for certain equipment expiring on January 1, 1999. At June 30, 1998, the gross amount of the equipment in the combined balance sheet approximately \$10,481,000. Amortization of equipment held under capital leases is included with depreciation expense.

The present value of future minimum capital lease payments as of June 30, 1998, follows:

<b>Year Ending June 30,:</b>	<b>(In Thousands)</b>
1999	\$ 1,254
Less amount representing interest	<u>(20)</u>
Present value of net minimum lease payments	1,234
Less current maturities of obligations under capital leases	<u>(1,234)</u>
Obligations under capital leases excluding current maturity	<u>\$ -</u>

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**d. Scheduled Maturities of Long-Term Debt:**

The scheduled maturities of long-term debt at June 30, 1998, including sinking fund debt service requirements, are as follow:

Year Ending June 30,	Power Revenue Bonds	RUS Power Revenue Bonds	Obligations Under Capital Leases (In Thousands)	Notes Payable	Total
1999	\$ 545,893	\$ 21,494	\$ 1,254	\$ 5,000	\$ 573,641
2000	333,283	16,428		5,000	354,711
2001	328,429	15,761			344,190
2002	335,231	15,455		5,000	355,686
2003	334,290	15,718			350,008
2004-2008	1,621,671	68,050			1,689,721
2009-2013	1,370,019	60,572			1,430,591
2014-2018	1,138,684	45,072			1,183,756
2019-2023	735,506	22,102			757,608
2024-2028	367,318	10,775			378,093
<b>Total</b>	<b>7,110,324</b>	<b>201,427</b>	<b>1,254</b>	<b>15,000</b>	<b>7,418,006</b>
<b>Less:</b>					
Unamortized discount	(77,247)				(77,247)
Excess reacquisition costs	(171,691)				(171,691)
Amount representing interest	(3,113,422)	(112,625)	(20)	-	(3,226,067)
<b>Total long-term debt</b>	<b>3,747,964</b>	<b>178,802</b>	<b>1,234</b>	<b>15,000</b>	<b>3,943,000</b>
Current portion, net of discount, excess reacquisition costs and interest	(218,392)	(8,329)	(1,234)	(5,000)	(232,955)
<b>Long-term debt, excluding current portion</b>	<b>\$ 3,529,572</b>	<b>\$ 170,473</b>	<b>\$ -</b>	<b>\$ 10,000</b>	<b>\$ 3,710,045</b>

**9. NOTES PAYABLE - BANKS:**

On July 3, 1995, the Authority, GDB, and certain banks entered into a new agreement for a revolving line of credit to be used for financing fuel purchases. Under the agreement the Authority borrowed \$125 million.

The Authority has \$125 million of credit facilities outstanding for 1998 and 1997, respectively. The average effective interest rate during each year and at year-end was 5.69% and 5.80%, respectively, for 1998 and 5.72% and 5.81%, respectively, for 1997.

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**10. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES:**

Accounts payable and accrued liabilities at June 30, consists of:

	1998	1997
	(In Thousands)	
Accounts payable, accruals, and withholdings in process of payment	\$ 146,127	\$ 150,225
Additional accruals and withholdings:		
Injuries and damages and other	20,328	17,743
Accrued vacation and payroll benefits	55,594	54,921
Accrued sick leave and payroll benefits - exclusive of benefits to be liquidated after one year of approximately \$129 million in 1998 and 1997	10,994	6,880
Accrued accident leave	3,073	3,973
Accrued compensation	16,231	14,498
Accrued (prepaid) pension plan contribution and withholding from employees:		
Employees' Retirement System	(6,879)	1,914
Supplemental unfunded benefit obligation spouse-survivor benefit - exclusive of benefit to be liquidated after one year of approximately \$48 million in 1998 and \$42 million in 1997	2,262	1,977
Supplemental unfunded pension obligation exchanged for forfeited sick leave benefits - exclusive of benefits to be liquidated after one year of approximately \$5 million in 1998 and \$14 million in 1997	20,990	19,782
Payroll taxes and withholdings	70	2,984
Employees health plan	10,987	7,600
Contract retentions	18,750	14,381
Contribution in lieu of taxes	4,568	1,513
Other accrued liabilities	6,496	14,577
	<u>\$ 310,491</u>	<u>\$ 312,968</u>

**11. COMPENSATED ABSENCES:**

The Authority's employees with over 20 years of service are entitled to exchange accrued sick leave for supplemental pension benefits, as discussed in Note 12, and/or be paid in cash the value of such sick leave upon separation from employment. The liability for this benefit obligation was \$140.1 million and \$135.9 million as of June 30, 1998 and 1997, respectively.

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**12. EMPLOYEES' RETIREMENT BENEFITS:**

**a. Pension Plan**

**Plan Description:** All of the Authority's permanent full-time employees are eligible to participate in the Authority Pension Plan, a single employer defined contribution 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 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) with 30 years of service; also, reduced benefits are available with early retirement. The plan was amended on February 9, 1993 providing revised benefits to new employees limiting the maximum retirement basic salary to \$50,000. 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 pension plan is not subject to the requirements of the Employees Retirement Income Security Act of 1974 (ERISA).

**b. Supplemental Benefits not Funded Through the System**

Although all benefits of the Plan are administered by the System, only the pension plan benefits is funded through the System. Supplemental benefits are unfunded and such benefits are reimbursed to the System when paid.

**Supplemental pension obligations exchanged for forfeited sick leave benefits:**

This benefit obligation is unfunded and the expense was recognized in a combination of the accrual and the pay-as-you-go methods, which approximates the actuarial valuation for the year ended June 30, 1997. The benefit obligation is determined by actuarial studies for the year ended June 30, 1998.

An accrual of \$26.0 and \$33.5 million exists as of June 30, 1998 and 1997, respectively. The expense for the years ended June 30, 1998 and 1997 amounted to approximately \$13.5 million and \$21.5 million, respectively.

**Supplemental Spouse Survivor Benefits:**

This benefit obligation is unfunded and the expense was recognised in a combination of the accrual and the pay-as-you-go methods, which approximates the actuarial valuation for the year ended June 30, 1997. The benefit obligation is determined by actuarial studies for the year ended June 30, 1998.

An accrual of \$49.9 and \$44.0 million existed as of June 30, 1998 and 1997, respectively. The expense for the years ended June 30, 1998 and 1997 was \$5.9 million and \$5.3 million, respectively.

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**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 pension benefit obligation was computed as part of an actuarial valuation performed as of June 30, 1997, and projected to June 30, 1998 based on current year demographic data. The Authority's annual pension cost for the current year and related information for each plan follows:

	<b>Pension Plan</b>	<b>Forfeited Sick Leave Benefits</b>	<b>Spouse Survivor Benefits</b>
Contribution rates:			
Authority	10.78%	7.76%	.84%
Plan members	9.31%	0%	0%
Annual pension cost (thousands)	\$ 29,157	\$ 13,447	\$ 5,892
Contributions made (thousands)	29,157	0	0
Actuarial valuation date	6/30/97	6/30/94	6/30/94
Actuarial cost method	Entry age	Unit credit	Unit credit
Amortization method	Level <i>percentage</i> of pay, closed (4.5% payroll increases per year)	Level <i>percentage</i> of pay, closed (4.5% payroll increases per year)	Level <i>percentage</i> of pay, closed (4.5% payroll increases per year)
Remaining amortization period	39 years	39 years	39 years
Asset valuation method	3 - year smoothed market	Not applicable	Not applicable
Actuarial assumptions.			
Investment rate of return (net of administrative expenses)*	8.5%	8.5%	8.5%
Projected salary increases*	6.0%	6.0%	6.0%
*Includes inflation at	3.5%	3.5%	3.5%
Cost-of-living adjustments	From 2% to 8% depending on the annual pension benefits	Not applicable	Not applicable

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<u>Fiscal Year</u> <u>Ending</u>	Three-Year Trend Information (In Millions)		
	<u>Annual</u> <u>Pension</u> <u>Cost (APC)</u>	<u>Percentage</u> <u>of APC</u> <u>Contributed</u>	<u>Net Pension</u> <u>Obligation</u>
<b><u>Pension Plan</u></b>			
6/30/96	\$ 34.6	100%	\$ -
6/30/97	29.0	100%	-
6/30/98	29.2	100%	-
<b><u>Forfeited Sick Leave Benefits</u></b>			
6/30/98	\$ 13.4	0%	\$ 13.4
<b><u>Spouse Survivor Benefits</u></b>			
6/30/98	\$ 5.9	0%	\$ 5.9

**b. Post Retirement Health Benefits:**

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

Costs of benefits provided by the Authority are based on a cost plus plan, except that in 1998 and 1997, the prescribed medicine cost is based on a fixed cost premium. Such costs are recognized as expense as claims are received from the plan administrators, a charge for an administration fee and an accrual for incurred but not reported claims. The costs of health care benefits to retirees amounted to approximately \$24.9 million in 1998 and \$21.2 million in 1997. Currently, 9,721 retirees meet eligibility requirements.

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**13. REVENUES FROM MAJOR CLIENTS AND RELATED PARTIES:**

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

	1998	1997
	(In Thousands)	
Governmental sector, principally instrumentalities, agencies, and corporations of the Commonwealth of Puerto Rico	\$ 210,690	\$ 217,563
Municipalities	84,829	86,782
	<u>\$ 295,519</u>	<u>\$ 304,345</u>

**14. CONTRIBUTION IN LIEU OF TAXES:**

Amounts charged to operations for the years ended June 30 are as follows:

	1998	1997
	(In Thousands)	
Municipalities	\$ 91,954	\$ 78,930
Commonwealth :		
Hotels	2,427	2,214
Fuel adjustment subsidy	8,200	8,224
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	2,573	2,318
	<u>\$ 105,154</u>	<u>\$ 91,686</u>

**15. RETAINED EARNINGS:**

Retained earnings at June 30, 1998 and 1997 include \$88.7 million and 84.2 million, respectively, which have been appropriated principally to provide a reserve for damaged or destroyed property of the Authority not fully covered by Insurance as required by the 1974 Agreement. Funds set aside for self-insurance purposes are deposited in the Self-Insurance Fund held by the Trustee (see Note 5).

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**16. COMMITMENTS AND CONTINGENCIES:**

**a. Environmental Matters:**

Facilities and operations of the Authority are subject to regulations under numerous Federal and Commonwealth environmental laws, including the Clean Air Act, Clean Water Act, and the National Pollutant Discharge Elimination System (NPDES). In February 1992, the Environmental Protection Agency (EPA) performed a multimedia inspection of various facilities of the Authority and noticed deficiencies in different areas mainly air opacity; water quality; spill prevention control and countermeasures; and underground storage tanks. EPA is claiming alleged civil violations of \$50 million dollars. Since 1993, the EPA, the Federal Department of Justice (DOJ) and the Authority have been involved in negotiations to pursue a comprehensive settlement of the case and assure future compliance with applicable regulatory provisions. Among other things, the settlement proposal considers investment in capital improvement and Supplemental Environmental Projects (SEPs) estimated at \$81 million during the five fiscal years ending June 30, 1998. Also, the Authority agreed to use fuel oil not exceeding a sulfur content of 1.5%, a vanadium content of 150 PPM and asphaltenes content of 8% at the generating plants with an additional annual fuel oil cost of approximately \$54 million per year.

On October 27, 1993, DOJ and EPA filed a complaint in the United States District Court for the District of Puerto Rico based upon the above violations notified to the Authority during 1992. The Authority and EPA undertook negotiations to resolve the issues and to ensure future compliance with all applicable regulations. As a result of the negotiations, the Authority and EPA, with the active participation of the United States Department of Justice, reached an agreement which resulted in a proposed Consent Decree. In the proposed Consent Decree, the Authority agreed to pay a civil penalty of \$1.5 million, to implement additional compliance projects costing \$4.5 million, both which the Authority has accrued as of June 30, 1998, and to undertake improvements to its existing compliance programs and its operations in order to assure compliance with environmental laws and regulations.

The Consent Decree was signed on December 19, 1996 and filed on January 10, 1997 in the United States District Court for the District of Puerto Rico for approval. The United States Department of Justice extended the comment period up to June 18, 1997. In January 1998, the Authority, EPA and the United States Department of Justice agreed to include some of the recommendations received during the comment period in a final version of the Consent Decree. This final version was approved by the Authority and EPA, and the United States Department of Justice has moved the Court to enter the Consent Decree if it appears that its approval is in the best public interest.

**b. Commitments:**

On October 11, 1994, the Authority signed a contract with AES Puerto Rico, L.P. (AES) for the purchase of up to 413 megawatt power generated from a coal fluidized bed combustion facility. The Authority will pay its purchased power based on an energy and dependable capacity delivered, as more fully explained in the Agreement.

On March 1995, the Authority also signed a contract with EcoEléctrica, a joint venture of Kenetech Corporation and Enron Corporation, to purchase power from a 461 megawatt gas-fired combined cycle power plant. The Authority will pay its purchased power based on an energy and dependable capacity delivered, as more fully explained in the Agreement. The project is currently under construction.

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**c. 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. Under the property and casualty insurance program the Authority provides coverage, among others, for up to a maximum of \$250,000 for each general and liability claim, and \$2,000,000, for each boiler and machinery and property liability claim. In addition, the property liability policy imposes windstorm and earthquake deductibles at 2% and 5% of the locations value subject to a maximum deductible of \$25 million per occurrence. The Authority purchases commercial insurance for claims in excess of coverage provided through the property and casualty insurance program. The Authority considers its Self-insurance Fund to provide for its self-insurance risk (see Note 5). Claims expenditures and liabilities are reported 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, except that in 1998 and 1997, the prescribed medicine cost is based on a fixed cost premium, covering substantially all employees. The Authority entered into contracts with two plan administrators for the processing, approval and payment of claims plus an administrative fee. The accrual includes claims processed and an estimate for claims incurred but not reported.

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

In addition, the Authority is self-insured for its transmission and distribution lines since June 1993. Transmission and distribution plant amounted to approximately \$2.2 billion at June 30, 1998. The Authority considers its Self-Insurance Fund to provide for its self insurance risk. This fund represents, principally retained earnings and restricted assets set aside for self insurance amounting to approximately \$88.7 million in 1998 and \$84.2 million in 1997.

Changes in the balances of the health insurance program and other self-insurance risks during fiscal years 1998 and 1997 were as follows:

	Liability Beginning Balance	Expenses	Payments	Liability End Balance
		(In Thousands)		
1996 - 1997	\$ 22,892	65,945	59,521	\$ 29,316
1997 - 1998	\$ 29,316	66,389	60,416	\$ 35,289

**d. Contingencies:**

The Authority is party to 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 any ultimate liability, if any, will not have a material effect on the Authority's financial position.

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**17. SUPPLEMENTAL DISCLOSURES OF NONCASH CAPITAL AND FINANCING INFORMATION:**

The accreted value of capital appreciation bonds equals the original principal amount of such capital appreciation bonds plus interest accrued from its date of issuance. During the years ended June 30, 1998 and 1997 the accrued interest on capital appreciation bonds amounted to \$16.4 and \$15.4 million, respectively.

**18. SUBSEQUENT EVENTS:**

- a. On July 23, 1998, the Authority entered into a commitment to issue \$196.8 million Power Revenue Bonds Series FF (the "Bonds") to advance refund \$192.2 million of outstanding Series N and O. The Bonds are expected to be issued on or about April 6, 1999. The Authority is required to issue and the Underwriters for the Bonds are required to purchase the Bonds unless certain condition occur as described in the Official Statement dated July 23, 1998. Upon the issuance of the Bonds, it is expected that the Authority execute a Supplemental Agreement (the "Agreement"), that will create a new Subordinate Obligations Fund to which deposits will be made after certain minimum deposits have been made to the Reserve Maintenance Fund and the monthly deposit requirements to the 1974 Agreement, as more fully described in the Agreement. The Amendment will expand the permitted investments of moneys in the Self-insurance Fund to include equity securities and all other investments permitted by law for the pension system of the Government of Puerto Rico and its instrumentalities, but the Authority must invest in Investment Obligations, at a minimum, the lesser of \$25 million and the entire balance of the Self-insurance Fund.
- b. On September 10, 1998, the Authority issued \$109.7 million Power Bonds with an average interest rate of 5.04% to advance refund \$97.8 million of outstanding Series P and X. The net proceeds of \$106.9 million (after a discount of \$1.7 million and payment of \$2.1 million in underwriting fees, insurance and other issuance costs) were used to purchase U.S. securities. Those securities were deposited in irrevocable trusts with an escrow agent to provide for all future debt service payments. The Authority defeased the bonds to reduce its total debt service payments over the next 23 years by almost \$10.9 million, and incurred in a deferred accounting loss of \$11.6 million but obtained an economic gain (difference between the net present value of the old and new debt service payments) of \$5.2 million.
- c. On September 21, 1998, the Authority's facilities suffered damages from Hurricane Georges. Estimated property damages of approximately \$170 million will be funded through insurance, Federal Emergency Management Agency funds and the Self-insurance Fund. The Authority's accounting policy for major replacements states that no loss will be recognized and the accumulated depreciation will be charged (see Note 2b).  
  
Also, the Authority experienced business interruptions for which it plans to file insurance claims with its insurance carrier.
- d. On December 1, 1998, the Governing Board of the Authority increased the amortization period of the unfunded actuarial liability of the System, as allowed by the GASB's, effective for the year ended June 30, 1998.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
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Schedule of Funding Progress (In Millions)							UAAAL
Actuarial Valuation Date	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL UAAAL (h - a)	Funded Ratio (a/b)	Covered Payroll (c)	Percentage of Covered Payroll (b) - (a)/c	
<b><u>Pension Plan</u></b>							
6/30/95	\$ 891.4	\$ 1,193.6	\$ 302.2	75%	\$ 247.2	122%	
6/30/96	999.9	1,255.6	255.7	80%	261.0	98%	
6/30/97	1,083.8	1,332.7	248.9	81%	270.5	92%	
<b><u>Forfeited Sick Leave Benefits Note 1</u></b>							
6/30/97	\$ -	\$ 213.8	\$ 213.8	0%	\$ 270.5	79%	
<b><u>Spouse Survivor Benefits Note 1</u></b>							
6/30/97	\$ -	\$ 82.7	\$ 82.7	0%	\$ 270.5	31%	

**Note 1:**

Estimated valuation, projected from actual June 30, 1994 valuation.

See accompanying Report of Independent Accountants.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
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**Employees' Retirement System of Puerto Rico Electric Power Authority**  
**Condensed Statements of Plan Net assets**  
**Unaudited**

	<b>(In Thousands)</b>	
	<b>1998</b>	<b>1997</b>
Assets:		
Current assets	\$ 30,451	\$ 47,244
Contribution receivable from the Authority	6,455	1,241
Property and equipment	340	683
Investments and loans receivable	1,246,466	1,055,737
Total assets	1,283,712	1,104,905
Current liabilities	20,292	17,952
Net assets held in trust for pension benefits	<u>\$ 1,263,420</u>	<u>\$ 1,086,953</u>

**Condensed Statements of Changes in Plan Assets**

	<b>1998</b>	<b>1997</b>
Contributions	\$ 63,488	\$ 59,964
Investment income	196,754	109,195
Total additions	260,242	169,159
Deductions	83,775	72,756
Net increase	176,467	96,403
Net assets held in trust for pension benefits:		
Beginning of year	1,086,953	990,550
End of year	<u>\$ 1,263,420</u>	<u>\$ 1,086,953</u>

**Note:**

The System reflects its investments at an average fair market value as of June 30, 1997 and 1998. If the System reflected its investments at fair market value as of June 30, 1998 and 1997, the net asset available for benefits would be increased by \$230,986,802 for 1998 and \$88,569,204 for 1997. The unfunded actuarial accrued liability would be reduced by the same amounts.

See accompanying Report of Independent Accountants.

**PUERTO RICO ELECTRIC POWER AUTHORITY**  
**Supplementary Information**  
**June 30, 1998 and 1997**

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