

# **PUERTO RICO TELEPHONE AUTHORITY AND SUBSIDIARY**

**Financial Statements and Supplementary Information  
for the Years Ended December 31, 1996 and 1995,  
Combining Schedules for the Year Ended  
December 31, 1996, and Independent Auditors' Report**

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**Financial Statements for the Years  
Ended December 31, 1996 and 1995  
and Independent Auditors' Report**

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## **INDEPENDENT AUDITORS' REPORT**

The Governing Board of  
Puerto Rico Telephone Authority:

We have audited the accompanying combined balance sheets of Puerto Rico Telephone Authority and Subsidiary (the "Authority"), a component unit of the Commonwealth of Puerto Rico, as of December 31, 1996 and 1995, and the related combined statements of income and retained earnings and of cash flows for the years then ended. These combined 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 in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements present fairly, in all material respects, the combined financial position of Puerto Rico Telephone Authority and Subsidiary as of December 31, 1996 and 1995, and the combined results of their operations and their cash flows for the years then ended in conformity with generally accepted accounting principles.

March 27, 1997  
(April 7, 1997 as to Note 17)

Stamp No.

affixed to original.

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## **PUERTO RICO TELEPHONE AUTHORITY AND SUBSIDIARY**

### **COMBINED BALANCE SHEETS DECEMBER 31, 1996 AND 1995**

	<b>1996</b>	<b>1995</b>
	<b>(In Thousands)</b>	
<b>ASSETS</b>		
Telephone plant (Notes 2, 6 and 11)	<u>\$ 1,946,955</u>	<u>\$ 1,820,312</u>
Sinking, construction and renewal and replacement funds, including debt securities held to maturity carried at amortized cost of \$ 58,793,408 in 1996 and \$22,633,059 in 1995 (Notes 3 and 4)	<u>81,544</u>	<u>175,994</u>
Current assets:		
Cash and cash equivalents (Note 4)	43,029	23,170
General, in lieu of taxes, and sinking funds (Notes 3 and 4)	96,649	89,745
Accounts receivable, net of allowance for doubtful accounts of \$57,465,000 in 1996 and \$41,406,000 in 1995	255,400	233,572
Accrued unbilled revenues	51,525	53,853
Materials and supplies	59,432	60,485
Prepaid expenses	<u>3,031</u>	<u>2,436</u>
Total current assets	<u>509,066</u>	<u>463,261</u>
Other assets:		
Unamortized debt expense	11,668	12,430
Other	<u>16,281</u>	<u>11,570</u>
Total other assets	<u>27,949</u>	<u>24,000</u>
<b>TOTAL</b>	<u><b>\$ 2,565,514</b></u>	<u><b>\$ 2,483,567</b></u>
<b>CAPITALIZATION AND LIABILITIES</b>		
Capitalization (Notes 5 and 6):		
Paid-in capital and retained earnings	\$ 1,185,294	\$ 1,081,697
Long-term debt, less current portion	<u>859,354</u>	<u>911,936</u>
Total capitalization	<u>2,044,648</u>	<u>1,993,633</u>
Current liabilities:		
Current portion of long-term debt (Note 6)	52,731	45,043
Accounts payable and accrued expenses, including excess of outstanding checks over bank balances	215,755	198,395
Due to affiliate		1,700
Accrued interest	5,855	4,694
Accrued pension costs and compensated absences (Notes 9, 10 and 15)	56,543	70,913
Payments to be made in lieu of taxes (Note 8)	74,358	71,255
Customers' deposits	<u>40,277</u>	<u>37,735</u>
Total current liabilities	<u>445,519</u>	<u>429,735</u>
Other liabilities (Notes 9 and 10)	75,347	60,199

Commitments and contingencies (Notes 11 and 12)		
Total liabilities	<u>520,866</u>	<u>489,934</u>
TOTAL	<u>\$ 2,565,514</u>	<u>\$ 2,483,567</u>

See notes to combined financial statements.

## **PUERTO RICO TELEPHONE AUTHORITY AND SUBSIDIARY**

### **NOTES TO COMBINED FINANCIAL STATEMENTS YEARS ENDED DECEMBER 31, 1996 AND 1995**

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#### **1. ORGANIZATION, REPORTING ENTITY AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

##### ***Organization***

Puerto Rico Telephone Authority (the "Authority") is a public corporation and an instrumentality of the Commonwealth of Puerto Rico created for the purpose of acquiring, developing and operating telephone, telegraph, radio, cable or other communication systems. The Authority is a component unit of the Commonwealth of Puerto Rico.

The Authority is obligated under a Trust Agreement to determine and collect reasonable rates for the use of its communication facilities in order to produce revenues sufficient to cover all operating and financing obligations, as defined in the Trust Agreement.

Puerto Rico Telephone Company (the "Company"), a Delaware corporation and a wholly-owned subsidiary of the Authority, provides local and intra-island long distance telephone services in Puerto Rico. The Company maintains its telephone accounting records in accordance with the rules and regulations of the Federal Communications Commission (FCC) on the accrual basis of accounting in conformity with generally accepted accounting principles applicable to an enterprise fund. The Company is the operating entity of the Authority.

##### ***Use of Estimates***

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

##### ***Principles of Combination***

The combined financial statements include the accounts of the Authority and its wholly-owned subsidiary, Puerto Rico Telephone Company. All significant intercompany balances and transactions have been eliminated in combination, except for transactions attributable to sales and services to regulated operations.

The Authority was affiliated until September 1996 to Puerto Rico Public Broadcasting Corporation (PRPBC), a component unit of the Commonwealth of Puerto Rico, which operates the radio and television stations of the government of the Commonwealth of Puerto Rico. PRPBC has operational autonomy as established by Act No. 7 of January 21, 1987 and, accordingly, the Authority had no equity interest in PRPBC and no financial accountability. The Governor of Puerto Rico appoints the Board of Directors of PRPBC. The Authority's contributions to PRPBC during fiscal years 1996 and 1995 were operating transfers accounted for as a charge to operations. These transfers amounted to \$15,500,000 and \$14,300,000 in 1996 and 1995, respectively.

The Governmental Accounting Standards Board ("GASB") issued in September 1993 Statement No. 20, ***Accounting and Financial Reporting for Proprietary Funds and other Governmental Entities that Use Proprietary Fund Accounting***. This Statement requires that proprietary activities apply all applicable GASB pronouncements as well as Statements and Interpretations issued by the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedures issued on or before November 30, 1989. In addition to applying FASB Statements and Interpretations, APB Opinions, and ARBs issued on or before November 30, 1989, a proprietary activity may also apply all FASB Statements and Interpretations issued after November 30, 1989, except those that conflict with or contradict GASB pronouncements. The Authority and its subsidiary implemented this Statement effective January 1, 1994 and elected to also apply FASB Statements and Interpretations issued after November 30, 1989 that do not conflict with GASB. Implementation of this Statement did not have a significant effect on the Authority's financial condition and results of operations.

The Authority has an investment in Telecomunicaciones Ultramarinas de Puerto Rico, Inc., a corporation organized under the laws of the Commonwealth of Puerto Rico which provides telecommunication services via satellite to radio common carriers. This investment is accounted for under the equity method of accounting.

### ***Telephone Plant***

Telephone plant is stated at the original cost of acquisition or construction. Maintenance, repairs and the cost of removal of minor items of property are charged to expense. Replacements of major items of property are charged to the plant accounts. Property retired or otherwise disposed of in the ordinary course of business, together with the cost of removal, 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. Estimated service lives of the telephone plant fluctuate as follows:

Buildings	22 to 30 years
Central office and transmission equipment	7 to 10 years
Outside plant	9 to 42 years
Other equipment	5 to 24 years

### ***Cash Equivalents and Temporary Cash Investments***

All highly liquid debt instruments with original maturities of three months or less are considered to be cash equivalents. Investments with an original maturity of over three months to one year are not considered cash equivalents and are included as temporary cash investments in the combined balance sheets. Cash and cash equivalents at December 31, 1996 and 1995 of \$43,029,000 and \$23,170,000, respectively, include cash equivalents of \$29,767,000 and \$9,415,000, respectively.

### ***Debt Securities***

Debt securities held to maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts. The Authority has both the intent and the ability to hold these debt securities to maturity.



### ***Allowance for Doubtful Accounts***

The allowance for doubtful accounts is an amount that management believes will be adequate to absorb possible losses on existing receivables that may become uncollectible based on evaluations of the collectibility of the receivables and prior loss experience. Because of uncertainties inherent in the estimation process, management's estimate of losses in the receivables outstanding and the related allowance may change in the near term.

### ***Materials and Supplies***

Inventories of materials and supplies are stated at average cost.

### ***Long Distance, Access, and Billing Services Revenues***

Long distance and access services revenues are derived from long distance calls within Puerto Rico, carrier charges for access to local exchange network, subscriber line charges and other services offered to the long distance carriers under contractual arrangements. Access services revenues are provided based on the participation by the Company in revenue pools with other telephone companies, which were funded by access charges authorized by the FCC and managed by the National Exchange Carrier Association (NECA). Such pooled amounts are subsequently divided among the various telephone companies based upon their respective estimated allocations of costs and investments in providing interstate services.

The billing service revenue is generated based on independent agreements with long distance carriers.

Revenues generated from access services and certain other long distance services have been determined from preliminary allocations and cost studies and are subject to final settlements in subsequent periods (refer to Note 7).

Toll services provided from overseas long distance telecommunications services are recognized when earned regardless of the period in which they are billed to the customer.

### ***Debt Expenses and Discounts***

Debt expenses and discounts are amortized by the interest method over the life of the respective bond issues.

### ***Interest Rate Exchange Agreement***

The Authority entered into an interest rate exchange agreement (SWAP) to reduce the impact of changes in interest rates on its variable interest rates subordinated notes.

### ***New Accounting Pronouncements***

In November 1994, the GASB issued Statement No. 27, ***Accounting for Pensions by State and Local Governmental Employers***. This Statement establishes standards for the measurement, recognition, and display of pension expense and related liabilities, assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. The provisions of this Statement are effective for periods beginning after June 15, 1997. During fiscal year 1995, the Company elected early adoption of this Statement. The implementation of this Statement in fiscal year 1995 resulted in an additional expense of approximately \$27 million, related to the program for the early retirement of salaried employees described in Note 15.

During the year ended December 31, 1996 the Authority adopted the provisions of SFAS No. 121, ***Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of***. This statement applies to long-lived assets, certain identifiable intangibles, and goodwill related to those assets to be held and used, to long-lived assets and certain identifiable intangibles to be disposed of, and requires that the company review such assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment is evaluated by comparing future cash flows undiscounted and without interest charges expected to result from the use of the asset and its eventual disposition to the carrying amount of the asset. The adoption of SFAS 121 during the year ended December 31, 1996 did not have an effect on the Authority's financial position or results of operations.

## 2. TELEPHONE PLANT

Telephone plant at December 31, 1996 and 1995 consists of:

	1996	1995
	(In Thousands)	
Land	\$ 26,612	\$ 26,264
Buildings	290,167	275,690
Central office and transmissio equipment	841,737	747,904
Outside plant	1,545,506	1,357,697
Other equipment	<u>337,912</u>	<u>325,330</u>
Total plant in service	3,041,934	2,732,885
Less accumulated depreciationand amortization	<u>1,275,156</u>	<u>1,111,750</u>
Net plant in service	1,766,778	1,621,135
Construction in progress	<u>180,177</u>	<u>199,177</u>
Total	<u>\$ 1,946,955</u>	<u>\$ 1,820,312</u>

The provision for depreciation approximated 9.0% and 8.4% of the cost of depreciable property in 1996 and 1995, respectively.

### 3. FUNDS

The noncurrent and current funds at December 31, 1996 and 1995 include the following:

	1996 (In Thousands)	1995 (In Thousands)
<b>Noncurrent funds:</b>		
Senior bonds reserve sinking fund	\$ 48,573	\$ 51,189
Construction fund	25,194	72,763
Renewal and replacement fund	<u>7,777</u>	<u>52,042</u>
Total	<u>81,544</u>	<u>175,994</u>
<b>Current funds:</b>		
General fund	2,151	15,311
In lieu of taxes fund	89,269	71,940
Senior bonds service account	5,126	2,389
Subordinated bonds service account	<u>103</u>	<u>105</u>
Total	<u>96,649</u>	<u>89,745</u>
Total funds	<u>\$ 178,193</u>	<u>\$ 265,739</u>

	1996 (In Thousands)	1995 (In Thousands)
Funds are composed of:		
Cash	\$ 4,711	\$ 2,139
Cash equivalents and temporary cash investments	160,820	248,350
Other investments, at cost, which approximates market value	<u>12,662</u>	<u>15,250</u>
Total funds	<u>\$ 178,193</u>	<u>\$ 265,739</u>

The amortized cost, gross unrealized gains and losses and fair value of debt securities as of December 31, 1996 and 1995, are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 1996:</b>				
Obligations of the U.S. Government, its Agencies and Instrumentalities	<u>\$ 58,793</u>	<u>\$ -</u>	<u>\$ 133</u>	<u>\$ 58,660</u>
<b>December 31, 1995:</b>				
Obligations of the U.S. Government, its Agencies and Instrumentalities	<u>\$ 22,633</u>	<u>\$ -</u>	<u>\$ 111</u>	<u>\$ 22,522</u>

The amortized cost and estimated fair value of debt securities as of December 31, 1996, by contractual maturity, are as follows:

	<b>Amortized Cost</b>	<b>Fair Value</b>
Obligations of the U.S. Government, its Agencies and Instrumentalities:		
Within one year	\$ 41,207	\$ 41,207
After one to five years	14,128	13,968
After five years	<u>3,458</u>	<u>3,485</u>
Total	<u>\$ 58,793</u>	<u>\$ 58,660</u>

#### **4. CASH AND FUNDS**

The Trust Agreement requires the investment of funds in federal and state government obligations, repurchase agreements with banks fully secured by government obligations, and in time deposits, certificates of deposit or similar arrangements with the Trustee, Government Development Bank for Puerto Rico (GDB) or any bank or trust company which is a member of the Federal Deposit Insurance Corporation having a combined capital and surplus aggregating not less than \$100,000,000.

The Trust Agreement provides that all deposits in excess of the amount guaranteed by the Federal Deposit Insurance Corporation or other Federal agency shall be continuously secured, for the benefit of the Authority and the holders of the bonds, either (a) by lodging with a bank or trust company approved by the Authority and the Trustee as custodian, or, if then permitted by law, by setting aside under the control of the trust department of the bank holding such deposit, as collateral security, Government Obligations, or with the approval of the Trustee, other marketable securities eligible as security for the deposit of trust funds under applicable regulations of the comptroller of the currency of the United States or applicable Commonwealth of Puerto Rico or state law or regulation, having a market value not less than the amount of such deposit, or (b) granting a preference in the case of the deposit of trust funds. All deposits and investments shall not be subject to lien attachment by creditors other than the bondholders of the Authority.

Pursuant to present statutes, deposits of the Authority and its wholly-owned subsidiary shall be in banks designated by the Secretary of the Treasury of the Commonwealth of Puerto Rico as depository institutions of public funds. Such deposits shall be guaranteed by sufficient collateral under the name and custody of the Secretary of the Treasury.

The Authority's cash and cash equivalents and funds are categorized below to give an indication of the level of risk assumed at December 31, 1996 and 1995. Category 1 includes cash and cash equivalents that are insured or collateralized with securities held by the Authority or by its agent in the Authority's name. Category 2 includes cash and cash equivalents that are collateralized with securities held by the pledging financial institution's trust department or agent in the Authority's name. Category 3 includes cash and cash equivalents that are not collateralized by the pledging financial institution or the pledging institution's trust department or agent, and are not in the Authority's name.

**December 31, 1996**

<b>Cash and Cash Equivalents</b>	<b>Category</b>			<b>Carrying Amount</b>	<b>Bank Balance</b>
	<b>1</b>	<b>2</b>	<b>3</b>		
Cash	\$ 13,262	\$ -	\$ -	\$ 13,262	\$ 13,842
Certificates of deposit	<u>20,000</u>		<u>9,767</u>		
				<u>29,767</u>	<u>29,767</u>
Total	<u>\$ 33,262</u>	<u>\$ -</u>	<u>\$ 9,767</u>	<u>\$ 43,029</u>	<u>\$ 43,609</u>

<b>Funds</b>	<b>Category</b>			<b>Carrying Amount</b>
	<b>1</b>	<b>2</b>	<b>3</b>	
Cash	\$ 4,711	\$ -	\$ -	\$ 4,711
Certificates of deposit	111,313		3,375	114,688
Collateralized mortgage obligations	7,963			7,963
Treasury notes	46,132			46,132
Government National Mortgage Association	2,699			2,699
Federal Home Loan Mortgage Corporation	<u>2,000</u>			<u>2,000</u>
Total	<u>\$ 174,818</u>	<u>\$ -</u>	<u>\$ 3,375</u>	<u>\$ 178,193</u>

**December 31, 1995**

<b>Cash and Cash Equivalents</b>	<b>Category</b>			<b>Carrying Amount</b>	<b>Bank Balance</b>
	<b>1</b>	<b>2</b>	<b>3</b>		
Cash	\$ 13,755	\$ -	\$ -	\$ 13,755	\$ 13,550
Certificates of deposit				<u>9,415</u>	<u>9,415</u>
	<u>9,415</u>				
Total	<u>\$ 23,170</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 23,170</u>	<u>\$ 22,965</u>

<b>Funds</b>	<b>Category</b>			<b>Carrying Amount</b>
	<b>1</b>	<b>2</b>	<b>3</b>	
Cash	\$ 2,139	\$ -	\$ -	\$ 2,139
Certificates of deposit	123,935		117,032	240,967
Collateralized mortgage obligations	10,000			10,000
Treasury notes	7,383			7,383
Government National Mortgage Association	3,250			3,250
Federal Home Loan Mortgage Corporation	<u>2,000</u>			<u>2,000</u>
Total	<u>\$ 148,707</u>	<u>\$ -</u>	<u>\$ 117,032</u>	<u>\$ 265,739</u>

The certificates of deposit classified in category 3 correspond to deposits issued by the Government Development Bank for Puerto Rico, a component unit of the Commonwealth of Puerto Rico. The bank balance of uninsured deposits at December 31, 1996 amounted to \$13,142.

## 5. PAID-IN CAPITAL AND RETAINED EARNINGS

Paid-in capital and retained earnings at December 31, 1996 and 1995 were as follows:

	<b>1996</b>	<b>1995</b>
	<b>(In Thousands)</b>	
Paid-in capital	\$ 24,962	\$ 24,962
Retained earnings	<u>1,160,332</u>	<u>1,056,735</u>
Total	<u>\$ 1,185,294</u>	<u>\$ 1,081,697</u>

Under the terms of the Trust Agreement, the Company is required to pay monthly dividends to the Authority in amounts essentially equal to its revenues less current expenses, excluding depreciation and current debt service requirements. Such dividends are charged against

retained earnings of the Company to the extent available and any excess is accounted for as a return of capital to the Authority.

The investment of the Authority in Puerto Rico Telephone Company at December 31, 1996 is represented by 564 shares of common stock issued and outstanding (545 shares at December 31, 1995), with a par value of \$10 per share.

## 6. LONG-TERM DEBT

Long-term debt at December 31, 1996 and 1995 consists of:

	1996 (In Thousands)	1995
Senior Revenue Bonds:		
Series J:		
Serial, at 7.875% to 8%, due annually from 1995 to 1998, in amounts ranging from \$6,315,000 to \$6,810,000 (net of discount)	\$ 6,810	\$ 13,125
Series K:		
Serial, at 7.875% to 8%, due annually from 1995 to 1998, in amounts ranging from \$6,250,000 to \$6,740,000 (net of discount)	6,740	12,990
Series L:		
Serial, at 5.75% to 6.125%, with amortization requirements from 2007 to 2022, in amounts ranging from \$4,360,000 to \$56,320,000 (net of discount)	112,393	112,333
Series M:		
Fixed rate, at 4.3% to 5.4%, due annually up to 2002 and 2008, in amounts ranging from \$24,585,000 to \$55,100,000	226,440	245,180
Bond payment obligations, at variable rates, due in 2005	52,082	52,485
Residual interest bonds, at variable rates, due in 2007 and 2015	125,350	125,350
Select auction variable rate securities, at variable rates, due in 2007 and 2015	125,350	125,350
Inverse floating rate notes, at variable rates, due in 2003 and 2004	93,900	93,900
Tax exempt municipal securities, at 7.53%, due in 1999	15,000	15,000
Series N:		
Serial, at 4.3% to 5.4%, due annually up to 2008, in amounts ranging from \$860,000 to \$1,510,000 (net of discount)	12,784	13,656
5.5%, with amortization requirements from 2009 to 2013, in amounts ranging from \$1,590,000 to \$1,970,000 (net of discount)	<u>8,666</u>	<u>8,664</u>
Balance carried forward	\$ 785,515	\$ 818,033



	1996	1995
	(In Thousands)	
Balance brought forward	\$ 785,515	\$ 818,033
Series N (cont.):		
5.5%, with amortization requirements from 2014 to 2022, in amounts ranging from \$2,080,000 to \$3,190,000 (net of discount)	22,853	22,847
Revenue Refunding Bonds - REA		
Series A, 5% serial bonds due semiannually up to 2015, in amounts ranging from \$1,375,000 to \$2,900,000	77,465	80,125
Subordinated revenue bonds - 6.75%		
serial bonds, due annually up to 1999	15,435	22,410
Subordinated notes Series 1989-A	<u>9,380</u>	<u>12,105</u>
Total	910,648	955,520
Obligations under capital leases	<u>1,437</u>	<u>1,459</u>
Total	912,085	956,979
Less current portion	<u>52,731</u>	<u>45,043</u>
Long-term debt, net	<u>\$ 859,354</u>	<u>\$ 911,936</u>

In August 1989, the Authority issued \$25,180,000 in subordinated notes to finance the acquisition of the property housing the Company's Purchases and Distribution Center and the acquisition of certain circuits in a fiber optic submarine cable to be used in telecommunication services between Florida, U.S.A. and Puerto Rico. The principal of these notes, amounting to \$9,380,000 at December 31, 1996, is due semiannually in amounts ranging from \$1,435,000 to \$1,700,000, from 1997 to 1999, at variable interest rates based on a percentage of the applicable LIBID rate. The applicable LIBID rate is equal to the bid quotation for the rate of interest on six-month deposits of United States dollars in the London interbank market, as determined by the indexing agent. The notes may be redeemed prior to their respective maturities at the option of the Authority on any interest payment date.

The Authority has entered into an interest rate swap agreement to reduce the impact of changes in interest rates on its variable interest rate subordinated notes. The interest rate swap agreement requires the Authority to pay a fixed rate while receiving amounts at a variable rate based on LIBOR, settled every six months, on notional principal amounts ranging from a high of \$6,216,000 up to February 15, 1997, to a low of \$1,343,000 from February 15, 1999 to August 15, 1999, dates of maturity of the notes and the swap agreement. As a result of this agreement, the effective rate on the variable interest rate subordinated notes of \$9,380,000 at December 31, 1996 and \$12,105,000 at December 31, 1995, was 5.32% in 1996 and 6.51% in 1995. The obligations of the other party in the agreement have been guaranteed by its parent company. The Authority is exposed to credit loss in the event of nonperformance by the other party to the interest rate swap agreement. However, the Authority does not anticipate nonperformance by the counterparty.

In connection with the acquisition of the net assets of Puerto Rico Communications Corporation [formerly Puerto Rico Communications Authority (PRCA)], the Authority issued \$104,887,000 in Revenue Refunding Bonds in exchange for all of the outstanding bonds then issued by PRCA and held by the Rural Electrification Administration (REA). The bonds bear interest at the rate of 5% annually and mature semiannually in amounts from \$1,375,000 to \$2,900,000 up to the year 2015. The bonds were issued under and pursuant to the provisions of the Trust Agreement.

In September 1992, the Authority issued \$114,185,000 in Revenue Bonds, Series L, with an average interest rate of approximately 6.1%, to pay the amount borrowed from GDB in connection with the Authority's acquisition of the net assets of PRCA of \$110,898,000.

The approximate aggregate maturities of long-term debt (excluding premium or discount), excluding obligations under capital leases, for the next five fiscal years and thereafter are as follows:

<b>Year Ending December 31,</b>	<b>Combined (In Thousands)</b>
1997	\$ 52,255
1998	55,680
1999	49,000
2000	43,915
2001	44,700
Thereafter	<u>663,295</u>
Total	<u>\$ 908,845</u>

## **7. LONG DISTANCE, ACCESS, AND BILLING SERVICES REVENUES**

The Authority's long distance, access, and billing services revenues have increased by \$2,228,000 in 1996 and \$9,900,000 in 1995 to reflect settlements of prior years' revenues.

Management is of the opinion that any subsequent settlements of prior years' revenue requirements will not have a material effect on the combined financial position or results of operations.

## **8. TAXES**

The Act authorizing the creation of the Authority exempts the Authority and its wholly-owned subsidiaries from all taxes levied on their properties or revenues by the Commonwealth of Puerto Rico and its municipalities. However, the Authority is required under a specific provision of the Act to make payments "in lieu of taxes" from its net revenues, as defined therein. These payments may not exceed the available net revenues, as defined, and the Authority shall not be required to make up any prior years' deficit.

The payments so required are determined on the basis of:

- a) An amount equal to the taxes on any and all property of the Authority or any of its subsidiaries that would have been due to the municipalities upon the nonexistence of the exemption provided by law; and

- b) An amount no less than \$20,000,000 or 4% of the gross revenues of the Authority, including its subsidiaries, as determined by the Governing Board. The Board is also entitled to approve a payment in excess of the above determined contribution if allowed by the economic situation of the Authority. This contribution will be used to finance the construction of physical facilities and programs to enhance public education in Puerto Rico.

The payments in lieu of taxes shall be made on or before April 15 of each year, and are subordinated to the requirements of the Trust Agreement. The contribution described in (b) is subordinated to the payment of the in lieu of taxes due to municipalities described in (a).

The accrual for in lieu of taxes at December 31, 1996 and 1995 is composed of the following:

	<b>1996</b>	<b>1995</b>
	<b>(In Thousands)</b>	
Payment due to municipalities	\$ 32,485	\$ 31,255
Payment for public education	20,000	20,000
Additional payment	<u>21,873</u>	<u>20,000</u>
Total	<u><b>\$ 74,358</b></u>	<u><b>\$ 71,255</b></u>

The amounts recorded as a liability at December 31, 1996 and 1995 for the payment of in lieu of taxes due for public education amounted to \$20,000,000 in each year. These amounts equal the sixth and fifth debt service payments of a \$125,000,000 loan granted by the Government Development Bank to the Office for the Improvement of Puerto Rico's Public Schools. The Authority projects future payments in lieu of taxes similar to the debt requirements of this loan.

For the years ended December 31, 1996 and 1995, the Governing Board of the Authority approved additional payments in lieu of taxes of \$21,873,000 and \$20,000,000, respectively.

The Company is incorporated under the laws of the state of Delaware, U.S.A. As such, it is subject to United States federal income tax. However, it has elected the benefits of Section 936 of the United States Internal Revenue Code, which allows certain income tax benefits to United States corporations deriving substantially all of their income from sources within possessions of the United States, including Puerto Rico. The Company has exercised the corresponding election to claim these benefits and has complied with the requirements of the United States Internal Revenue Code; accordingly, liability for U.S. federal income tax, if any, would arise only on income from sources outside Puerto Rico. Effective January 1, 1994, the credit allowed is subject to one of two alternative limitations. The Company elected to compute its credit under the economic activity method, which provided in fiscal years 1996 and 1995 a credit in excess of the credit needed to offset any U.S. federal income tax liability.

On August 20, 1996, the U.S. Congress enacted the Small Business Job Protection Act of 1996 (the "Act"). Under the Act, the tax credits allowable on business income under Section 936 are restricted for taxable years beginning between the period from January 1, 2002 and December 31, 2005. Thereafter, all such credits will be eliminated.

## 9. PENSION PLANS

The Authority contributes to two separate noncontributory, single employer defined benefits pension plans covering substantially all of its salaried and hourly employees, The Retirement Plan for Salaried Employees of Puerto Rico Telephone Company (Salaried Plan) and The Pension Fund for Hourly Employees of Puerto Rico Telephone Company (Hourly Plan). These plans provide retirement and disability benefits to plan members and beneficiaries as follows:

- a) **Salaried Plan** - Participants are entitled to annual pension benefits at normal retirement age (65) equal to 2% of the highest consecutive three-year average salary during their final ten years of employment multiplied by their years of credited service (not over 25 years), plus 1-1/2% of such average multiplied by credited service over 25 years (but not greater than 15 years), minus an offset factor, varying from .21% to .635% depending upon age at retirement, multiplied by covered compensation and further multiplied by credited service (up to 35 years). The Plan permits early retirement at ages 55-64 and 10 years of credited service. Also, using the "Sum of 85 Years Provision" an employee is eligible for pension benefits without reduction when his age plus years of service equal 85. Employees may elect to receive their pension benefits in the form of a joint and survivor annuity, a life annuity or under a guaranteed period option. Active employees who retire before age 62 may elect benefits under a Social Security level option.
- b) **Hourly Plan** - Participants are entitled to monthly pension benefits at normal retirement age (65) equal to \$36.00 per year of credited service up to a maximum of forty (40) credited years of service. The Plan permits early retirement at ages 52-64 and 20 years of credited service, or ages 55-64 and 10 years of service.

Employees with 5 years or more of service who terminate are eligible for vested benefits. If termination occurs before rendering 5 years of service, they forfeit the right to receive their accumulated pension benefits.

The Salaried Plan is subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"). Also, the Hourly Plan is subject to revisions in accordance with the bargaining contracts signed by the Company and to certain applicable sections of ERISA. Both plans issue a publicly available financial report that includes financial statements, notes to the financial statements and required supplementary information.

The funding policy of the Authority is to make quarterly contributions to the plans as determined by the consulting actuaries, necessary to comply with the minimum funding requirements of ERISA. Annual contributions to the plans equal to the amounts accrued for the expense.

The annual pension cost and net pension obligation of the Salaried and Hourly Plans for the year ended December 31, 1996 were as follows:

Salaried	Hourly	Total
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Annual required contribution	<u>\$ 31,434,277</u>	<u>\$ 10,682,861</u>	<u>\$ 42,117,138</u>
Annual pension cost	31,434,277	10,682,861	42,117,138
Contributions made	<u>(29,207,595)</u>	<u>(16,660,372)</u>	<u>(45,867,967)</u>
Increase in net pension obligation	2,226,682	(5,977,511)	(3,750,829)
Net pension obligation, beginning of year	<u>9,963,912</u>	<u>6,290,539</u>	<u>16,254,451</u>
Net pension obligation, end of year	<u>\$ 12,190,594</u>	<u>\$ 313,028</u>	<u>\$ 12,503,622</u>

The annual required contribution for the current year was determined as part of the December 31, 1996 actuarial valuation using the projected unit credit actuarial cost method. The annual required contribution is consistent with the requirements of GASB No. 27, **Accounting for Pensions by State and Local Governmental Employers**. The actuarial assumptions included (a) 8% investment rate of return (net of administrative expenses) and (b) projected salary inflation of 6% per year. The actuarial value of the assets was determined using an asset valuation method which takes into account the market value of the assets and which complies with regulations issued by the IRS. The unfunded actuarial accrued liability is being amortized for both plans on an individual basis based on the years specified by ERISA. The remaining amortization period at December 31, 1996 ranged from 1 to 29 years.

Other required information for both plans follows:

<b>Fiscal Year Ending</b>	<b>Annual Pension Cost (APC)</b>	<b>Percentage of APC Contributed</b>	<b>Net Pension Obligation</b>
<b><i>December 31, 1996:</i></b>			
Salaried	\$ 31,434,277	61.22 %	\$ 12,190,594
Hourly	10,682,861	97.07 %	313,028
<b><i>December 31, 1995:</i></b>			
Salaried	\$ 25,562,391	61.02 %	\$ 9,963,912
Hourly	13,737,739	54.21 %	6,290,539
<b><i>December 31, 1994:</i></b>			
Salaried	20,595,660	67.93 %	6,604,665
Hourly	6,436,716	34.80 %	4,196,673

<b>Actuarial Valuation Date</b>	<b>Actuarial Value of Assets</b>	<b>Actuarial Accrued Liability (AAL)</b>	<b>Unfunded AAL (UAAL)</b>	<b>Funded Ratio</b>	<b>Covered Payroll</b>	<b>UAAL as a Percentage of Covered Payroll</b>
<b>December 31, 1996:</b>						
Salaried	\$ 268,502,400	\$ 416,764,474	\$ 148,262,074	64.43 %	\$122,050,537	121.48 %
Hourly	83,249,227	102,119,399	18,870,172	81.52 %	n/a	n/a
<b>December 31, 1995:</b>						
Salaried	\$ 233,632,573	\$ 405,777,264	\$ 172,144,691	57.58 %	\$ 123,203,738	139.72 %
Hourly	68,458,997	95,198,688	26,739,691	71.91 %	N/A	N/A
<b>December 31, 1994:</b>						
Salaried	183,257,734	310,484,535	127,226,801	59.02 %	116,229,941	109.46 %
Hourly	47,567,339	84,915,542	37,348,203	56.02 %	N/A	N/A

The Company implemented GASB No. 27, ***Accounting for Pensions by State and Local Governmental Employers*** during the year ended December 31, 1995.



### ***Puerto Rico Employees' Retirement System***

Some of the employees (the former employees of Puerto Rico Communications Corporation, which merged with the Company on May 4, 1994), participate in the Commonwealth of Puerto Rico Employees' Retirement System (the "System"), a cost-sharing multiple-employer retirement system.

Benefits provided by the System and required contributions by employees are determined by law. Covered employees are required to contribute 5.775% for the first \$550 of monthly salary plus 8.275% for the excess over \$550 of monthly salary or, on the alternative, 8.275% of all salary. The Company is required to contribute 9.275% of the employee's salary.

Participants who have attained an age of at least fifty-five (55) years and have completed at least twenty-five (25) years of creditable service or members who have attained an age of at least fifty-eight (58) years and have completed at least ten (10) years of creditable service, are entitled to an annual benefit, payable monthly for life.

The amount of the annuity shall be one and a half percent of the average compensation multiplied by the number of years of creditable service up to twenty (20) years, plus two percent of the average compensation multiplied by the number of years of creditable service in excess of twenty (20) years. In no case will the annuity be less than \$200 per month.

Participants who have completed at least thirty (30) years of creditable service are entitled to receive the Merit Annuity. Participants who have not attained fifty-five (55) years of age will receive 65% of the average compensation or if they have attained fifty-five (55) years of age will receive 75% of the average compensation. Disability retirement benefits are available to members for occupational and non-occupational disability. However, for non-occupational disability a member must have at least ten (10) years of service.

No benefits are payable if the participant receives a refund of accumulated contributions.

Total employee and employer contributions for the year ended December 31, 1996 amounted to approximately \$1,489,000 and \$1,231,000, respectively. Total payroll covered for the year was approximately \$16,056,000.

For the year ended December 31, 1995, the amount contributed was of approximately \$3,676,000, which represented approximately 100% of required contributions.

Additional information on the System will be provided in its financial statements for the year ended June 30, 1996 a copy of which can be obtained from the System.

The Authority is subject to a possible claim by the System based on the provisions of Act No. 447 of May 15, 1951 (the "Act"). The Act provides that government instrumentalities shall cover possible actuarial deficiencies related to the accrued benefits from the respective instrumentality in a manner to be determined by the System. At present, the Authority has not been required to cover its estimated unfunded pension obligation.

## 10. POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

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

The components of the net periodic postretirement benefit cost for the years ended December 31, 1996 and 1995 are as follows:

	1996	1995
	(In Thousands)	
Service costs of benefits earned during the period	\$ 3,796	\$ 3,107
Interest cost on accumulated postretirement benefit obligation	10,853	7,988
Amortization of accumulated postretirement benefit obligation	<u>6,551</u>	<u>4,414</u>
Total	<u>\$ 21,200</u>	<u>\$ 15,509</u>

The amounts recognized in the combined balance sheets at December 31, 1996 and 1995 are as follows:

	1996	1995
	(In Thousands)	
Accumulated postretirement benefit obligation:		
Retirees and fully eligible active plan participants	\$ (99,991)	\$ (63,854)
Other active plan participants	<u>(46,966)</u>	<u>(48,302)</u>
Accumulated postretirement benefit obligation (APBO)		
in excess of plan assets	(146,957)	(112,156)
Unrecognized net loss	10,990	5,893
Unrecognized past service	20,233	
Unrecognized transition obligation	<u>71,485</u>	<u>75,889</u>
Accrued postretirement benefit cost	<u>\$ (44,249)</u>	<u>\$ (30,374)</u>

The discount rate used in 1996 and 1995 in determining the APBO was 8% in each year. The assumed health-care cost trend rate used in 1996 and 1995 in measuring the APBO was 9% and 10%, respectively, declining by 1% per year to an ultimate rate of 5%.

## 11. LEASES

The Authority and its subsidiary use certain building facilities and equipment under various capital and operating leases.

At December 31, 1996 and 1995, the cost and accumulated amortization of building facilities and equipment under capital leases are as follows:

	1996	1995
	(In Thousands)	
Cost	\$ 2,236	\$ 4,674
Less accumulated amortization	<u>(827)</u>	<u>(3,381)</u>
Total	<u>\$ 1,409</u>	<u>\$ 1,293</u>

The amortization of assets held under capital leases is included in the depreciation and amortization expense account.

Future minimum lease payments under noncancelable capital and operating leases in effect at December 31, 1996 are as follows:

	Capital (In Thousands)	Operating (In Thousands)
<i>Year Ending December 31,</i>		
1997	\$ 502	\$ 7,290
1998	325	5,373
1999	220	4,862
2000	313	3,183
2001	90	1,114
Thereafter	<u>370</u>	<u>1,594</u>
Total minimum lease payments	1,820	23,416
Less amount representing interest	<u>383</u>	
Present value of minimum lease payments	<u>\$ 1,437</u>	<u>\$ 23,416</u>

Rental costs charged to operations under operating leases for the years ended December 31, 1996 and 1995 amounted to approximately \$9,361,000 and \$6,107,000, respectively.

## 12. COMMITMENTS AND CONTINGENCIES

### (a) **Construction Commitments**

The Authority's construction program for 1997 amounts to approximately \$384,000,000, including commitments for the purchase and installation of telephone equipment and materials and supplies. The above construction program is intended to be financed substantially with internally generated funds.

### (b) **Litigation**

In September 1993, the National Exchange Carrier Association ("NECA") informed the Authority that they would not accept the inclusion of the additional in lieu of taxes payment corresponding to 1992, for interstate settlement purposes unless the Authority obtains approval from the FCC. On November 30, 1993, the Authority submitted a request for ruling by the FCC on the issue. On February 5, 1996, the FCC concluded that the Authority could not include for interstate settlement purposes the additional in lieu of taxes payments. On March 6, 1996, the Authority filed with the FCC a petition for reconsideration seeking a reversal on the decision. On March 26, 1997, the FCC denied the petition and affirmed the findings of the previous order. The amount of the potential liability is recorded in the combined financial statements at December 31, 1996 and 1995.

The Authority and its subsidiary have been advised of certain unasserted claims and are defendants in several lawsuits arising out of the conduct of their normal course of business. On July 31, 1992, a suit against a computer manufacturer was filed seeking damages in the amount of \$40,000,000 for a computer system sold to the Company, which it is alleged was not properly installed. The manufacturer filed a counterclaim against the Company, in the amount of \$12,000,000 for the alleged loss of expected revenues. These claims have been vigorously contested and management, after consultation with legal counsel, believes that their final resolution will not have a material adverse effect on the combined financial position of the Authority and its subsidiary.

## 13. FAIR VALUE OF FINANCIAL INSTRUMENTS AND CONCENTRATION OF RISK

The Authority adopted in 1993 Statement of Financial Accounting Standards No. 107, ***Disclosures About Fair Value of Financial Instruments***, which requires disclosure about the fair value of certain financial instruments.

The following methods and assumptions were used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value:

- ***Cash and cash equivalents, sinking, construction and renewal and replacement funds, general, in lieu of taxes and sinking funds, and temporary cash investments*** - the carrying amounts approximate fair values because of the short maturity of those instruments.
- ***Debt*** - the carrying amount (including accrued interest) of the debt maturing within one year approximates fair value because of the short-term maturities involved. The fair value of the long-term debt was estimated based on the year-end quoted market price for the same or similar issues.

- ***Interest rate swap agreements*** - the carrying amount of the agreements approximates fair value.

The estimated fair values of the financial instruments at December 31, 1996 and 1995 are as follows:

	<b>1996</b>	
	<b>Carrying Amount</b>	<b>Fair Value</b>
	<b>(In Thousands)</b>	
Financial assets:		
Sinking, construction and renewal and replacement funds	\$ 81,544	\$ 81,544
Cash and cash equivalents	43,029	43,029
General, in lieu of taxes and sinking funds	96,649	96,649
Financial liabilities:		
Long-term debt	912,085	912,085
	<b>Contract or Notional Amount</b>	<b>Fair Value</b>
Off-balance sheet items:		
Interest rate swap agreements in a net payable position	\$ 9,380	\$ 9,380
	<b>1995</b>	
	<b>Carrying Amount</b>	<b>Fair Value</b>
	<b>(In Thousands)</b>	
Financial assets:		
Sinking, construction and renewal and replacement funds	\$ 175,994	\$ 175,933
Cash and cash equivalents	23,170	23,170
General, in lieu of taxes and sinking funds	89,745	89,745
Financial liabilities:		
Long-term debt	956,979	956,979
	<b>Contract or Notional Amount</b>	<b>Fair Value</b>
Off-balance sheet items:		
Interest rate swap agreements in a net payable position	\$ 12,105	\$ 12,105



#### **14. OFF-BALANCE SHEET RISK AND CONCENTRATION OF CREDIT RISK**

The Authority is a party to interest rate swap agreements which expose the Authority to off-balance-sheet risk and credit risk. The credit risk associated with the interest rate swap agreements is controlled through the evaluation and continual monitoring of the credit worthiness of the counterparties.

#### **15. EARLY RETIREMENT BENEFIT**

On January 25, 1996, the Board of Directors of the Authority approved a program for the early retirement as of May 1, 1996 of salaried employees of the Company which as of December 31, 1995 met certain specific requirements. This "window benefit" program was accepted by most of the targeted employees. As a result, the estimated benefit obligation of \$27,000,000 resulting from this early retirement program was recorded as a current liability at December 31, 1995.

#### **16. SUPPLEMENTAL DISCLOSURE OF CASH FLOW TRANSACTIONS**

During fiscal years 1996 and 1995, the Authority acquired other equipment amounting to \$534,000 and \$233,000 assuming long-term obligations for the same amount.

#### **17. SUBSEQUENT EVENTS**

On April 7, 1997, the Governor of Puerto Rico announced the intention of the Commonwealth of Puerto Rico to sell the Authority and its subsidiaries. This sale is expected to be completed within one year, subject to approval of the related legislation by the Legislature of Puerto Rico.

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## **INDEPENDENT AUDITORS' REPORT ON ADDITIONAL INFORMATION**

The Governing Board of  
Puerto Rico Telephone Authority:

Our audits were made for the purpose of forming an opinion on the basic 1996 and 1995 combined financial statements of Puerto Rico Telephone Authority and Subsidiary (the "Authority") taken as a whole. The additional information included in Schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the basic combined financial statements. This additional information is the responsibility of the Authority's management. Such 1996 and 1995 information has been subjected to the auditing procedures applied in the audits of the basic combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic combined financial statements taken as a whole.

March 27, 1997  
(April 7, 1997 as to Note 17)

Stamp No.

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## SCHEDULE 1

### PUERTO RICO TELEPHONE AUTHORITY AND SUBSIDIARY

#### COMBINED STATEMENTS OF REVENUES AND EXPENSES FOR REVENUE FUND PURPOSES YEARS ENDED DECEMBER 31, 1996 AND 1995

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	1996 (In Thousands)	1995
Revenues:		
Operating revenues	\$ 1,153,960	\$ 1,062,423
Other income (expense), net	<u>6,599</u>	<u>(36,843)</u>
Total	<u>1,160,559</u>	<u>1,025,580</u>
Current expenses:		
Operations	442,454	370,106
Maintenance	215,373	181,263
Interest	<u>1,726</u>	<u>1,620</u>
Total	<u>659,553</u>	<u>552,989</u>
Balance of revenues after current expenses	<u>501,006</u>	<u>472,591</u>
Debentures requirement under Trust Agreement:		
Principal, as defined by Section 701		
Interest		
Total	<u>-</u>	<u>-</u>
Balance for transfer to Puerto Rico Telephone Authority Revenue Fund	501,006	472,591
Amount consisting primarily of effect of transfer being made in the month following the month to which the amount to be transferred applies, and elimination of negative balances for transfer to the revenue fund	<u>2,058</u>	<u>18,746</u>
Dividends paid and returns of capital to Puerto Rico Telephone Authority	503,064	491,337
Puerto Rico Telephone Authority current expenses paid	<u>1,037</u>	<u>921</u>
Amount available in Revenue Fund for distribution to other funds	502,027	490,416
Interest received by certain funds	<u>8,026</u>	<u>6,183</u>
Puerto Rico Telephone Authority net revenues, as defined, including interest received by certain funds	<u>\$ 510,053</u>	<u>\$ 496,599</u>



## **INDEPENDENT AUDITORS' REPORT ON COMBINING INFORMATION**

The Governing Board of  
Puerto Rico Telephone Authority:

Our audit was made for the purpose of forming an opinion on the 1996 combined financial statements of Puerto Rico Telephone Authority and Subsidiary (the "Authority") taken as a whole. The accompanying additional combining information is presented for purposes of additional analysis of the combined financial statements rather than to present the financial position, results of operations and cash flows of the individual companies, and is not a required part of the basic combined financial statements. This additional information is the responsibility of the Authority's management. Such additional information has been subjected to the auditing procedures applied in the audit of the combined financial statements and, in our opinion, is fairly stated in all material respects in relation to the combined financial statements taken as a whole.

March 27, 1997  
(April 7, 1997 as to Note 17)

Stamp No.

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