AUDITED FINANCIAL STATEMENTS

Puerto Rico Electric Power Authority
(A Component Unit of the Commonwealth of Puerto Rico)
Years Ended June 30, 2010 and 2009
With Report of Independent Auditors

ERNST & YOUNG

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(A Component Unit of the Commonwealth of Puerto Rico)

Audited Financial Statements

Years Ended June 30, 2010 and 2009

Contents

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Report of Independent Auditors

To the Governing Board of the
Puerto Rico Electric Power Authority

We have audited the accompanying financial statements of the Puerto Rico Electric Power Authority (the Authority), a component unit of the Commonwealth of Puerto Rico, as of and for the years ended June 30, 2010 and 2009, as listed in the table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of PREPA Networks, Inc. (PREPA.Net) (a blended component unit), which financial statements reflect total assets constituting approximately .2% and .3% of total assets as of June 30, 2010 and 2009, and revenues constituting .2% and .2% of total revenues for the years then ended. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for PREPA Holdings and PREPA.Net, is based solely on the reports of the other auditors.

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

In our opinion, based on our audits, and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Authority as of June 30, 2010 and 2009, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the financial statements, the Authority changed its method of accounting for derivative instruments as a result of the adoption of the Governmental Accounting Standards Board (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, effective July 1, 2009.

In accordance with *Government Auditing Standards*, we have also issued our report, dated January 31, 2011, on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

Management's Discussion and Analysis on pages 3 through 13 and the required supplementary information disclosed on page 83 are not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board (GASB). We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Ernst & Young LLP

January 31, 2011

Stamp No. 2576794
affixed to
original of
this report.

This section of the financial report of Puerto Rico Electric Power Authority (the Authority) presents the analysis of the Authority's financial performance during the fiscal years ended June 30, 2010, 2009 and 2008. As management of the Authority, we offer readers of the financial statements this narrative overview and analysis of the financial activities. We recommend readers to consider the information herein presented in conjunction with the financial statements that follow this section.

Financial Highlights

- Operating income for fiscal year ended June 30, 2010 was $359.5 million representing a decrease of .9 percent for the fiscal year ended June 30, 2009. For the fiscal years ended June 30, 2009 and 2008 was $362.6 million and $181.1 million respectively, representing 100 percent increase and 51.1 percent decrease when compared to fiscal years ended June 30, 2008 and 2007, respectively.

- Operating expenses increased by $171.9 million or 4.7 percent for the fiscal year ended June 30, 2010; decreased by $541.0 million or 12.9 percent and increased by $871.7 million or 26.3 percent for the fiscal years ended June 30, 2009 and 2008, respectively, when compared to previous fiscal years.

- In June 2008, the Government Accounting Standards Board (GASB) issued Statement 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB 53 addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. The Authority adopted GASB statement 53 in Fiscal Year 2010. The effect of applying this statement was reported as a restatement of 2009 financial statements resulting in an increase of deferred outflows and fair value of derivatives instruments of $103.9 million.

- The Authority's Net Utility Plant for the fiscal year ended June 30, 2010 increased by $116.1 million or 1.8 percent. For the fiscal year ended 2009 and 2008 the increase was $236.2 million and $419.4 million or 3.8 percent and 7.3 percent, respectively.

- Total assets increased by $195.5 million and decreased by $346.1 million and $989.9 million, or 2.2 percent increase, 3.7 percent decrease and 12.0 percent increase, respectively, for the fiscal years ended June 30, 2010, 2009 and 2008.

- For the fiscal year ended June 30, 2010, as compared to the fiscal year ended June 30, 2009 and June 30, 2008, accounts receivable decreased by 3.7 percent, from $1,126.9 million to $1,085.1 million and by 11.5 percent from $1,272.8 million to $1,126.9 million, respectively. The decrease in 2010 was mainly due to a collection of over $120 million from the government sector and the efforts of the Collection and Energy Theft Programs with the private sector. The decrease in 2009 was mainly due to the collection of $136.7 million from insurance companies related to a claim filed as a result of two fires at the Palo Seco Steam Plant and to a decline in the average fuel oil price per barrel of $7.95 (9.4%).

- Accounts receivable from the governmental sector decreased from $471.4 million on June 30, 2009 to $345.5 million on June 30, 2010, representing a 26.7 percent reduction and increased from $357.3 million on June 30, 2008 to $471.4 million on June 30, 2009, representing a 31.9 percent.

- The Authority's net assets decreased by $142.8 million (364.2 percent), $147.5 million (79.0 percent) and $284.7 million (60.4 percent) as a result of operations during fiscal years ended June 30, 2010, 2009 and 2008, respectively. As of June 30, 2010, the Authority is on a net deficit position.

- Ratios of fuel and purchased power adjustment revenues to total operating revenues were 72.7 percent for 2009-2010, 72.8 percent for 2008-2009 and 73.8 percent for 2007-2008.

- Ratios of fuel oil and purchased power expense to total operating expense (excluding depreciation expense) were 77.9 percent for 2009-2010, 77.7 percent for 2008-2009 and 76.3 percent for 2007-2008.

- The increase in the fuel adjustment revenues and fuel expense for fiscal year 2010 as compared to 2009 of 94.4 million and 87.1 million, respectively, was mainly due to an increase in the average fuel oil price per barrel of $0.32 (0.4%). The decrease in the fuel adjustment revenues and fuel expense for fiscal year 2009 as compared to 2008 of $311.6 million and $383.2 million, respectively, was mainly due to a decrease in the average fuel oil price per barrel of $7.95 (9.4%) and a decrease of 2.2 million (7.9%) in the consumption of fuel oil barrels for 2008-2009. In addition, the increase in the fuel adjustment revenues and fuel expense for fiscal year 2008 as compared to 2007 of $695.0 million and $586.1 million, respectively, was mainly due to an increase in fuel oil price per barrel of $26.63 (46.3%).

- The increase in the purchased power adjustment revenue and expense of $24.9 million and $21.9 million, respectively, was due to an increase of 243,159 MWh (or 3.6 percent) purchase power for fiscal 2010 when compared to fiscal 2009. The increase in the purchased power adjustment revenue and expense of $6.9 million and $10.8 million, respectively, was mainly due to an increase of 1.0 cent (9.9 percent) per kWh in the average price of purchased power for fiscal 2009 when compared to 2008. The increase in the purchased power adjustment revenue and expense of $36.8 million and $36.4 million, respectively, was mainly due to an increase of 312,676 MWh (4.5 percent) purchased power for fiscal 2008, when compared to fiscal 2007.

Plans to Address the Authority's Challenges

The Authority faced a number of business challenges that have been exacerbated by the Commonwealth's economic recession and the volatility in oil prices. Its principal challenges, some of which are interrelated, are: (i) addressing the decline in electric energy sales; (ii) addressing the volatility of oil costs; (iii) addressing high customer electric power rates; (iv) reducing government accounts receivables; and (v) improving its liquidity.

The Authority's management focused on addressing these challenges by implementing a financial stabilization plan and other strategic initiatives. The principal component of the financial stabilization plan was the reduction of operating costs in line with the reduction in electric energy sales in order to maintain adequate operating margins. As a result of various cost reduction measures implemented, the Authority's operating expenses for fiscal year 2010 (excluding fuel and purchased power) decreased by $92.1 million, or 11.2%, compared to fiscal year 2008 and by $58.0 million, or 7.4%, compared to fiscal year 2009.

The principal cost reduction measures included in the plan are (i) reducing the number of employees through a combination of attrition from voluntary retirement and the elimination of temporary and vacant positions, (ii) reducing retiree health care benefits, as explained below, and (iii) reducing overtime and miscellaneous expenses. The Authority has already implemented measures that are expected to result in recurring annual savings of approximately $121 million, consisting of (i) a reduction of 739 employees from January 1, 2009 through June 30, 2010 that is expected to result in annual savings of approximately $52 million, (ii) changes to retiree health care benefits that are expected to result in annual savings of approximately $46 million, and (iii) other cost reduction initiatives, such as the reduction of overtime and miscellaneous expenses, that are expected to result in annual savings of approximately $23 million.

Via Verde Pipeline

The Via Verde Pipeline is a planned natural gas network that will supply energy from north to south Puerto Rico. Proposed by the Island government more than 20 years ago, it found new backing under current Puerto Rican Governor Luis Fortuño, who projects that it will be operational by the end of 2011. Via Verde is expected to save Puerto Rican consumers more than $1 billion in energy costs annually, and will cut carbon emissions by an average of 64 percent. This pipeline is part of PREPA's commitment to green energy on the Island and to weaning the Island off of much more expensive imported crude oil.

The pipeline itself will cost $74 million to build, part of an overall project cost of $450 million that includes the conversion of several oil-fired power plants to natural gas. Via Verde's capacity will help the Island secure long-term energy savings through the purchase of a 30-year futures contract for natural gas. Further, natural gas is valued as a "clean-burning" fuel, accounting for just 10 percent of the world's carbon emissions.

Customer Care and Billing Project

On February 2010 the contracts for the implementation and Quality Control respectively, of this Oracle based System were signed with PWC Consulting and AAC Consulting. The purpose of this implementation is to replace the Customer Service System installed in the early 1980's. This new system will be capable of providing detailed information on PREPA's wide customer base, as well as serving as the energy sales Accounts Receivable Subsidiary Ledger. It will also improve the quality of this important information and enhance the financial analysis currently performed using a variety of tools. The system is expected to be commissioned by December 2012. It is part of our commitment to use technology to improve customer services quality, financial performance and operational efficiency.

Overview of Financial Report

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

Required Financial Statements

The financial statements report the financial position and operations of Puerto Rico Electric Power Authority and its blended component units, Puerto Rico Irrigation Systems and PREPA Holdings LLC as of and for the year ended June 30, 2010, and PREPA Networks, Corp. as of and for the year ended June 30, 2009, which include a Balance Sheet, Statement of Revenues, Expenses and Changes in Net Assets, Statement of Cash Flows and the notes to financial statements.

PREPA Networks, Corp. issues a separate financial report that includes audited financial statements. That report may be obtained by writing to PREPA Networks, Corp. City View Plaza Suite 803, Guaynabo, Puerto Rico 00968.

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

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

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

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

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

Financial Analysis

The Authority's net assets decreased by $142.8 million, $147.5 million and $284.7 million for the fiscal years ended June 30, 2010, 2009 and 2008, respectively. Our analysis below focuses on the Authority's net assets and changes in net assets during the year.

Authority's Net Assets
(*In thousands*)

	2010	2009	2008
Current, non-current and other assets	**$ 2,563,179**	$ 2,475,320	$ 3,057,603
Capital assets	**6,517,826**	6,410,173	6,173,993
Total assets	**$ 9,081,005**	$ 8,885,493	$ 9,231,596
Long-term debt outstanding	**$ 7,572,024**	$ 6,843,137	$ 7,113,832
Other liabilities	**1,612,597**	2,003,137	1,931,082
Total liabilities	**$ 9,184,621**	$ 8,846,274	$ 9,044,914
Net assets:			
Invested in capital assets, net of related Debt	**$ (45,160)**	$ 19,433	$ 55,101
Restricted	**136,053**	233,208	307,666
Unrestricted	**(194,509)**	(213,422)	(176,085)
Total net assets (deficit)	**$ (103,616)**	$ 39,219	$ 186,682

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

Net assets invested in utility plant, net of related debt decreased from $19.4 million in 2008-2009 to ($45.2) million in 2009-2010, mainly due to increases in the financing of construction expenditures to compensate for a reduction in the availability of internal funds allocated to the construction activity.

Restricted assets for capital and debt service requirements decreased from $233.2 million as of June 30, 2009 to $136.1 million as of June 30, 2010. The increase was mainly due to an increase in the reserve account. As allowed by the 1974 Trust Agreement, cash reserves in excess of required balances were transferred to debt service accounts.

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

Authority's Changes in Net Assets
(In thousands)

	Year Ended June 30		
	2010	**2009**	**2008**
Operating revenues	**$4,171,493**	$ 4,002,713	$ 4,362,209
Other income	**11,160**	25,326	25,874
Total revenues	**4,182,653**	4,028,039	4,388,083
Operating expenses	**3,811,971**	3,640,109	4,181,143
Interest expense, net	**346,653**	326,165	312,269
Total expenses	**4,158,624**	3,966,274	4,493,412
Income (loss) before contribution in lieu of taxes and other and contributed capital	**24,029**	61,765	(105,329)
Contribution in lieu of taxes and other	**(232,431)**	(224,792)	(218,379)
Loss before contributed capital	**(208,402)**	(163,027)	(323,708)
Contributed capital	**65,567**	15,564	38,982
Change in net assets	**(142,835)**	(147,463)	(284,726)
Net assets, beginning of year	**39,219**	186,682	471,408
Net assets, end of year	**$ (103,616)**	$ 39,219	$ 186,682

For fiscal year ended June 30, 2010, as compared to June 30, 2009, Net Assets decreased by $142.8 million. The reduction in Net Assets was mainly due to an increase in operating expenses of $171.9 million, mainly due to increases of $38.9 and $37.8 in the Administrative and General and Depreciation Expenses, respectively, as well as increases in Interest Expense and Contribution in Lieu of Taxes.

The Authority's management has taken the following expense control measures:

The Authority reduced the number of employees through a combination of attrition from voluntary retirement and the elimination of temporary and vacant positions. In addition, the Authority is still enforcing the new staff hiring freeze implemented in January 2009.

The Authority's management has also identified the following strategies to stabilize the cost of energy:

- Revenue diversification - Net income generated from two recently created subsidiaries will be used to find a revenue stabilization fund to reduce fuel price volatility.
- Fuel diversification – The Authority is in the process of evaluating generating units that use fuel oil to convert them to burn coal and natural gas.
- Reducing energy theft – The Authority has implemented an energy theft reduction program through the use of smart grid technologies and increasing the unannounced door-to-door visits.

For the fiscal year ended June 30, 2009, as compared to June 30, 2008, operating revenues and expenses decreased by $359.5 million (or 8.2%) and $541.0 million (or 12.9%), respectively, resulting in a decrease in net assets of $147.5 million. The decrease in net assets was mainly due to a reduction of 1,085.8 MWh in sales of electric energy, which represented $59.6 million in basic rate revenues. In addition, revenues decreased due to a decline in the price of fuel of $7.95 per barrel. Expenses decreased mainly due to a reduction in the price of fuel and an adjustment to Other Pension Obligation Expenses, resulting from the modification of health benefits to retired employees.

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

Capital Assets and Debt Administration

Capital Assets

The Authority's investment in capital assets as of June 30, 2010, 2009 and 2008, amounts to approximately $6,526 million, $6,410 million and $6,174 million (net of accumulated depreciation), respectively. This investment in capital assets includes land, generation, transmission and distribution systems, buildings, fixed equipment, furniture, fixtures and equipment. The total increases in the Authority's investment in capital assets (net of accumulated depreciation) were 1.8 percent, 3.8 percent and 7.3 percent for 2009-2010, 2008-2009 and 2007-2008, respectively.

A substantial portion of the capital expenditures for production plant in fiscal year ended June 30, 2010, 2009 and 2008, was spent on the rehabilitation and life extension of generating plants in order to achieve and maintain higher levels of availability, reliability and efficiency.

Major capital assets projects during fiscal years 2009 and 2010 included the following:

- The Authority replaced the four 21 MW combustion turbines with new four 55MW dual fuel aero-derivative combustion turbines, which represent a net increase in capacity of approximately 136 MW over the replaced combustion turbines and they will generate electricity more efficiently. The first two combustion turbines were installed in fiscal year 2009 and the remainders two were installed and in service on fiscal year 2010.

- The Authority modified the eight 50 MW combustion turbines of Aguirre Combined Cycle Plant to enable them to burn natural gas or light distillate. This conversion to dual capability was completed on fiscal year 2010. The Authority evaluates various alternatives to supply natural gas to the plant.

- The Authority repaired steam turbines generator and replaced transformers and major electrical equipments of Palo Seco Steam units, which have 85 MW capacities. In addition, the Authority replaced the control room for all the units and switchgear for Palo Seco Steam Plant units two, three and four. The total cost of repairing the Palo Seco Steam Plant was approximately $125 million.

- The Authority is now constructing a 38-mile long 230 kV transmission line between the South Coast Steam Plant and Cambalache gas turbines plant's switchyard. The first stage of this project consists of the reconstruction and conversion to 230 kV of an existing 115 kV circuit line between the South Coast Steam Plant and Dos Bocas hydroelectric power plant. The second stage of the project consists of the construction of a new 230 kV line from Dos Bocas to the Cambalache facilities. The construction of both stages is expected to be completed during fiscal year 2013. The estimated cost of this project is $80 million.

- The Authority is also constructing a new 50-mile long 230 kV transmission line between its South Coast Steam Plant and the transmission center in Aguas Buenas. The construction of this new transmission line is expected to be completed during fiscal year 2015. The estimated cost of this project is $120 million.

- The program to improve the 38 kV sub-transmission systems continues in effect, including the construction of underground 38 kV lines in Guaynabo, Isabela, and San Juan. In addition, major reconstruction projects of aerial 38 kV lines in the central and western part of the Island will significantly improve the reliability of the sub-transmission system.

- The Authority completed an underground 115 kV transmission circuit line around the San Juan metropolitan area in order to reduce the incidents of loss of power in the aftermath of hurricanes and other major storms, which strike Puerto Rico from time to time. This project is presently improving the reliability of its transmission system in San Juan by interconnecting two steam plants, three existing transmission centers, and four new 115 kV gas insulated (GIS) substations through a 30-mile underground loop of 115 kV. The cost of this project was $200 million. The Federal Emergency Management Agency provided $75 million for of construction for this project through grants to the Authority.

- Martin Peña GIS is a new gas insulated 115/38 kV transmission center with a 300 MVA installed transforming capacity. Palo Seco GIS, one of PREPA's major gas insulated 115/38 kV switchyards with direct interconnection to 600 MW of generating capability, was energized during fiscal year 2009 at a cost of $66 million. San Juan GIS, one of PREPA's major gas insulated 115/38 kV switchyards with direct interconnection through the existing air insulated 115kV bus to approximately more than 850 MW of generating capability, is expected to be in service during fiscal year 2012. A new gas insulated 38 kV substation in Isabela, is also expected to be in service during fiscal year 2011.

- Two major expansion projects to add 300 MVA of 115/38 kV transforming capacity in the transmission centers of Aguadilla and Ponce were completed and energized between fiscal year 2010 and the beginning of fiscal year 2011. A new air insulated 38 kV switchyards in the municipality of Aguadilla also started operating during fiscal year 2010. A new 150 MVA 115/38 kV transmission center in the municipality of Bayamón (Hato Tejas TC) as well as a major expansion projects that add 150 MVA of 115/38 kV transforming capacity in the transmission center of Canóvanas are expected to be completed during fiscal year 2011. In addition, a new 450 MVA 230/115 kV transmission center in Ponce TC is expected to be completed during fiscal year 2011.

- The following projects are expected to be in construction for the next five years: a new 230 kV line between Aguirre steam plant and Cayey, the new transmission centers below: Venezuela TC in Río Piedras, Bairoa TC in Caguas, Barranquitas TC and Las Cruces TC in Cidra, to add 500 MVA of 115/38 kV transforming capacity.

- A new 115 kV capacitor bank is also expected to be energized in the transmission center of Canóvanas during fiscal year 2011.

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

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

Long-Term Debt

At the end of the fiscal year 2010, 2009 and 2008, the Authority had total long-term debt outstanding of $7,587.1 million, $6,843.1 million and $7,113.8 million, respectively, comprised of revenue bonds and other borrowings.

Authority's Outstanding Debt
(In thousands)

	2010	2009	2008
Power revenue bonds, net	**$ 7,572,024**	$ 6,008,385	$ 6,162,987
Notes payable	**15,090**	834,752	950,845
	7,587,114	6,843,137	7,113,832
Current portion	**(187,368)**	(1,067,310)	(598,296)
Long-term debt excluding current portion	**$ 7,399,746**	$ 5,775,827	$ 6,515,536

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

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

Economic Factors and Next Year's Budgets and Rates

In the last five years, Puerto Rico's economy has shown a different behavior from US economy in term of the annual Gross Domestic Product growth, even though Puerto Rico its part of the US monetary and banking systems. The US economy, measured by the Real Gross Domestic Product (GDP), decreased 2.6% in calendar year 2009. In the first and second quarter of 2010, real GDP increased 3.7% and 1.7%, respectively.

The economy of Puerto Rico is measured by the Gross National Product. For the fiscal year 2010, the Puerto Rico Planning Board estimated a decrease of 3.6%, according to their last forecast of May 2010. The main components of the PR economy are: manufacturing (around 40% of the GNP), finance, insurance and the real estate, trade and service sectors.

The Authority adopted the 2011 fiscal year budget on June 30, 2010. The total revenues for fiscal year 2010-2011 are projected to be approximately $4,522.1 million. In addition, the Capital Improvement Program amounted to approximately $300.0 million. The 2011 consolidated budget increased by $917.5 million (25.45 percent) when compared to the ammended consolidated budget approved on April 21, 2009 for fiscal year 2009-2010, due mainly to a increase on projected fuel oil prices per barrel from $65.59 for 2009-2010 to $88.20 for 2010-2011, representing a 34.5 percent. In addition, the Capital Improvement Program decreased by $50.0 million, representing a 14.3 percent.

Request for Information

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

Puerto Rico Electric Power Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Balance Sheets
(In thousands)

	June 30	
	2010	**2009**
		(As restated)
Assets and deferred outlaws		
Current assets:		
Cash and cash equivalents	**$ 81,646**	$ 76,194
Receivables, net	**976,896**	1,018,796
Fuel oil, at average cost	**185,293**	210,262
Materials and supplies, at average cost	**178,897**	200,084
Prepayments and other assets	**3,364**	2,177
Total current assets	**1,426,096**	1,507,513
Other non-current receivables	**108,216**	108,061
Restricted assets:		
Cash and cash equivalents held by trustee for payment of principal and interest on bonds	**198,693**	304,480
Investments held by trustee	**433,496**	329,625
Construction fund and other special funds	**162,866**	23,788
Total restricted assets	**795,055**	657,893
Utility plant:		
Plant in service	**10,304,310**	9,352,258
Accumulated depreciation	**(4,960,294)**	(4,639,335)
	5,344,016	4,712,923
Construction in progress	**1,182,225**	1,697,250
Total utility plant, net	**6,526,241**	6,410,173
Deferred expenses:		
Unamortized debt issue costs	**63,914**	64,476
Deferred outflows	**109,938**	103,888
Other	**51,545**	33,489
Total deferred expenses	**225,397**	201,853
Total assets and deferred outflows	**$ 9,081,005**	$ 8,885,493

(Continue)

	June 30	
	2010	**2009**
		(As restated)
Liabilities and net assets		
Current liabilities:		
Notes payable	**$ 15,090**	$ 595,374
Accounts payable and accrued liabilities	**926,801**	820,851
Customers' deposits	**40,354**	38,447
Total current liabilities	**982,245**	1,454,672
Current liabilities payable from restricted assets:		
Current portion of long-term debt and bond anticipation notes	**172,278**	853,040
Notes payable from restricted assets	**–**	11,622
Accrued interest	**23,978**	148,910
Other current liabilities payable from restricted assets	**72,432**	96,050
Total current liabilities payable from restricted assets	**268,688**	1,109,622
Noncurrent liabilities:		
Long-term debt, excluding current portion	**7,399,746**	5,775,827
Fair value of derivative instruments	**109,938**	103,888
Customers' deposits (excluding current portion)	**134,431**	131,545
Sick leave benefits to be liquidated after one year	**128,810**	136,544
Accrued unfunded other post-employment benefits liability	**160,763**	134,176
Total noncurrent liabilities	**7,933,688**	6,281,980
Total liabilities	**9,184,621**	8,846,274
Net assets:		
Invested in utility plant, net of related debt	**(45,160)**	19,433
Restricted for capital activity and debt service	**136,053**	233,208
Unrestricted	**(194,509)**	(213,422)
Total net assets	**(103,616)**	39,219
Total liabilities and net assets	**$ 9,081,005**	$ 8,885,493

See accompanying notes.

Puerto Rico Electric Power Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Revenues, Expenses and Changes in Net Assets
(In thousands)

	Year Ended June 30	
	2010	**2009**
Operating revenues	**$ 4,171,493**	$ 4,002,713
Operating expenses:		
Operations:		
Fuel	**2,006,931**	1,919,789
Purchased power	**693,724**	671,849
Other production	**64,948**	64,409
Transmission and distribution	**164,033**	168,102
Customer accounting and collection	**114,686**	111,337
Administrative and general	**210,721**	171,864
Maintenance	**212,993**	226,642
Depreciation	**343,935**	306,117
Total operating expenses	**3,811,971**	3,640,109
Operating income	**359,522**	362,604
Interest income and other	**11,160**	25,326
Income before interest charges, contribution in lieu of taxes and contributed capital	**370,682**	387,930
Interest charges:		
Interest on bonds	**304,614**	299,173
Interest on notes payable and other long-term debt	**34,279**	28,798
Other interest	**1,907**	2,819
Amortization of debt discount, issuance costs and refunding loss	**14,281**	13,905
Allowance for funds used during construction	**(8,428)**	(18,530)
Total interest charges, net	**346,653**	326,165
Income before contribution in lieu of taxes and contributed capital	**24,029**	61,765
Contribution in lieu of taxes and other	**(232,431)**	(224,792)
Loss before contributed capital	**(208,402)**	(163,027)
Contributed capital	**65,567**	15,564
Change in net assets	**(142,835)**	(147,463)
Net assets, beginning balance	**39,219**	186,682
Net assets, ending balance	**$ (103,616)**	$ 39,219

See accompanying notes.

Puerto Rico Electric Power Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Cash Flows

(In thousands)

	Year Ended June 30	
	2010	**2009**
Cash flows from operating activities		
Cash received from customers	**$ 4,210,885**	$ 3,955,522
Cash paid to suppliers and employees	**(3,554,091)**	(3,382,771)
Net cash flows provided by operating activities	**656,794**	572,751
Cash flows from noncapital financing activities		
Proceeds from notes payable	**38,364**	195,000
Principal paid on notes payable	**(337,985)**	(247,821)
Interest paid on notes payable	**(16,937)**	(12,716)
Principal paid on fuel line of credit	**(275,000)**	–
Proceeds from fuel line of credit	**–**	50,000
Interest paid on fuel line of credit	**(11,992)**	(11,064)
Net cash flows used in noncapital financing activities	**(603,550)**	(26,601)
Cash flows from capital and related financing activities		
Construction expenditures	**(395,444)**	(527,161)
Proceeds received from contributed capital	**14,408**	12,661
Allowance for funds used during construction	**8,428**	18,530
Power revenue bonds:		
Proceeds from issuance of bonds, net of original discount	**1,547,073**	–
Principal paid on revenue bonds maturities	**(173,062)**	(164,511)
Interest paid on revenue bonds	**(353,501)**	(285,353)
Proceeds from issuance of refunding bonds, net of original discount	**939,646**	–
Defeased bonds, net of original discount or premium	**(924,361)**	–
Proceeds from bond anticipation notes	**186,610**	98,000
Payment of bond anticipation notes	**(747,675)**	(200,000)
Interest paid on notes payable	**(24,547)**	(18,820)
Net cash flows provided by (used in) capital and related financing activities	**77,575**	(1,066,654)
Cash flows from investing activities		
Purchases of investment securities	**(2,231,395)**	(1,512,316)
Proceeds from sale and maturities of investment securities	**2,137,457**	1,539,206
Interest on investments	**11,795**	25,295
Transfer from restricted funds to general fund	**–**	29,523
Transfer from general fund to restricted funds	**(15,000)**	(15,000)
Net cash flows (used in) provided by investing activities	**(97,143)**	66,708
Net increase (decrease) in cash and cash equivalents	**33,676**	(453,796)
Cash and cash equivalents at beginning of year	**397,968**	851,764
Cash and cash equivalents at end of year	**$ 431,644**	$ 397,968

(Continue)

Puerto Rico Electric Power Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Statements of Cash Flows (continued)
(In thousands)

	Year Ended June 30	
	2010	2009
Cash and cash equivalents		
Unrestricted	**$ 81,646**	$ 76,194
Restricted:		
Cash and cash equivalents held by trustee for payment of principal and interest on bonds	**198,693**	304,480
Cash and cash equivalents within construction and other special funds	**151,305**	17,294
	$ 431,644	$ 397,968
Reconciliation of net operating revenues to net cash provided by operating activities		
Operating income	**$ 359,522**	$ 362,604
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation	**343,935**	306,117
Provision for uncollectible accounts and other	**29,063**	20,637
Changes in assets and liabilities:		
Receivables	**(217,776)**	(118,391)
Fuel oil	**36,961**	12,828
Materials and supplies	**17,792**	(7,517)
Prepayments and other assets	**(1,187)**	333
Other deferred debits	**(17,494)**	50,659
Noncurrent liabilities, excluding revenue bonds and notes payable	**18,853**	(42,287)
Accounts payable and accrued liabilities	**82,332**	(17,749)
Customer's deposits	**4,793**	5,517
Total adjustments	**297,272**	210,147
Net cash flows provided by operating activities	**$ 656,794**	$ 572,751

See accompanying notes.

1. Reporting Entity

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

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

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

Basis of Presentation – Blended Component Units

The financial statements of the Authority as of June 30, 2010, include the financial position and operations of the Puerto Rico Irrigation Systems (Irrigation Systems) and PREPA Holdings LLC. The Irrigation Systems operate pursuant to the provisions of the Act, and Acts No. 83 and 84, approved on June 20, 1955, regarding the Puerto Rico Irrigation Service, South Coast, and Isabela Irrigation Service, respectively, and the Lajas Valley Public Irrigation Law, approved on June 10, 1953, as amended. PREPA Holdings LLC, a wholly-owned subsidiary of the Authority, was created for the sole purpose of acting as a holding company and has no current operations. PREPA Holdings LLC is the direct parent of the following entities: PREPA Networks, LLC, also known as PREPA.net; PREPA Utilities, LLC; PREPA Oil & Gas, LLC; and InterAmerican Energy Sources, LLC.

The financial statements of the Authority as of June 30, 2009, include the financial position and operations of the Irrigation System and PREPA.Net.

1. Reporting Entity (continued)

Basis of Presentation – Blended Component Units (continued)

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

Condensed financial information as of June 30, 2010 and 2009 and for the years then ended for the Irrigation Systems is as follows:

	2010	**2009**
	(*In thousands*)	
Balance sheets:		
Assets:		
Receivables, net	**$ 14,829**	$ 18,796
Prepayments and other assets	**240**	2,186
Utility Plant, net of depreciation	**20,081**	20,211
Total assets	**$ 35,150**	$ 41,193
Liabilities:		
Accounts payable, net	**$ 1,043**	$ 1,020
Statements of revenues, expenditures and changes in net assets:		
Operating revenues	**$ 7,370**	$ 7,619
Operating expenses	**(13,436)**	(4,735)
	(6,066)	2,884
Net assets, beginning balance	**40,173**	37,289
Net assets, ending balance	**$ 34,107**	$ 40,173

1. Reporting Entity (continued)

Basis of Presentation – Blended Component Units (continued)

Pursuant to the Act, the Authority is authorized to create subsidiaries in order to, among other things, delegate or transfer any of its rights, powers, functions or duties. The Authority currently has four principal subsidiaries organized in a holding company structure. Currently, only PREPA.Net has significant operations.

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

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

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

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

PREPA Utilities, LLC, was created for the purpose of investing, financing, constructing and operating industrial projects and other infrastructure relating to the optimization of the Authority's electric infrastructure.

PREPA Oil & Gas, LLC, was created for the purpose of buying, selling, exchanging and otherwise trading or dealing with the export, import, manufacture, production, preparation, handling, storage, and distribution of oil and gas and any other fuels required to satisfy the Authority's power generation needs.

1. Reporting Entity (continued)

Basis of Presentation – Blended Component Units (continued)

InterAmerican Energy Sources was created for the purpose of investing, developing, financing, constructing and operating renewable energy projects and other infrastructure related to the optimization of the Authority's electric infrastructure. PREPA Utilities, LLC, PREPA Oil & Gas, LLC, and InterAmerican Energy Sources, LLC are currently not operating.

Condensed financial information for PREPA Holdings LLC as of June 30, 2010 and for the year then ended is as follows:

	2010
	(In thousands)
Balance sheets:	
Assets:	
Cash and cash equivalents	**$ 13,062**
Receivables, net	**2,324**
Prepayments and other assets	**17**
Utility plant, net of depreciation	**7,903**
Other receivables	**155**
Total assets	**$ 23,461**
Liabilities:	
Accounts payable, net	**$ 7,451**
Notes payable	**10,100**
Total liabilities	**$ 17,551**
Statements of revenues, expenditures and changes in net assets:	
Operating revenues	**$ 9,781**
Operating expenses	**(7,131)**
	2,650
Net assets, beginning balance	**3,260**
Net assets, ending balance	**$ 5,910**

1. Reporting Entity (continued)

Basis of Presentation – Blended Component Units (continued)

Condensed financial information as of June 30, 2009 and for the year then ended for PREPA.Net is as follows:

	2009
	(In thousands)
Balance sheets:	
Assets:	
Cash and cash equivalents	$ 10,421
Receivables, net	1,369
Prepayments and other assets	163
Utility plant, net of depreciation	8,163
Other receivables	–
Total assets	$ 20,116
Liabilities:	
Accounts payable, net	$ 16,856
Statements of revenues, expenditures and changes in net assets:	
Operating revenues	$ 9,075
Operating expenses	(6,399)
	2,676
Net assets, beginning balance	584
Net assets, ending balance	$ 3,260

2. Summary of Significant Accounting Policies

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

Basis of Accounting

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

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

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

Impact of Recently Issued Accounting Principles

In June 2008, the GASB issued Statement 53, *Accounting and Financial Reporting for Derivative Instruments.* GASB 53 addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. The requirements of this Statement are effective for financial statements for periods beginning after June 15, 2009. The Authority adopted GASB 53 in Fiscal Year 2010. This statement requires for it to be applied retroactively by restating financial statements for all prior periods presented.

2. Summary of Significant Accounting Policies (continued)

Impact of Recently Issued Accounting Principles (continued)

The effect of the accounting change on previously reported balances for fiscal year 2009 is as follows:

	As Previously Reported	Effect	As Restated
Deferred outflows	$ –	$103,888	$103,888
Fair value of derivative instruments	–	103,888	103,888

Because the Authority's derivative instruments are classified as hedging derivatives, there was no impact on the statement of revenues, expenses and changes in net assets.

Cash and Cash Equivalents

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

Receivables

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

Materials, Supplies and Fuel Oil

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

2. Summary of Significant Accounting Policies (continued)

Investments

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

The funds under the 1974 Agreement may be invested in:

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

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

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

Effective April 1999, the 1974 Agreement was amended to provide that permitted investments of moneys to the credit of the Self-insurance Fund be expanded (subject to the Authority's adoption of an investment policy with the consent of GDB) to coincide with the investments permitted for the pension fund for employees of the Commonwealth of Puerto Rico and its instrumentalities.

Such investments include various debt instruments, such as mortgage loans and leases, common and preferred stock, real property and various other financial instruments.

2. Summary of Significant Accounting Policies (continued)

Utility Plant

Utility plant is carried at cost, which includes labor, materials, overhead, and an allowance for the cost of funds used during construction (AFUDC). AFUDC represents the cost of borrowed funds used to finance construction work in progress. AFUDC is capitalized as an additional cost of property and as a reduction of interest expense. Capitalized interest expense is reduced by interest income earned on related investments acquired with proceeds of tax-exempt borrowings. Such costs are recovered from customers as a cost of service through depreciation charges in future periods. Capitalized interest during the years ended June 30, 2010 and 2009 amounted to $8.4 million and $18.5 million, respectively. These amounts are net of interest income earned on investments amounting to $.7 million and $4.1 million, respectively.

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

Depreciation

Depreciation is computed on the straight-line method at rates considered adequate to allocate the cost of the various classes of property over their estimated service lives. The annual composite rate of depreciation, determined by the Authority’s consulting engineers, was approximately 4.25% for 2010 and 2009.

Unamortized Debt Issuance Expense

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

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

2. Summary of Significant Accounting Policies (continued)

Pension Plan

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

Other Postemployment Benefits

Other Postemployment Benefits (OPEB) cost of healthcare provided to employees is measured and disclosed using the accrual basis of accounting (see Note 12).

Accounting for Compensated Absences

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

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

Revenue Recognition, Fuel Costs and Purchase Power

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

2. Summary of Significant Accounting Policies (continued)

Contributions in Lieu of Taxes and Governmental Subsidies

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

Municipalities

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

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

a) Twenty percent of the Authority's Adjusted Net Revenues (Net Revenues, as defined in the 1974 Agreement, less the cost of the Commonwealth rate subsidies);

b) The cost collectively of the actual electric power consumption of the municipalities; or

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

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

Commonwealth of Puerto Rico

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

2. Summary of Significant Accounting Policies (continued)

Contributed Capital

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

Interest-Rate Swap Agreements

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

3. Cash and Cash Equivalents

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

At June 30, 2010 and 2009, the carrying amount and bank balance of cash deposits held by the Authority and restricted cash deposits held by the Trustee under the 1974 Agreement are as follows (in thousands):

	2010		**2009**	
	Carrying Amount	**Bank Balance**	**Carrying Amount**	**Bank Balance**
Unrestricted	**$ 81,646**	**$ 57,326**	$ 76,194	$ 76,578
Restricted:				
Held by the Trustee	**198,693**	**198,693**	304,480	304,480
Held by the Authority	**151,305**	**151,305**	17,294	17,294
	$ 431,644	**$ 407,324**	$ 397,968	$ 398,352

3. Cash and Cash Equivalents (continued)

Custodial Credit Risk - Deposits

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

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

4. Accounts Receivable

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

	2010	2009
Electric and related services:		
Government agencies and municipalities	**$ 345,535**	$ 471,400
Residential, industrial, and commercial	**657,426**	545,150
Recoveries under fuel adjustment clause under billed	**14,412**	25,189
Unbilled services	**179,583**	150,742
Commonwealth subsidy (fuel adjustment clause) for certain residential clients	**18,980**	18,980
Miscellaneous accounts and others	**23,946**	25,938
	1,239,882	1,237,399
Allowance for uncollectible accounts	**(194,852)**	(163,556)
	1,045,030	1,073,843
Recovery from insurance companies and other	**37,954**	50,229
Accrued interest on investments	**2,128**	2,785
Less other non-current receivables, mostly related to the Commonwealth	**(108,216)**	(108,061)
	$ 976,896	$ 1,018,796

4. Accounts Receivable (continued)

On October 29, 1991, the Authority entered into an agreement with the Commonwealth for the payment of the outstanding fuel adjustment subsidy receivable amounting to approximately $94 million. Under this agreement, the Commonwealth was paying that amount over a fifteen-year period in installments of approximately $6.3 million per year, without interest. As of June 30, 2004, the outstanding fuel adjustment subsidy receivable amounted to approximately $31.6 million. In June 2004, the Legislature of the Commonwealth of Puerto Rico superseded the 1991 agreement with a revised agreement containing an eight-year payment schedule that totals $55.7 million. The amount owed to the Authority under the 2004 agreement includes an allocation for past due government account receivables in addition to the unpaid balance of the fuel adjustment subsidy. As of June 30, 2010 and 2009, the outstanding receivable amounted to approximately $18.9 million. This amount is included in other non-current receivables in the accompanying balance sheet.

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

5. Restricted Assets

At June 30, 2010 and 2009, certain investments and cash deposits of the Authority were restricted to comply with long-term principal and interest debt service requirements (sinking funds) as well as for self-insurance. These restricted assets are held by the Trustee under the 1974 Agreement (see Note 3) in the following funds:

1974 Reserve Account – Reserve for payment of principal of and interest on Power Revenue Bonds in the event moneys in Bond Service Account or Redemption Account are insufficient for such purpose. During fiscal year 2008-2009, as allowed by the Trust Agreement, the Authority withdrew $29.6 million, which were accumulated in excess of the amount required.

5. Restricted Assets (continued)

1974 Self-Insurance Fund – Fund to pay the cost of repairing, replacing or reconstructing any property damaged or destroyed from, or extraordinary expenses incurred as a result of a cause, which is not covered by insurance required under the 1974 Agreement. The 1974 Self-Insurance Fund also serves as an additional reserve for the payment of the principal of and interest on the Power Revenue Bonds, and meeting the amortization requirements to the extent that moneys in the Bond Service Account, the Redemption Account and the 1974 Reserve Account are insufficient for such purpose. During fiscal years 2009-2010 and 2008-2009, the Authority deposited $10 million each to the 1974 Self-Insurance Fund.

Bond Service Account and Redemption Account (1974 Sinking Fund) – Current year requirements for principal of and interest on Power Revenue Bonds. As of June 30, 2010 and 2009, cash and cash equivalents in this account amounted to $198.7 million and $304.5 million, respectively.

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

	2010	**2009**
1974 Reserve Account	**$ 359,714**	$ 267,001
1974 Self-Insurance Fund	**73,782**	62,624
	$ 433,496	$ 329,625

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

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

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

5. Restricted Assets (continued)

Reserve Maintenance Fund – Fund to pay the cost of unusual or extraordinary maintenance or repairs, not recurring annually, and renewals and replacements, including major items of equipment. The Reserve Maintenance Fund also serves as an additional reserve for the payment of principal of and interest on the Power Revenue Bonds and meeting the amortization requirements to the extent that moneys in the 1974 Sinking Fund, including money in the 1974 Reserve Account, are insufficient for such purpose. During fiscal years 2009-2010 and 2008-2009 the Authority deposited $5 million in each fiscal year to the 1974 Reserve Maintenance Fund.

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

	2010		**2009**	
	Cash and Cash Equivalents	**Investments**	**Cash and Cash Equivalents**	**Investments**
1974 Construction Fund	**$ 149,405**	**$ 921**	$ 14,884	$ 921
Reserve Maintenance Fund	**–**	**10,640**	–	5,573
Other Restricted Funds	**1,900**	**–**	2,410	–
	$ 151,305	**$ 11,561**	$ 17,294	$ 6,494

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

	2010	**2009**
U.S. Government obligations	**$ 921**	$ 921
Certificate of deposit	**10,640**	5,573
	$ 11,561	$ 6,494

5. Restricted Assets (continued)

Investments

The following table provides a summary of the Authority's investments by type at June 30, 2010 (in thousands):

June 30, 2010

	Coupon Rate	Maturity Dates	Face Value	Fair Value	% of Total Portfolio
1974 Reserve Maintenance Fund					
Federal National Mortgage Association	1.00%	Jun-13	5,602	$ 5,635	53%
Certificate of Deposits	0.24%	Jul-10	5,004	5,004	47%
			Total Portfolio	10,639	
1974 Self Insurance Reserve Fund					
Federal Home Loan Mortgage Corp.	2.35%	Mar-12	11,500	11,532	16%
Federal National Mortgage Association	2.00%	Feb-13	10,100	10,116	14%
Federal Home Loan Bank	1.69 to 2.00%	4/2013 to 6/2013	20,611	20,644	28%
Certificates of Deposit	.24 to .37%	Jul-10	31,490	31,490	43%
			Total Portfolio	73,782	
1974 Reserve Account					
Federal Home Loan Mortgage Corporation	3.00 to 3.05%	1/2015 to 5/2015	66,389	66,846	19%
Federal Home Loan Bank	2.09 to 3.00%	9/2013 to 6/2015	85,850	86,249	24%
Federal National Mortgage Association	2.00 to 3.05%	6/2013 to 2/2015	51,640	51,817	14%
Federal Farm Credit Bank	2.35 to 2.80%	9/2014 to 5/2015	25,323	25,419	7%
Certificates of Deposit	.18 to .50%	Jul-10	129,384	129,384	36%
			Total Portfolio	359,715	
1974 Construction Fund					
Other – Rural Electrification Administration (REA) Investment			921	921	100%
			Total Portfolio	921	
				$ 445,057	

5. Restricted Assets (continued)

Investments (continued)

The following table provides a summary of the Authority's investments by type at June 30, 2009 (in thousands):

June 30, 2009

	Coupon Rate	Maturity Dates	Face Value	Fair Value	% of Total Portfolio
1974 Reserve Maintenance Fund					
Certificate of Deposits	0.18 to 0.21%	Jul-09	$ 5,573	$ 5,573	100.0%
			Total Portfolio	5,573	
1974 Self Insurance Reserve Fund					
Federal Home Loan Mortgage Corp.	2.0 to 5.05%	03/2012 to 06/2012	42,282	42,472	67.8%
Federal Home Loan Bank	2.00%	Jun-12	10,165	10,146	16.2%
Certificates of Deposit	0.18 to 0.19%	Jul-09	10,006	10,006	16.0%
			Total Portfolio	62,624	
1974 Reserve Account					
Federal Home Loan Mortgage Corporation	2.00%	Oct-09	40,550	40,474	15.2%
Federal Home Loan Bank	2.35 to 3.38%	12/2011 to 12/2014	105,625	105,773	9.6%
Federal National Mortgage Association	3.25%	Feb-09	20,500	20,535	7.7%
Federal Farm Credit Bank	2.60 to 4.90%	01/2013 to 05/2014	99,433	99,559	37.3%
Certificates of Deposit	0.08 to 0.18%	Jul-09	660	660	.2%
			Total Portfolio	267,001	
1974 Construction Fund					
Other – Rural Electrification Administration (REA) Investment			921	921	100.0%
			Total Portfolio	921	
				$336,119	

5. Restricted Assets (continued)

Credit Risk

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

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

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

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

As of June 30, 2010, the Authority's investments in Federal Home Loan Mortgage, Federal Home Loan Bank, Federal National Mortgage Association and Federal Farm Credit Bank and Freddie Mac were rated AAA by Standard & Poor's and Aaa by Moody's Investors Service.

Concentration Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of investment in a single issuer by five percent or more of total investment. The Authority's investment policy does not contain a limitation to invest in the securities of single issuer. As June 30, 2010, more than 5% of the Authority's total investments are in Federal Home Loan Mortgage, Federal Home Loan Bank, Federal National Mortgage Association, Federal Farm Credit Bank, and Certificate of Deposits.

5. Restricted Assets (continued)

Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater the sensitivity of its fair value to changes in market interest rates. In accordance with the 1974 Trust Agreement, the Authority manages its exposure to declines in fair values by limiting the maturity of its investment portfolio up to 5 years. Information about the sensitivity of the fair values of the Authority's investment to market interest fluctuations is provided by the following tables that show the distribution of the investments by maturity as of June 30, 2010 and 2009 (in thousands):

June 30, 2010

		Investment Maturities		
Investment Type	**Fair Value**	**Less than 1 year**	**1-5 years**	**Total**
Federal Home Loan Mortgage	**$ 78,378**	**$ –**	**$ 78,378**	**$ 78,378**
Federal Home Loan Bank	**106,893**	**–**	**106,893**	**106,893**
Federal National Mortgage	**67,568**	**–**	**67,568**	**67,568**
Federal Farm Credit Bank	**25,419**	**–**	**25,419**	**25,419**
Certificate of Deposits	**165,878**	**165,878**	**–**	**165,878**
Other – REA Investment	**921**	**–**	**921**	**921**
Total Investments				**$ 445,057**

June 30, 2009

		Investment Maturities		
Investment Type	**Fair Value**	**Less than 1 year**	**1-5 years**	**Total**
Federal Home Loan Mortgage	$ 82,946	$ –	$ 82,946	$ 82,946
Federal Home Loan Bank	115,919	–	115,919	115,919
Federal National Mortgage	20,535	–	20,535	20,535
Federal Farm Credit Bank	99,559	–	99,559	99,559
Certificate of Deposits	16,239	16,239	–	16,239
Other – REA Investment	921	–	921	921
Total Investments				$ 336,119

6. Utility Plant

As of June 30, utility plant consists of:

	2010	2009
	(In thousands)	
Distribution	**$ 2,937,624**	$ 2,603,970
Transmission	**1,637,902**	1,387,017
Production	**2,389,143**	2,295,224
Other production	**1,409,138**	1,173,550
Hydroelectric	**128,702**	124,547
General	**1,751,793**	1,726,617
Irrigation systems	**33,307**	33,170
Fiber Network	**16,701**	8,163
	10,304,310	9,352,258
Less accumulated depreciation	**(4,960,294)**	(4,639,335)
	5,344,016	4,712,923
Construction in progress	**1,182,225**	1,697,250
	$ 6,526,241	$ 6,410,173

Utility plant activity for the years ended June 30, 2010 and 2009 was as follows (in thousands):

	2009 Beginning Balance	Increases	Decreases	Transfers	2010 Ending Balance
Utility plant	$ 9,352,258	$ –	$ (22,976)	$ 975,028	**$ 10,304,310**
Construction work in progress	1,697,250	460,003	–	(975,028)	**1,182,225**
Total utility plant	11,049,508	460,003	(22,976)	–	**11,486,535**
Less:					
Accumulated depreciation	(4,639,335)	(343,935)	22,976	–	**(4,960,294)**
Total utility plant, net	$ 6,410,173	$ 116,068	$ –	$ –	**$ 6,526,241**

6. Utility Plant (continued)

	2008 Beginning Balance	Increases	Decreases	Transfers	2009 Ending Balance
Utility plant	$ 8,001,401	$ –	$(50,667)	$ 1,401,524	$9,352,258
Construction work in progress	2,556,476	542,298	-	(1,401,524)	1,697,250
Total utility plant	10,557,877	542,298	(50,667)	–	11,049,508
Less:					
Accumulated depreciation	(4,383,884)	(306,118)	50,667	–	(4,639,335)
Total utility plant, net	$ 6,173,993	$ 236,180	$ –	$ –	$6,410,173

Construction work-in-progress at June 30, 2010 and 2009 consists principally of expansions and upgrades to the electric generation, distribution and transmission systems.

7. Defeasance of Debt

In prior years, the Authority has refunded in advance certain Power Revenue Bonds and other obligations by placing the proceeds of new debt in an irrevocable trust to provide for future debt service payments on such bonds. Accordingly, the trust accounts, assets, and liabilities for the defeased bonds are not included in the Authority's financial statements. At June 30, 2010, $4,079 million of Power Revenue Bonds which remain outstanding are considered defeased.

8. Notes Payable

The following is a summary of notes payable as of June 30, 2010:

June 30, 2009

	Maturity Date	**Effective Interest Rate**	**Current Liabilities**	**Long-Term Debt**	**Total**
Notes payable, unrestricted:					
Line of credit of $64.2 million to fund payments required under a settlement agreement with municipalities	**Jun-2014**	**3.40%(V)**	**$ 9,200**	**$ 29,858**	**$ 39,058**
Loan of $41.5 to sale at discount the funds assigned by the Legislature of Puerto Rico through Joint Resolution 1290 of August 24, 2004, to pay the amount owed by the Commonwealth regarding the fuel subsidy	**Nov-2013**	**4.30%(V)**	**5,609**	**10,754**	**16,363**
Line of credit of $35.0 million for the construction of Gasoducto del Sur	**Aug-2011**	**6.00%(F)**	**–**	**26,271**	**26,271**
PREPA.Net - Loan used in the acquisition of subsidiary, Ultramarinas de P.R. (ULTRACOM)	**Feb-2023**	**3.36%(V)**	**281**	**9,819**	**10,100**
Total notes payable			**$ 15,090**	**$ 76,702**	**$ 91,792**

(V) – *variable interest rate*
(F) – *fixed interest rate*

8. Notes Payable (continued)

The following is a summary of notes payable as of June 30, 2009:

June 30, 2009	Maturity Date	Effective Interest Rate	Current Liabilities	Long-Term Debt	Total
Notes payable, unrestricted:					
Revolving line of credit or $275 million to finance fuel purchases	Jun-2010	4.11%(V)	$ 275,000	$ –	$ 275,000
Line of credit of $25 million to finance improvements of Isabela Irrigation System	Jun-2010	4.60%(V)	6,104	–	6,104
Line of credit of $100 million to be used in the recovery of Palo Seco Steam Plant (PSSP)	Dec-2009	3.81%(V)	50,000	–	50,000
Line of credit of $100 million to be used in the recovery of PSSP	Jun-2010	3.63%	50,000	–	50,000
Revolving line of credit of $200 million for operational purposes	Jun-2010	3.12%(V)	199,892	–	199,892
Line of credit of $64.2 million to fund payments required under a settlement agreement with municipalities	Jun-2014	3.40%(V)	9,000	39,058	48,058
Loan of $41.5 to sale at discount the funds assigned by the Legislature of Puerto Rico through Joint Resolution 1290 of August 24, 2004, to pay the amount owed by the Commonwealth regarding the fuel subsidy	Nov-2013	4.30%(V)	5,378	16,363	21,741
Prepa.Net entered an agreement for a loan to be used on the acquisition of subsidiary, Ultramarinas de P.R. (ULTRACOM)	Feb-2023	3.36%(V)	–	10,100	10,100
			595,374	65,521	660,895
Notes payable, restricted:					
Current portion of bond anticipation notes					
Revolving line of credit of $400 million to finance various capital projects under Capital Improvement Program (CIP)	Sep-2009	2.45%(V)	250,000	–	250,000
Bridge loan of $200 million to finance CIP	Dec-2009	3.80%(V)	200,000	–	200,000
Line of credit of $96 million to finance CIP	Jun-2011	4.75%(V)	–	48,000	48,000
Line of credit of $57 million to finance infrastructure in the municipalities	Jun-2010	3.62%(V)	56,961	–	56,961
			506,961	48,000	554,961
Other notes payable, restricted:					
Revolving line of credit of $150 million to cover the cash collateral required by the Basis Swap Agreement	Dec-2009	3.01%(V)	11,622	–	11,622
			11,622	–	11,622
Total notes payable			$ 1,113,957	$ 113,521	$1,227,478

(V) – *variable interest rate*
(F) – *fixed interest rate*

8. Notes Payable (continued)

Short-term debt activity for the years ended June 30, 2010 and 2009 was as follows:

	2010	2009
	(In thousands)	
Balance at beginning of year	**$ 1,113,957**	$ 652,508
Proceeds and transfers from long-tem debt	**177,183**	709,270
Payment of short-term debt	**(1,276,050)**	(247,821)
Balance at end of year	**$ 15,090**	$ 1,113,957
Notes payable – short-term:		
Unrestricted	**$ 15,090**	$ 595,374
Restricted	**–**	518,583
Total of notes payable	**$ 15,090**	$ 1,113,957

9. Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities at June 30, 2010 and 2009 were as follows:

	2010	2009
	(In thousands)	
Accounts payable, accruals, and withholdings in process of payment	**$ 662,783**	$ 537,200
Additional accruals and withholdings:		
Injuries and damages and other	**23,911**	23,210
Accrued vacation and payroll benefits	**59,833**	57,374
Accrued sick leave and payroll benefits - exclusive of benefits to be liquidated after one year of approximately $128.9 million in 2010 and $136.5 in 2009	**34,139**	25,749
Accrued compensation	**34,770**	27,294
Accrued pension plan contribution and withholding from employees:		
Employees' Retirement System	**15,800**	15,154
Employees health plan	**14,607**	21,803
Contribution in lieu of taxes	**70,813**	100,462
Other accrued liabilities	**10,145**	12,605
	$ 926,801	$ 820,851

10. Other Current Liabilities Payable from Restricted Assets

	2010	2009
	(In thousands)	
Contract retainage	**$ 12,733**	$ 20,794
Other liabilities	**59,699**	75,256
	$ 72,432	$ 96,050

11. Long-Term Debt

At June 30, long-term debt consists of:

	2010	2009
	(In thousands)	
Power Revenue Bonds payable:		
Publicly offered at various dates from 1997 to 2010, interest rates ranging from 2% to 6.125%, maturing to 2040	**$ 7,422,875**	$ 6,004,060
Rural Utility Services (RUS) issues - interest rate of 5%, maturing through 2028	**–**	26,631
	7,422,875	6,030,691
Plus (less) unamortized premium (discount) and debt reacquisition costs	**72,447**	(22,306)
Revenue bonds payable, net	**7,495,322**	6,008,385
Notes payable and bond anticipation notes	**91,792**	834,752
	7,587,114	6,843,137
Less current portion of long-term debt:		
Notes payable from unrestricted assets	**15,090**	214,270
Notes payable and bond anticipation notes from restricted assets	**–**	506,961
Power revenue bonds	**172,278**	346,079
Current portion of long term debt from restricted assets	**172,278**	853,040
Total current portion of long-term debt	**187,368**	1,067,310
	$ 7,399,746	$ 5,775,827

11. Long-Term Debt (continued)

Long-term debt activity for the years ended June 30, 2010 and 2009 was as follows:

	2010	2009
	(In thousands)	
Long-term debt excluding current portion	**$ 6,843,137**	$ 7,113,832
New issues:		
Power revenue bonds	**1,536,105**	–
Power revenue refunding bonds	**994,235**	–
Debt discount and excess reacquisition costs on new bond issues – net	**43,621**	–
Defeaseance of bonds	**(965,094)**	–
Debt discount and excess reacquisition costs on cancelled bonds – net	**40,734**	–
Notes payable	**212,881**	98,000
	8,705,619	7,211,832
Payments:		
Power revenue bond – July 1	**(172,640)**	(164,111)
Power revenue bond – January 1	**(422)**	(400)
Notes payable	**(955,841)**	(214,093)
Total payments	**(1,128,903)**	(378,604)
Amortization of debt discount and excess reacquisition costs	**10,398**	9,909
Balance at end of year	**$ 7,587,114**	$ 6,843,137
Current portion of notes payable	**$ 15,090**	$ 721,231
Current portion of power revenue bonds	**172,278**	346,079
Total current portion of long-term debt	**$ 187,368**	$ 1,067,310

11. Long-Term Debt (continued)

Power Revenue Bonds Payable

During fiscal year 2010, the Authority issued its Power Revenue Bonds, Series XX, ZZ, AAA, BBB and CCC. In addition, Series YY was issued under the Build America Bonds (BAB's) federal program, for the purpose of financing the cost of its Capital Improvements Program (CIP). Under this program the Authority will receive a credit from the United States Treasury equal to 35% of the stated interest paid on such bonds.

A summary of the net proceeds of the Power Revenue Bonds, Series XX, YY, ZZ, AAA, BBB and CCC and the application of the proceeds follows:

Principal amount of the bonds	$ 2,530,340,000
Net original issue discount	(6,991,364)
Net original issue premium	58,914,651
Deposits in bond service accounts	235,931,271
Total sources	$ 2,818,194,558
Application of net proceeds:	
Deposit to 1974 construction fund	$ 163,527,429
Deposit to reserve account	80,501,967
Deposit to the debt service reserve fund	2,637,499
Deposit to escrow fund for the refunded bonds	662,846,662
Capitalized interest on bonds through July 1, 2010	188,825,168
Payment of accrued interest on lines of credit	325,094
Underwriting discount and estimated legal, printing and other financing expenses	27,773,823
Swap termination payment	44,500,000
Repurchase of the purchased bonds	329,306,031
Repayment of bond anticipation notes	100,473,310
Repayment of lines of credit	1,108,177,373
Repayment of Government Development Bank line of credit	109,300,202
Total application of proceeds	$ 2,818,194,558

11. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

Maturities of the Power Revenue Bonds Series XX issued during fiscal year 2010 range from July 1, 2025 to July 1, 2040. The Series XX Bonds bear fixed interest rates ranging from 4.6% to 5.7%. Interest on the Series XX Bonds is payable on each July 1 and January 1.

Maturities of the Power Revenue Refunding Bonds Series YY issued during fiscal year 2010 range from July 1, 2037 to July 1, 2040. The Series YY Bonds bear a coupon rate of 6.1%. Interest on the Series YY Bonds is payable quarterly on each July 1, October 1, January 1 and April 1.

Maturities of the Power Revenue Refunding Bonds Series ZZ issued during fiscal year 2010 range from July 1, 2011 to July 1, 2028. The Series ZZ Bonds bear fixed interest rates ranging from 2.0% to 5.2%. Interest on the Series ZZ Bonds is payable on each July 1 and January 1.

Maturities of the Power Revenue Refunding Bonds Series AAA issued during fiscal year 2010 range from July 1, 2021 to July 1, 2031. The Series AAA Bonds bear a fixed interest rate of 5.25%. Interest on the Series AAA Bonds is payable on each July 1 and January 1.

Maturity of the Power Revenue Bonds Series BBB issued during fiscal year 2010 is July 1, 2028. The Series BBB Bonds bear fixed interest rate of 5.4%. Interest on the Series BBB Bonds is payable quarterly on each July 1, October 1, January 1 and April 1.

Maturities of the Power Revenue Bonds Series CCC issued during fiscal year 2010 range from July 1, 2021 to July 1, 2028. The Series CCC Bonds bear fixed interest rates ranging from 4.3% to 5.3%. Interest on the Series CCC Bonds is payable on each July 1 and January 1.

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

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

11. Long-Term Debt (continued)

Power Revenue Bonds Payable (continued)

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

Bond Anticipation Notes

Bond anticipation notes (BANs) are used primarily to provide interim construction financing and usually are retired with the proceeds of long-term debt.

Interest-Rate Swap Agreements

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

On June 30, 2010 and 2009, the Authority had the following derivative instruments outstanding:

Item	Type	Objective	Notional Amount	Effective Date	Maturity Date	Terms	Counterparty Credit Rating
A	Pay-Fixed Interest Rate Swap	Hedge of changes in cash flows on the Series UU Bonds	$ 25,525,000	5/3/2007	7/1/2017	Pay 4.014%; receive 5Y SIFMA	Aa1/AA-
B	Pay-Fixed Interest Rate Swap	Hedge of changes in cash flows on the Series UU Bonds	17,000,000	5/3/2007	7/1/2018	Pay 4.054%; receive 5Y SIFMA	Aa1/AA-
C	Pay-Fixed Interest Rate Swap	Hedge of changes in cash flows on the Series UU Bonds	29,055,000	5/3/2007	7/1/2020	Pay 4.124%; receive 5Y SIFMA	Aa1/AA-
D	Pay-Fixed Interest Rate Swap	Hedge of changes in cash flows on the Series UU Bonds	14,570,000	5/3/2007	7/1/2025	Pay 4.232%; receive 67% 3M LIBOR + 0.68%	Aa1/AA-
E	Pay-Fixed Interest Rate Swap	Hedge of changes in cash flows on the Series UU Bonds	169,531,850	5/3/2007	7/1/2029	Pay 4.08%; receive 67% 3M LIBOR + 0.52%	Aa1/AA-
F	Pay-Fixed Interest Rate Swap	Hedge of changes in cash flows on the Series UU Bonds	72,800,000	5/3/2007	7/1/2031	Pay 4.286%; receive 67% 3M LIBOR + 0.70%	Aa1/AA-
G	Pay-Fixed Interest Rate Swap	Hedge of changes in cash flows on the Series UU Bonds	83,343,150	5/3/2007	7/1/2029	Pay 4.08%; receive 67% 3M LIBOR + 0.52%	Aa3/A+
H	Basis Swap	Hedges tax risk on underlying fixed rate bonds (various) and provides expected positive cash flow accrual	1,375,000,000	7/1/2008	7/1/2037	Pay SIFMA; receive 62% 3M LIBOR + 0.29% + 0.4669%	A1/A

11. Long-Term Debt (continued)

Interest-Rate Swap Agreements (continued)

Derivative instruments A through G hedge changes in cash flows of the underlying bonds – floating rate notes with coupons based on 5y SIFMA or 67% of 3m LIBOR index, and maturities equal to the maturities of the corresponding swaps. As such they are considered hedging derivative instruments. The total fair value of these instruments as of June 30, 2010 is ($64.1) million.

The terms, fair values and credit ratings of the outstanding swaps as of June 30, 2010, were as follows:

Associated Power Revenue Bonds	Notional Amount	Effective Date	Maturity Date	Fixed Rate	Fair Value 2010	Fair Value 2009
LIBOR Bonds, Series UU	$ 169,531,850	3-May-07	2-Jul-29	4.080%	**$ (29,278,981)**	$ (20,176,328)
LIBOR Bonds, Series UU	14,570,000	3-May-07	1-Jul-25	4.232%	**(2,293,680)**	(1,560,026)
LIBOR Bonds, Series UU	72,800,000	3-May-07	1-Jul-31	4.286%	**(13,311,308)**	(9,324,288)
LIBOR Bonds, Series UU	83,343,150	3-May-07	2-Jul-29	4.080%	**(14,462,927)**	(9,996,186)
Muni-BMS Bonds, Series UU	25,525,000	3-May-07	3-Jul-17	4..014%	**(1,618,579)**	(531,489)
Muni-BMS Bonds, Series UU	17,000,000	3-May-07	2-Jul-18	4.054%	**(1,120,913)**	(352,374)
Muni-BMS Bonds, Series UU	29,055,000	3-May-07	1-Jul-20	4.124%	**(2,010,221)**	(600,796)
Total	$ 411,825,000				**$ (64,096,609)**	$ (42,541,487)

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

During fiscal years 2009-2010 and 2008-2009, the payments of fixed rate interest from the Authority exceeded the amount received as variable interest rate from swap counter parties by $23.4 million and $16.6 million, respectively.

Using rates as of June 30, 2010, debt service requirements of the variable-rate debt and net swap payments, assuming current interest rates remain the same for their term, would be as follows. These debt service requirements are included in the scheduled maturities of long-term debt disclosed further on this note. As rates vary, variable-rate bond interest payments and net swap payments will vary.

11. Long-Term Debt (continued)

Interest-Rate Swap Agreements (continued)

Fiscal Year Ending June 30	Principal	Interest	Interest Rate Swap, Net	Total
2011	$ –	$ 4,101,362	$ 12,864,730	$ 16,966,092
2012	–	4,101,362	12,864,730	16,966,092
2013	–	4,101,362	12,864,730	16,966,092
2014	–	4,101,362	12,864,730	16,966,092
2015	–	4,101,362	12,864,730	16,966,092
2016-2031	411,825,000	42,240,680	168,398,696	210,639,376
Total	$ 411,825,000	$ $62,747,490	$ $232,722,346	$ $295,469,836

As of June 30, 2010 and 2009, the swaps had a negative fair value of approximately $64.1 million and $42.5 million, respectively. The negative fair value of the swaps may be countered by reduction in future net interest payments required on the variable-rate Power Revenue Bonds, creating higher synthetic rates.

As of June 30, 2010 and 2009, the Authority was not exposed to credit risk because the swaps had a negative fair value in the amount of the swaps' fair value. However, should interest rates change and the fair value of the swap become positive, the Authority would be exposed to credit risk in the amount of the derivative's fair value. The swaps counterparties were rated Aa1 and Aa3 as issued by Moody's Investor Services (Moody's), AA- and A+ by Standard & Poors (S&P), and AA- and A+ by Fitch Ratings.

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

11. Long-Term Debt (continued)

Basis Swap Agreement

In March 2008 (with effective date of July 1, 2008), the Authority entered into a basis swap agreement in the notional amount of $1,375 million with an amortization schedule matching certain maturities of the Authority's outstanding power revenue and revenue refunding bonds issued in various years from 2027 to 2037 (the 2008 basis swap). Under the terms of a master swap agreement, the Authority receives from its counterparty (Goldman Sachs Capital Markets, L.P., an affiliate of Goldman, Sachs & Co.) quarterly, commencing on October 1, 2008, a floating amount applied to said notional amount at a rate equal to 62% of the taxable London Inter-Bank Offering Rate (LIBOR) index reset each week plus 29 basis points (hundredths of a percent) and a fixed rate payment of 0.4669% per annum (the "basis annuity"), quarterly for the term of swap in return for quarterly payments by the Authority, commencing also on October 1, 2008, on such notional amount at a rate based on the Securities Industry and Financial Markets Association (SIFMA) municipal swap index.

The basis swap hedges the portion of the fair value of the underlying liabilities attributable to the relative value/basis risk between tax-exempt and taxable rates. Because of the tax-exemption, tax-exempt bonds trade at yields lower than taxable yields. The percent at which tax-exempt yields trade relative to taxable yields (UST or LIBOR) is referred to as MMD ratios or muni bond ratios.

In order to assess effectiveness of the basis swap as a hedge, the Authority ran a regression of SIFMA ratios (as an independent variable) and MMD ratios (as dependent variable), adjusting to the specific circumstances. The result showed a high correlation. The method used can be qualified as Other Quantitative Method.

Because the MMD ratios and SIFMA ratios reflected respectively the change in the relative value of the tax-exempt rates to taxables in the bond market and the SIFMA swap market, the Authority concluded that the regression showed that the SIFMA swap could effectively hedge the bond's value attributable to basis risk between tax-exempt and taxables and, therefore, the basis swap was considered an effective hedge instrument under GASB 53.

11. Long-Term Debt (continued)

Basis Swap Agreement (continued)

By using derivative financial instruments to hedge the exposure to changes in interest rates, the Authority exposes itself to credit risk, market-access risk and basis risk. Credit risk is the failure of the counterparty to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Authority, which creates a credit risk for the Authority. When the fair value of the derivative contract is negative, the Authority owes to the counterparty and, therefore, does not pose credit risk to the Authority. The Authority minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties whose credit rating is acceptable under the investment policies of the Authority and of Government Development Bank for Puerto Rico (GDB), its fiscal agent.

Market risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The market risk associated with an interest rate swap contract is managed by establishing and monitoring parameters that limit the types and degree of market risk that may be undertaken. The Authority assesses market risk by continually identifying and monitoring changes in interest rate exposures that may adversely affect expected interest rate swap contract cash flows and evaluating other hedging opportunities. The Authority and GDB maintain risk management control systems to monitor interest rate cash flow risk attributable to both the Authority's outstanding or forecasted debt obligations as well as the Authority's offsetting hedge positions.

Basis risk arises when different indices are used in connection with a derivative instrument such as an interest rate swap contract. The 2009 basis swap exposes the Authority to basis risk should the relationship between LIBOR and the SIFMA municipal swap index converge. If a change occurs that results in the relationship moving to convergence, the expected financial benefits may not be realized. The Authority assesses basis risk by following the aforementioned market risks control system.

11. Long-Term Debt (continued)

Basis Swap Agreement (continued)

During the fiscal years 2009-2010 and 2008-2009, the Authority received from its counterparty $9.5 million and $7.9 million, respectively. The following table shows the cash flow benefit of the basis annuity in exchange for the Authority taking tax and other basis risks tied to the change in the relationship between LIBOR and the SIFMA municipal swap index.

	2009-2010	**2008-2009**
	(In thousands)	
Basis annuity received	$ 6,420	$ 6,420
LIBOR index amounts received	6,919	20,662
SIFMA index amounts paid	(3,832)	(19,179)
Net amount received	$ 9,507	$ 7,903

As of June 30, 2010 and 2009, the 2008 basis swap had a negative fair value to the Authority of approximately $45.8 million and $61.3 million, respectively. The negative fair value of the basis swap may be viewed as a reduction in future benefits to be received from the counterparty.

According to the Credit Support Annex of the Master Swap Agreement, if the fair value of the 2008 basis swap is negative and exceeds the threshold amount, the Authority shall post eligible collateral on the next business day upon notification from its counterparty. During fiscal year 2008-2009 the threshold amount for the Authority was $50.0 million. The Authority and GDB entered into an agreement for a $150 million revolving line of credit to meet collateral posting requirements from the 2008 basis swap. As of June 30, 2010 and 2009, there was no balance outstanding on the line of credit.

GASB Statement No. 53

For fiscal year 2010, the Authority adopted GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, which requires that the fair value of derivatives be reported in a government entity's financial statements. An adjustment of $109.9 and $103.9 million as of June 30, 2010 and 2009, respectively, was recorded as the fair value of derivative instruments off-set with deferred outflows, resulting from the change in the fair market value of the derivative instruments.

11. Long-Term Debt (continued)

Scheduled Maturities of Long-Term Debt

The scheduled maturities of long-term debt with interest thereon at June 30, 2010, are as follows:

Fiscal Year Ending June 30,	Principal	Interest	Total
		(In thousands)	
2011	$ 190,545	$ 374,493	$ 565,038
2012	228,271	366,293	594,564
2013	210,363	355,367	565,730
2014	215,605	345,380	560,985
2015	215,252	335,143	550,395
2016-2020	1,253,568	1,497,974	2,751,542
2021-2025	1,597,968	1,150,949	2,748,917
2026-2030	1,565,610	725,040	2,290,650
2031-2035	844,395	423,484	1,267,879
2036-2040	1,193,090	184,081	1,377,171
Total	7,514,667	5,758,204	13,272,871
Less:			
Unamortized discount and premium	205,867	–	205,867
Excess reacquisition costs	(133,420)	–	(133,420)
Interest		(5,758,204)	(5,758,204)
Total long-term debt	7,587,114		7,587,114
Current portion of notes payable			
Current portion, net of discount and excess reacquisition costs of bonds	(172,278)	–	(172,278)
Current portion of notes payable from restricted assets	(15,090)	–	(15,090)
Current portion of long-term debt from restricted assets	–	–	–
Total current portion	(187,368)	–	(187,368)
Long-term debt, excluding current portion	$ 7,399,746	$ –	$ 7,399,746

12. Employees' Retirement Benefits

Pension Plan

Plan Description

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

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

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

Funding Policy and Annual Pension Cost

The contribution requirements of plan members and the Authority are established and may be amended by the Authority. The Annual Pension Cost (APC) and the Annual Required Contribution (ARC) were computed as part of an actuarial valuation performed as of June 30, 2008 and projected to June 30, 2010, based on current year demographic data.

12. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System

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

Supplemental Pension Obligations Exchanged for Forfeited Sick Leave Benefits

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

The Authority's annual pension cost for the year ended June 30, 2010 and related information for the Plan and supplemental benefits follows:

	Pension Plan
Contribution rates:	
Authority	19. 70%
Plan members	10. 09%
Annual pension cost (thousands)	$70,208
Contributions made and accruals (thousands)	$69,928
Actuarial valuation date	6/30/2008
Actuarial cost method	Entry age
Amortization method	Level percentage of pay, closed (4% payroll increases per year)

12. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System (continued)

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

	Pension Plan
Remaining amortization period	28 years
Asset valuation method	5-year smoothed market
Actuarial assumptions:	
Investment rate of return (net of administrative expenses)*	8.5%
Projected salary increases*	4.10 – 5.40% depending on age
*Includes inflation at	3.0%
Cost-of-living adjustments	8% per year for yearly pension up to $3,600 and 4% per year for yearly pension between $3,600 and $7,200, 2% per year for yearly pension in excess of $7,200. The minimum adjustment is $300 per year. The maximum is $600 per year.

12. Employees' Retirement Benefits (continued)

Supplemental Benefits not Funded Through the System (continued)

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

Trend Information
(In millions)

Fiscal Year Ending	Annual Pension Cost (APC)	Percentage of APC Contributed	Net Pension Obligation
Pension Plan:			
06/30/02	43	100%	0.0
06/30/03	50.6	100%	0.0
06/30/04	65	81%	12.3
06/30/05	69.9	100%	12.6
06/30/06	74.8	100%	12.9
06/30/07	74.6	100%	13.2
06/30/08	76.3	100%	13.5
06/30/09	78.6	100%	13.8
06/30/10	75.9	100%	14.1

The annual required contribution amounted to $75.9 million and $78.6 million in 2010 and 2009, respectively. The net pension obligation is included in accounts payable and accrued liabilities on the balance sheet.

Other Post-Employment Benefits (OPEB)

Postemployment Health Plan

Plan Description – PREPA Retired Employees Healthcare Plan (Health Plan) is a single-employer defined contribution benefit healthcare plan administered by the Authority. During the fiscal year 2008-2009, the Authority adopted a resolution to change the Health Plan. The Health Plan for all retirees will be capped at $300 per member per month for retirees and spouses under age 65 and $200 per member per month for retirees and spouses age 65 and over.

12. Employees' Retirement Benefits (continued)

Other Post-Employment Benefits (OPEB) (continued)

Postemployment Health Plan (continued)

Membership – During the fiscal year 2008-2009, the Health Plan changed to require all new retired employees on or after September 1, 2009, to have 30 year of services to receive health benefits. Certain retired employees on or after September 1, 2009, all retired employees before September 1, 2009, their legal spouses, and certain disabled dependents are eligible to participate in the Postretirement Health Plan. To remain eligible for participation, Medicare eligible retired participants and their spouses must enroll in Medicare Part B at age 65, or whenever eligible, at their own expenses. The benefit provisions to retired employees are established and may be amended by the Authority.

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

The Annual OPEB Cost is calculated based on the Annual Required Contribution (ARC) of the employer, an amount actuarially determined in accordance with the provisions of GASB Statement No. 45. The ARC represents a level of funding that, if paid on ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities over a period not to exceed thirty years. The following table shows the components of the Authority's annual OPEB cost for the fiscal year 2009-2010 and 2008-2009 (in thousands):

	2010	**2009**
Annual OPEB cost (or ARC)	**$ 26,587**	$ 24,363
Actuarial Accrued Liability (AAL)	**$ 586,886**	$ 531,054
Unfunded AAL	**$ 586,886**	$ 531,054
Funded Ratio	**0%**	0%
Annual Covered Payroll	**$ 362,893**	$ 348,929

12. Employees' Retirement Benefits (continued)

Other Post-Employment Benefits (OPEB) (continued)

Postemployment Health Plan (continued)

The net OPEB obligation change is as follows (in thousands):

	2010	2009
Change in net OPEB obligation:		
Net OPEB obligation, beginning balance	**$ 134,176**	$ 189,492
Total annual required contribution (ARC), July 1–June 30	**27,481**	25,626
Actual benefit payments, July 1–June 30	**(43,326)**	(80,942)
Net OPEB obligation, ending balance	**$ 118,331**	$ 134,176

The net OPEB obligation is recorded as a component of compensated absences and postemployment benefits in the accompanying balance sheet as of June 30, 2010 and 2009.

For the fiscal years ended June 30, 2010 and 2009, the Authority's annual OPEB expense was $26.6 million and $(55.3) million (which reduced the accrued unfunded OPEB liability), respectively. This expense is included in Administrative and General Expenses.

Major changes to the Health Plan during 2008-2009, which reduced the accrued unfunded OPEB liability in such year, were as follows:

1. All future retirees on or after September 1, 2009 to have 30 years of service to received health benefits.
2. Health benefits for all current and future retirees will be applied at $300 per member per month per retirees and spouses under age 65 and $200 per member per month for retirees and spouses over age 65 and over.

The OPEB expense is not equal to the Annual Required Contribution, which is $27.5 million. The OPEB expense is considered in operating expenses in the Authority's Statement of Revenues, Expenses and Changes in Net Assets. The actual payment to the health plan for retirees and their beneficiaries, which totaled $43.3 million, is included in Administrative and General Expenses.

12. Employees' Retirement Benefits (continued)

Other Post-Employment Benefits (OPEB) (continued)

Postemployment Health Plan (continued)

For the fiscal year ended June 30, 2009, the Authority's annual OPEB expense of $134.2 million was not equal to the Annual Required Contribution, which was $24.4 million. The payment to the health plan for retirees and their beneficiaries, which totaled $80.9 million for fiscal year 2009, is included in Administrative and General Expenses.

OPEB Actuarial Valuation – The Authority's other Post-Employment Benefits Program actuarial valuation was conducted by Cavanaugh Macdonald Consulting, LLC. Cavanaugh Macdonald Consulting, LLC is a member of the American Academy of Actuaries. The valuation was performed in accordance with GASB Statement No. 45 requirements.

Actuarial Methods and Assumptions:

Actuarial Valuation Date	July 1, 2008
Actuarial Cost Method	Projected Unit Credit
Amortization method	Level Dollar Amortization over 30 years
Remaining Amortization Period	27 years
Actuarial Assets Valuation Method	Not applicable
Investment Rate of Return	4% (includes inflation rate)
Inflation Rate:	3%
Medical	Not applicable
Prescription drug	Not applicable
Dental	Not applicable
Projected Salary Increases	4%

12. Employees' Retirement Benefits (continued)

Other Post-Employment Benefits (OPEB) (continued)

Postemployment Health Plan (continued)

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

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

13. Revenues from Major Clients and Related Parties

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

	2010	**2009**
	(In thousands)	
Governmental sector, principally instrumentalities, agencies and corporations of the Commonwealth of Puerto Rico	**$ 497,697**	$ 497,951
Municipalities of the Commonwealth of Puerto Rico	**196,490**	187,686
	$ 694,187	$ 685,637

14. Net Assets

Restricted assets at June 30, 2010 and 2009 include $136.1 million and $233.2 million, respectively, which have been appropriated principally to comply with long-term principal and interest debt services requirements and a reserve for damaged or destroyed property of the Authority not fully covered by insurance as required by the 1974 Agreement. Funds set aside for self-insurance purposes are deposited in the Self-Insurance Fund held by the Trustee (see Note 5).

14. Net Assets (continued)

As of June 30, 2010, the Authority is in a net deficit position. The Authority faces a number of business challenges that have been exacerbated by the Commonwealth's economic recession, the volatility in oil prices, and the fact that the Authority has not increased rates to its customers at sufficient levels to offset the effects of its rising costs. Its principal challenges, some of which are interrelated, are: (i) addressing the decline in electric energy sales; (ii) addressing the volatility of oil costs; (iii) addressing high customer electric power rates; (iv) reducing government accounts receivables; and (v) improving its liquidity. The Authority is committed to take all necessary measures to ensure it achieves a healthy financial condition.

15. Claim for Extra Fuel Expense

The Authority expects insurance companies to cover higher fuel price and other costs associated with alternate generation capacity in connection with two fires on the Authority's generating units. In years preceding and up to June 30, 2009, there were $334 million in claims to insurance companies due to these fires. $283 million has been collected up to June 30, 2009 and $51 million was outstanding as of June 30, 2009. During the year ended June 30, 2009, there were no additional claims related to extra fuel expense. During fiscal year June 30, 2010, the Authority received $17 million of the outstanding amount.

16. Contribution in Lieu of Taxes

	2010	**2009**
	(In thousands)	
Municipalities	**$ 196,490**	$ 187,686
Commonwealth:		
Hotels	**6,316**	6,508
Fuel adjustment subsidy	**29,625**	30,579
Other subsidies (offset against outstanding accounts receivable and reimbursable costs)	**–**	19
	$ 232,431	$ 224,792

17. Commitments and Contingencies

Environmental Matters

Facilities and operations of the Authority are subject to regulation under numerous Federal and Commonwealth environmental laws, including the Clean Air Act, Clean Water Act, Oil Pollution Act (OPA), Resource Conservation Recovery Act (RCRA), Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) and Underground Storage Tanks, among others.

In February 1992, the Environmental Protection Agency (EPA) conducted a multimedia inspection of the Authority's facilities and identified several alleged instances of non-compliance related to the Authority's air, water and oil spill prevention control and countermeasures compliance programs.

The Authority and the EPA undertook negotiations to resolve the issues regarding the deficiencies observed during the inspection and to ensure future compliance with all applicable laws and regulations. As a result of the negotiations, the Authority and the EPA reached an agreement that resulted in a consent decree (the Consent Decree) approved by the United States federal court in March 1999. Under the terms and conditions of the Consent Decree, the Authority paid a civil penalty of $1.5 million, and implemented additional compliance projects amounting $4.5 million. In addition, the Consent Decree requires that the Authority improves and implements compliance programs and operations in order to assure compliance with environmental laws and regulations.

In 2004, the United States federal court approved a modification to the Consent Decree agreed by the Authority and the EPA under which the Authority reduced, in two steps, the sulfur content in the No. 6 fuel oil used in certain generating units of its Costa Sur and Aguirre power plants (to 0.75% or less by March 1, 2005 and to 0.5% or less by March 1, 2007), and used No. 6 fuel oil with sulfur content of not more than 0.5% through July 18, 2009 at its Palo Seco and San Juan power plants. Additionally, the Authority has completed a nitrogen oxide emissions reduction program and modified the optimal operating ranges for all its units under the Consent Decree. The Authority also paid a $300,000 civil fine and reserved $200,000 to fund certain supplemental environmental projects and programs under the Consent Decree.

17. Commitments and Contingencies (continued)

Environmental Matters (continued)

Since September 2004, there has been no legal action in the United States federal court or any administrative proceeding against the Authority regarding the Consent Decree or its modification. The Consent Decree includes stipulated penalties for certain events of non-compliance. Non compliance events must be disclosed to EPA in the corresponding report. Ordinarily, when a covered non compliance event occurs, the Authority pays the stipulated penalty in advance in order to benefit from a 50% discount of the applicable stipulated penalty.

Other Proceedings

In 1997, as a result of an inspection carried out by the EPA and the Puerto Rico Environmental Quality Board (the EQB) at the Authority's Palo Seco power plant, the EPA issued an Administrative Order for the investigation and possible remediation of seven areas identified by the EPA at the Palo Seco power plant and the Palo Seco General Warehouse (Depot). The Administrative Order required the Authority to carry out a Remedial Investigation/Feasibility Study (RI/FS). The RI/FS required under the order is designed to: (1) determine the nature and extent of contamination and any threat to the public health, welfare or environmental caused by any release or threatened release of hazardous substances, pollutants, or contaminants at or from the site; and (2) determine and evaluate alternatives for the remediation or control of the release or threatened release of hazardous substances, pollutants, or contaminants at or from the site. The RI/FS is still in progress. The RI was completed and a final report was submitted to EPA for evaluation. PREPA is waiting for EPA's evaluation.

The information gathered under the RI reflected the presence of free product (Separate Phase Hydrocarbons) in several monitoring wells. The analysis of this product also reflected a low concentration of polychlorinated biphenyls (PCBs). PREPA and EPA entered into an Administrative Order on Consent (CERCLA-02-2008-2022) requiring the Authority to complete a removal plan that consists of determining if the underground water has been impacted by PCBs , the extension of the contamination and the implementation of a work plan for free product removal. Analytical data collected during this activity reflected that underground water has not been impacted by PCBs. Nevertheless, water/oil mix has been found in seven monitoring wells (MWs). PCBs concentrations between 1.36-2.36 parts per million were detected in the oil found in 3 of the 7 MWs. Multiphase extraction (MPE) activities in the MWs where water/oil phases

17. Commitments and Contingencies (continued)

Environmental Matters (continued)

Other Proceedings (continued)

were found, has been performed on a weekly basis. MWs gauging readings are performed during these activities. MPE will end by December 2010. Collected data will be evaluated in order to determine further actions. It is EPA's interest that RI/FS be completed by September 2011.

The remaining costs to achieve compliance have been estimated at $500,000. The Order also establishes a Reimbursement of Costs condition in which the Authority agrees to reimburse EPA for all costs incurred by EPA in connection to the site. No bill has been received by the Authority, as of this date.

In 2002, the Authority received a "Special Notice Concerning Remedial Investigation/Feasibility Study for Soil at the Vega Baja Solid Waste Disposal Superfund Site. The EPA has identified the Authority and six other entities as "potentially responsible parties", as defined in the CERCLA. In 2003, the Authority agreed to join the other potentially responsible parties in an Administrative Order on Consent (AOC) for an RI/FS, with the understanding that such agreement did not constitute an acceptance of responsibility. Under the AOC, the Authority committed up to $250,000 as its contribution to partially fund the RI/FS. At this time, RI/FS has been completed. The work proceeded in accordance with the schedule established by the Authority and the other designated potentially responsible parties. On July 2010, a proposed Plan was issued identifying the Preferred Alternative to address soil contamination at the Vega Baja Solid Waste Disposal Site. EPA held a public hearing on August 3, 2010 to discuss the alternatives to address soil contamination. A Record of Decision (ROD) by EPA is scheduled for the end of September 2010 in which a determination of the selected alternative will be made.

In 2004, the EPA filed a complaint against the Authority regarding an alleged Resource Conservation and Recovery Act (RCRA) violation at its Aguirre power plant related to an oil sheen observed during an EPA inspection in 2000. The Authority filed an answer to the complaint disputing the allegations. The Authority paid a $67,000 penalty and carried out certain activities at the Aguirre power plant designed to prevent future, similar violations.

17. Commitments and Contingencies (continued)

Environmental Matters (continued)

Other Proceedings (continued)

In December 2004, the EPA sent a request for information to the Authority and to other potentially responsible parties that did business with certain recycling companies regarding the release of pollutants by these recycling in a Toa Baja superfund site. The EPA has stated that is particularly interested in entities that disposed of batteries at this site. The Authority has responded to the request for information, stating that it only sold scrap metal to these recycling companies. The Authority does not believe it has any liability regarding this site. At this time, we have no knowledge that the EPA has initiated, or intends to initiate any action against the Authority concerning this matter.

Compliance Programs

The Authority continues to develop and implement a comprehensive program to improve environmental compliance in all applicable environmental media. This program has been and continues to be updated to conform to new regulatory requirements.

Air Quality Compliance

In general, the Authority is consistently maintaining a 99% or better level of compliance with in-stack opacity requirements. The Authority continues to use No. 6 fuel oil with a sulphur content equal to or less than 0.5% in all its power plant which should contribute maintains air quality. These are requirements under the Consent Decree as modified in June 2004.

QA/QC Continuous Monitoring Program

This program requires quarterly audits to the opacity monitors to insure compliance with the Consent Decree Clean Air Compliance Program. All quarterly reports have been performed and submitted in compliance with the Consent Decree stipulations.

17. Commitments and Contingencies (continued)

Compliance Programs (continued)

Title V Permitting Program

This program requires operational permits for PREPA's units. During the year 2009, the permit renewal applications for the gas turbines facilities located at Daguao, Vega Baja, and Jobos were submitted in compliance with the Clean Air Title V Program stipulations. On May 14, 2010, the EQB issued a final permit for the Daguao gas turbines.}

Water Quality Compliance

As of December 2009, the Authority had achieved a level of compliance with the Clean Water Act regulations (NPDES permits, Drinking Water Program, OPA'90 (FRP's and Operations Manual) and SPCC Regulation) in excess of 99%.

The Authority has completed compliance plans for abating water pollution at its four major power plants - Aguirre, San Juan, South Coast, and Palo Seco, as required by the Consent Decree, Part VI.

Water Quality Compliance

The Authority submitted to EPA an updated request under Section 316(a) of the Clean Water Act that its South Coast power plant be permitted to discharge into the Caribbean Sea heated sea water that was previously used as for cooling purposes, as part of the plant's combustion and generation process, known as "thermal effluent". After several discussions and meetings, EPA and PREPA agreed to perform a Detailed Engineering and Environmental Review (DEER) of alternatives to select a final alternative for the cooling water discharge that meets the water temperature standard or otherwise, qualify for a waiver request under Section 316(a) of the Water Quality Act. While the DEER was in progress EPA issued a draft permit for the power plant, which commencing period is currently in hold until the DEER process is finished. The Implementation Plan is currently under discussion with EPA. The alternative estimated capital cost is approximately $60.0 M. EPA issued a final permit in October 1, 2009 with a schedule of compliance for relocation of Outfall 001 PREPA submitted a Joint Permit Application, the scoping document and an inventory of the environmental studies already performed, in December 2009 for the Outfall 001 relocation. As part of the permit requirements, PREPA has to prepare the Environmental Impact Statement including the discussions of the alternatives for the 001 Outfall by October 2011.

17. Commitments and Contingencies (continued)

Compliance Programs (continued)

Water Quality Compliance (continued)

EPA included, as part of Section 316 (a) requirements in the current San Juan Power Plant NPDES Permit, the performance of thermal plume studies and the biological monitoring program. PREPA submitted the thermal plume study plan and the QA/QC Plan for the Biological Monitoring Program in March 13, 2009, and it is waiting for EPA approvals. Also, EPA included, as another compliance requirement, the performance of a Comprehensive Demonstration Study (CDS) under the Section 316(b) of the Clean Water Act. On March 31, 2008, PREPA submitted an Impingement and Entrainment Characterization Study and Current Status Report for EPA evaluation. Also, PREPA submitted a Post-repowering Verification Study Work Plan for 316 (b) in June 30, 2008 and it is waiting for EPA approval.

Underground Injection Control Regulation

The Authority has prepared a compliance plan in order to comply with the Puerto Rico Environmental Quality Board's underground injection control regulations. The compliance plan contemplates the closing of septic systems where sanitary discharges can be connected to the facilities of the Puerto Rico Aqueduct and Sewer Authority. As of December 2009, the projects at San Juan, Aguirre and Palo Seco Power Plants for the connection of the sanitary discharges to the PRASA system were 100% completed. The project at South Coast was finished early this year, after additional related works were completed. Consequently, the execution of the compliance plans for the closing of the septic tanks at the power plants is on-going. Currently, PREPA is in the process of sampling and analyzing the septic systems at Aguirre, with San Juan and Palo Seco Power Plants during the next few months.

Spill Prevention Control and Countermeasures Plan

To meet its obligations under the Spill Prevention Control and Countermeasures (SPCC), a program under the Oil Pollution Act of 1990 plan requirements and the Consent Decree, the Authority continues to implement corrective measures at all of its facilities. As of December 2009, the Authority completed all the compliance projects under the Spill Prevention Maintenance and Construction Program of the Consent Decree in accordance with the established scope of work. In July of 2002, an amendment to the SPCC regulations was adopted that affects the Authority's oil filled equipment at its electrical transmission and distribution

17. Commitments and Contingencies (continued)

Compliance Programs (continued)

Spill Prevention Control and Countermeasures Plan (continued)

substations. The Authority has been inspecting its substations and evaluating the impact of these new requirements for the preparation of the SPCC plan for the corresponding substations. EPA extended the regulatory deadline until November 10, 2010 to comply with the SPCC plans substations implementation. PREPA is already implementing the monitoring and inspection program required under the non-contention clause stipulated at 40 CFR 112.7 (k). Notwithstanding, PREPA is working with a construction program to provide the secondary containment for 53 substations located adjacent to water bodies, instead of the 316 substations considered at the initial plan. Current project estimated cost is $3.6 million.

CERCLA Compliance

The Remedial Investigation (RI)/Feasibility Study (FS) for the Palo Seco Power Plant were the result of a joint inspection performed by EPA and EQB in the decade of the 90's. This inspection determined that conditions existed that represented a risk to human health. Therefore, PREPA was ordered to perform a RI/FS. The RI was completed and the report was submitted to EPA for evaluation. PREPA is waiting for EPA's evaluation to determine if the FS has to be performed or a Record of Decision is issued which could indicate that no remedial actions or control is needed for the areas under study. However, the studies performed under the RI reflected the presence of free product (Separate Phase Hydrocarbons) in several monitoring wells. The analysis of this product also reflected a low concentration of polychlorinated biphenyls (PCBs). PREPA and EPA reached an agreement in which PREPA must complete a removal plan that consists of determining if the underground water has been impacted by PCBs, the extension of the contamination and the implementation of a work plan for free product removal. Analytical data collected during this activity reflected that underground water has not been impacted by PCBs. Nevertheless, water/oil mix has been found in seven monitoring wells (MWs). PCBs concentrations between 1.36 - 2.36 parts per million were detected in the oil found in 3 of the 7 MWs. Multiphase Extraction (MPE) activities in the MWs where water/oil phases were found, has been performed on a weekly basis. MWs gauging readings are performed during these activities. MPE will end by December 2010. Collected data will be evaluated in order to determine further actions. It is EPA's interest that RI/FS be completed by September 2011.

17. Commitments and Contingencies (continued)

Compliance Programs (continued)

CERCLA Compliance (continued)

The Remedial Investigation/Feasibility Study for the Vega Baja Solid Waste Superfund Site is schedule for completion by the summer of 2010.

PCB Program

The Authority has completed a ten-year EPA-mandated program to sample and test its oil-filled transformers and other equipment in order to identify and dispose of transformers with more than 49 part per million (ppm) of PCBs. Pursuant to this program, the Authority has completed the removal and disposal of PCBs transformers with PCBs concentrations of more than 500 ppm. According to EPA, the Authority has been the only utility to go so far with a program to sample, test, identify, remove and dispose of PCBs or PCBs contaminated transformers. The Authority continues with the removal and disposal of transformers with PCB concentrations of between 50 and 499 ppm. The Authority updated the estimate of these units pending for disposal. As of June 30, 2010, the Authority had 36 PCBs contaminated transformers for disposal.

Capital Improvement Program

The Authority's capital improvement program for fiscal year ended June 30, 2010 includes $12.8 million in order to comply with existing Commonwealth and federal environmental laws and regulations, including the South Coast water related projects in compliance with the Clean Water Act 316(a) and 316(b) sections previously discussed. The Authority believes it is taking the necessary steps to comply with all applicable environmental laws and regulations and the Consent Decree requirements.

17. Commitments and Contingencies (continued)

Compliance Programs (continued)

Capital Improvement Program (continued)

Changes in the balances of the health insurance program (self-insurance risk) incurred but no recorded (IBNR) during fiscal years 2010 and 2009 were as follows:

	Liability Beginning Balance	Expenses	Payments	Liability Ending Balance
		(In thousands)		
2009	$ 7,154	$ 136,348	$ 137,950	$ 5,552
2010	**$ 5,552**	**$ 114,179**	**$ 114,134**	**$ 5,507**

Gasoducto del Sur

On January 10, 2008, the Authority and Skanska Energy Services, LLC (Skanska) entered into an Engineer Procure Construct Finance Contract for the construction of the Gasoducto del Sur Project (the Project) for an original Contract Price of $74,324,259. On December 2, 2008, the Superior Court of Ponce issued an injunction stopping all construction. On July 23, 2009, PREPA'S Governing Board authorized the termination and settlement of the Contract. The Authority obtained title to all equipment and material procured and 100% of engineering documents and all pending disputes were settled for a lump-sum payment of $59,000,000 due to the Contractor. The Termination and Settlement Agreement was executed on August 7, 2009. Pursuant to an Asset Purchase Agreement dated August 17, 2009, PREPA sold the assets of the Gasoducto del Sur Project to The Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority (AFICA by its Spanish acronym) for approximately $36 million. In addition, PREPA entered into a Subordinated Loan Agreement with the Government Development Bank (GDB) for $35,000,000 evidenced by a 24-month subordinated note until such time that Puerto Rico Aqueduct and Sewer Authority (PRASA) shall purchase from AFICA the Project.

17. Commitments and Contingencies (continued)

Contingencies

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

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

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

In 2008, Power Technologies Corp. filed a suit against the Authority, alleging that the Authority had withdrawn from a contracting process for a new energy facility, in which Power Technologies was involved, without explanation or justification. Power Technologies seeks damages of $51.4 million. The case is currently in the discovery stage.

17. Commitments and Contingencies (continued)

Contingencies (continued)

In addition to these cases, the Authority is involved in typical litigation for an electric power utility, but the Legal Counsel estimates the amounts of such claims are not material and will not affect adversely the Authority's operations.

Construction and Other Commitments

As of June 30, 2010, the Authority has commitments of approximately $23.6 million on active construction, maintenance and engineering services contracts.

18. Recently Issued Accounting Pronouncements

In May 2009, the GASB issued Statement 54 (GASB 54), *Fund Balance Reporting and Governmental Fund Type Definitions*. GASB 54 requires the use of new fund balance classifications and clarifies existing governmental fund type definitions. The requirements of this statement are effective for financial statements for periods beginning after June 15, 2010. Retroactive restatement of fund balance is required for all prior periods presented. The adoption of GASB 54 does not have any impact on the Authority's financial Statements.

In December 2009, the GASB issued Statement 57 (GASB 57), *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*. GASB 57 address issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer other postemployment benefit (OPEB) plans and clarifies that when actuarially determined OPEB measures are reported by an agent multiple-employer OPEB plan and its participating employers. Provisions of this Statement related to the use and reporting of the alternative measurement method are effective immediately. The adoption of GASB 57 does not have any impact on the Authority's financial Statements.

In December 2009, the GASB issued Statement 58 (GASB 58), *Accounting and Financial Reporting for Chapter 9 Bankruptcies*. GASB 58 provides accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the United States Bankruptcy Code. It requires governments to re-measure liabilities that are adjusted in bankruptcy when the bankruptcy court confirms (that is, approves) a new payment plan. This Statement is effective for reporting periods beginning after June 15, 2009. The adoption of GASB 58 does not have any impact on the Authority's financial statements.

18. Recently Issued Accounting Pronouncements (continued)

In June 2010, The GASB issued Statement 59, *Financial Instruments Omnibus*. GASB 59 updates and improves existing standards regarding financial reporting and disclosure requirements of certain financial instruments and external investment pools for which significant issues have been identified in practice. The requirements of this Statement will improve financial reporting by providing more complete information, by improving consistency of measurements, and by providing clarifications of existing standards. This Statement is effective for financial statements for periods beginning after June 15, 2010. The Authority is currently assessing the impact of GASB 59 on its finical position.

19. Subsequent Events

Via Verde Pipeline

The Authority plans to convert existing oil-fired facilities to allow them to use either oil or natural gas and to build a pipeline system to be known as "Via Verde", to transport natural gas to several of the Authority's generating plants. In order to achieve this, during December 2010 the Authority issued bonds pursuant to Section 208 of the Trust Agreement to finance a portion of its capital improvement program and a portion of the construction of the Via Verde natural gas pipeline.

On July 29, 2010 the Authority established with Citibank, N.A. a $200 million line of credit, with a maturity date of June, 2011, for the purchase of fuel oil and energy.

On September 2010, pursuant to the Trust Agreement, the Authority issued Power Revenue Refunding, Series DDD, with a par amount of $218,225,000 to provide funds to refund certain series with redemption dates that range between November 15, 2010 and January 1, 2011.

On November 5, 2010 the Authority entered into a $50 million loan agreement with FirstBank to finance initial disbursements related to Via Verde Project. This loan will be paid off with the proceeds of the bonds issuance expected on December 2010.

On December 2010, the Authority issued Series EEE amounting $355.7 million to funding portion of its capital improvement program, to repay the FirstBank loan and to finance portion of the construction costs of the Via Verde natural gas pipeline.

19. Subsequent Events (continued)

Energy Diversification

On July 10, 2010, the Government enacted Act No. 82, known as the Act for a Public Policy for Energy Diversification Through Sustainable and Alternative Renewable Energy. Act No. 82 requires the Authority to meet prescribed targets of energy generation from renewable sources by specified dates, as follows: 12% of energy sales from renewable energy production by 2015 and 15% of energy sales from renewable energy production by 2020, with a requirement to establish a plan to reach 20% of energy sales from renewable energy production by 2035. Act No. 82 also establishes Renewable Energy Certificates as a legally recognized asset that can be purchased, sold, traded and transferred separately from electric power and used to meet the renewable energy targets and creates a Renewable Energy Commission with the power to implement and supervise compliance with Act No. 82. Failure to comply with the renewable energy targets could result in the imposition of fines. Concurrently with the enactment of Act No. 82, the Government enacted Act No. 83 of July 19, 2010, known as the Green Energy Incentives Act, which provides incentives to promote the development of renewable energy projects. The Authority is taking measures to comply with Act No. 82, such as entering into power purchase agreements with developers of renewable energy projects, but it is too early to determine whether the Authority will be able to comply with the requirements of Act No. 82 and what impact Act No. 82 and Act No. 83 will have on the Authority.

Wheeling

Act No. 73 provides that the Authority shall identify and implement a system that permits the operation of a wheeling service mechanism by January 2, 2010. Act No. 73 also provides for the creation of a Committee of Wheeling, which Committee is responsible for the implementation of the wheeling system. The Committee of Wheeling engaged Christensen Associates Energy Consulting, LLC, based in Wisconsin, to prepare the Puerto Rico Wheeling System Implementation Plan Study that was delivered to the Authority in December 2009. This study, which included various regulatory proposals regarding the establishment of the system and the applicable tariffs, was reviewed by the Authority and substantial changes were made.

19. Subsequent Events (continued)

Wheeling (continued)

Public Hearings were held on June 1 and 2, 2010 to consider the following documents: Wheeling System Tariffs, Wheeling Transmission Regulation and Wheeling Interconnection Procedure. The public hearing examiner submitted a final report to the Authority's Governing Board on June 30, 2010. In the report, the examiner recommends approval of the Wheeling Transmission Regulation and Wheeling Interconnection Procedure, but rejected approval of the Wheeling System Tariffs based on lack of information to the public. The Tariffs have to be submitted to the public hearings procedure again with enough time for public evaluation.

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

The Governing Board
Puerto Rico Electric Power Authority

We have audited the financial statements of the Puerto Rico Electric Power Authority (the Authority) as of and for the year ended June 30, 2010, and have issued our report thereon dated January 31, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal control over financial reporting

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

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

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

Compliance and other matters

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

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

Ernst & Young LLP

January 31, 2011

Stamp No. 2576795
affixed to
original of
this report.

Required Supplementary Information

Puerto Rico Electric Power Authority
(A Component Unit of the Commonwealth of Puerto Rico)

Supplementary Schedule of Funding Progress

June 30, 2010

(In millions)

Actuarial Valuation Date	Actuarial Value of Assets (a) Note 1	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b) - (a)	Funded Ratio (a)/(b)	Covered Payroll (c)	UAAL Percentage Of Covered Payroll [(b) - (a)]/(c)
Pension Plan						
6/30/97	$1,084	$1,333	$ 249	51%	$271	92%
6/30/98*	1,268	1,495	227	85%	274	83%
6/30/99**	1,443	1,538	95	94%	277	34%
6/30/00	1,550	1,799	250	86%	278	90%
6/30/01	1,547	1,964	417	79%	290	144%
6/30/02	1,441	2,012	572	72%	298	192%
6/30/03	1,337	2,137	799	63%	306	262%
6/30/04	1,294	2,139	846	60%	335	252%
6/30/05	1,338	2,203	866	61%	349	248%
6/30/06	1,403	2,280	877	62%	349	251%
6/30/07	1,488	2,313	826	64%	349	237%
6/30/08	1,571	2,337	766	67%	363	211%
Postemployment Health Plan						
6/30/07	–	3,375	3,375	0%	349	967%
6/30/08	–	531	531	0%	349	152%

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

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

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

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