Puerto Rico Sales Tax Financing Corporation

(A Component Unit of the Commonwealth of Puerto Rico)

Basic Financial Statements and Required Supplementary Information as of and for the Year Ended June 30, 2010, and Independent Auditors' Report

PUERTO RICO SALES TAX FINANCING CORPORATION
(A Component Unit of the Commonwealth of Puerto Rico)

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors of
Puerto Rico Sales Tax Financing Corporation
San Juan, Puerto Rico

We have audited the accompanying financial statements of the governmental activities and each major fund of Puerto Rico Sales Tax Financing Corporation (the "Corporation"), a component unit of the Commonwealth of Puerto Rico, as of and for the year ended June 30, 2010, which collectively comprise the Corporation's basic financial statements, as listed in the table of contents. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the respective financial statements are free of material misstatement. An audit includes 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 Corporation'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 respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of Puerto Rico Sales Tax Financing Corporation, as of June 30, 2010, and the respective changes in financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As described in Note 2 to the basic financial statements, the Corporation adopted Governmental Accounting Standards Board Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, in fiscal year 2010.

The management's discussion and analysis on pages 2 through 5 is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. This supplementary information is the responsibility of the Corporation's management. 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 such information and we do not express an opinion on it.

Deloitte & Touche LLP

March 2, 2011

Stamp No. 2574790
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As management of the Puerto Rico Sales Tax Financing Corporation (the "Corporation"), we offer readers of the Corporation's financial statements this narrative overview and analysis of the financial performance during the fiscal year ended June 30, 2010. Please read it in conjunction with the Corporation's basic financial statements including the notes thereto, which follow this section.

1. Financial highlights:

- The Corporation issued approximately $3,625 million of Sales Tax Revenue Bonds, First Subordinate Series 2010 A, C, D and E consisting of $1,824 million, $1,619 million, $89.4 million and $92.8 million, respectively. The proceeds from these bond issuances were mainly used to repay bond anticipation and demand notes issued to financial institutions, cover operational expenses of the Commonwealth for fiscal years 2010 and 2011, fund the Puerto Rico Economic Stimulus Fund, fund the Puerto Rico Stabilization Fund, and provide $732,797,165, along with $17,500,000 of other funds, to purchase U.S. Government State and Local Government Series securities that were placed in an irrevocable trust with an escrow agent for the purpose of generating resources for all future debt services payments of the $700,000,000 Series 2009A mandatory tender notes outstanding at June 30, 2010, which are subject to mandatory tender for purchase on August 1, 2011.

- Net deficit government wide grew to $11,785 million at June 30, 2010 from $8,558 million at June 30, 2009. The increase in net deficit is mainly due to the payment of obligations of the Commonwealth of Puerto Rico of approximately $2,899 million and interest expense on Sales Tax Revenue Bonds of approximately $683.5 million offset by Pledge Sales Tax received from the Commonwealth of Puerto Rico of approximately $550.8 million. Net deficit was also negatively impacted by the implementation of a new accounting standard related to accounting for derivative instruments. At June 30, 2010, the fair value of investment derivative instruments was a negative of approximately $195.9 million, which is now recorded as a liability in the statement of deficit, thus, increasing it by such amount (see Notes 2 and 7 for further details related to derivative instruments).

- Revenues from pledged sales taxes increased to $550.8 million in fiscal year 2010 from $199.6 million in fiscal year 2009, an increase of $351.3 million. This increase was due to an amendment to the Act that created the Corporation, which was effective on July 1, 2009, that increased the portion of the Commonwealth's sales tax transferred to the Corporation from 1% to 2.75%. See Note 1.

2. Overview of the financial statements:

These financial statements include the management's discussion and analysis section, the independent auditors' report, and the basic financial statements of the Corporation. The basic financial statements also include notes that explain in more detail some of the information in the basic financial statements.

3. **Required financial statements:**

- The statement of net deficit provides information about the nature and amounts of resources (assets) and the Corporation's obligations (liabilities).
- Current year revenues and expenses are accounted for in the statement of activities. This statement measures the results of the Corporation's operations over the past year.
- Governmental funds' financial statements present the financial position and results of operations of the Corporation's two governmental fund types using a current financial resources measurement focus. The statement of revenues, expenditures, and changes in fund balance can be used to determine, for example, whether and how the Corporation met its debt service requirements for the year.

4. **Financial analysis:**

In evaluating the Corporation's finances, in addition to the Corporation's assets and liabilities, one needs to consider various non-financial factors, such as changes in economic conditions, and new or changed government legislation. Due to the nature of the Corporation's activities, the Corporation's financial strength and ability to repay its obligations is solely dependent on the sales tax transferred to the Corporation by law and used to fund the debt service fund. Since its inception, the sales tax has proven to be resilient and is the Commonwealth's strongest tax pledge.

For additional information about the sales tax transferred to the Corporation, refer to Note 1 to these financial statements.

5. **Government wide financial analysis:**

The government wide financial statements were designed so that the user could evaluate the Corporation's financial condition at the end of the year. The following is a condensed summary of net deficit for the Corporation at June 30, 2010 and 2009 (amounts in thousands):

	June 30,		Change	
	2010	**2009**	**Amount**	**Percent**
ASSETS:				
Unrestricted assets	$ 18,113	$ 89,045	$ (70,932)	(79.66)%
Restricted assets	2,536,613	2,406,854	129,759	5.39 %
Total assets	2,554,726	2,495,899	58,827	2.36 %
LIABILITIES:				
Accounts payable and accrued interest payable	20	6,170	(6,150)	(99.68)%
Liabilities payable from restricted assets	14,339,642	10,946,955	3,392,687	30.99 %
Notes payable to Puerto Rico Public Finance Corporation		101,051	(101,051)	(100.00)%
Total liabilities	14,339,662	11,054,176	3,285,486	29.72 %
NET DEFICIT– Unrestricted	$ (11,784,936)	$ (8,558,277)	$ (3,226,659)	37.70 %

As noted above, the Corporation's deficit at June 30, 2010, amounted to $11,785 million, an increase of $3,227 million or 37.70% from $8,558 million at June 30, 2009. At June 30, 2010, the Corporation had $13,856 million of bonds payable outstanding an increase of $3,035 million or 28.04% from $10,821 million at June 30, 2009. Restricted assets mainly consist of investments held by the trustee for the Corporation's debt service, which are funded mostly from the collection of the Dedicated Sales Tax Fund, and investments restricted by law to be used in certain authorized purposes of the Corporation. (Refer to Note 1.)

Condensed revenues, expenses, and change in net deficit for the year ended June 30, 2010 and 2009, are presented below (amounts in thousands):

	June 30,		Change	
	2010	2009	Amount	Percent
GOVERNMENTAL ACTIVITIES:				
Payment of obligation of the Commonwealth of Puerto Rico	$ (2,899,116)	$ (3,327,000)	$ 427,884	(12.86)%
Interest on long-term debt	(753,086)	(327,151)	(425,935)	130.20 %
Pledged sales tax from the Commonwealth	550,846	199,565	351,281	176.02 %
Termination fee on swap agreements		(74,671)	74,671	(100.00)%
Upfront fee on swap agreements		35,980	(35,980)	(100.00)%
Total governmental activities	(3,101,356)	(3,493,277)	391,921	(11.22)%
GENERAL EXPENSES — Professional fees and other	(999)	(602)	(397)	65.95 %
SPECIAL ITEMS — Contribution from Puerto Rico Public Finance Corporation Authority		94,894	(94,894)	(100.00)%
Change in net deficit	$ (3,102,355)	$ (3,398,985)	$ 296,630	(8.73)%

For the year ended June 30, 2010, revenues to fund the debt service totaled $552.8 million; $550.8 million from the collection of sales taxes of the Dedicated Sales Tax Fund and $2.0 million from investments. For the year ended June 30, 2009, revenues to fund the debt service totaled $201.2 million; $199.6 million from the collection of sales taxes of the Dedicated Sales Tax Fund and $1.6 million from investments.

6. Governmental fund financial analysis:

The Corporation's governmental funds reported a total fund balance as of June 30, 2010 and 2009, of $2,210 million and $2,237 million, respectively. The debt service fund is funded with the Pledged Sales Tax revenues and interest thereon. For the years ended June 30, 2010 and 2009, the Pledged Sales Tax revenues amounted to $550.3 million and $199.6 million, respectively. During fiscal year 2010, total revenues received equaled the base amount for the year, while in fiscal year 2009 the Pledged Sales Tax revenues exceeded the base amount by approximately $7.7 million.

7. Debt administration:

During the year ended June 30, 2010, the Corporation issued $3,625 million on Sales Tax Revenue Bonds. As of June 30, 2010, the Corporation's outstanding bonds balance was $13,856 million, after taking into account unamortized bond premium of $63.2 million, deferred refunding gain of $112.1 million, deferred refunding loss of $39.9 million and unamortized discount of $117.8 million. As of June 30, 2009, the Corporation's outstanding bonds balance was $10,821 million, after taking into account unamortized bond premium of $47.5 million, deferred refunding gain of $114.5 million, and unamortized discount of $66.4 million. The bonds are payable in various dates through fiscal year 2058.

8. Request for information:

This financial report is designed to provide those interested with a general overview of the Corporation's finances and to enhance the Corporation's accountability for the funds it receives. Questions about this report or requests for additional information should be addressed to Puerto Rico Sales Tax Financing Corporation, PO Box 42001, San Juan, Puerto Rico, 00940-2001.

PUERTO RICO SALES TAX FINANCING CORPORATION
(A Component Unit of the Commonwealth of Puerto Rico)

STATEMENT OF NET DEFICIT
AS OF JUNE 30, 2010

ASSETS:	
Interest-bearing deposits with Government Development Bank for Puerto Rico	$ 18,111,839
Accrued interest receivable	1,489
Restricted assets:	
Interest-bearing deposits with Government Development Bank for Puerto Rico	13,983,950
Cash held by trustee	14,719,042
Pledged sales tax receivable	103,647,532
Accrued interest receivable	31
Investments	2,167,876,434
Deferred outflow of resources	47,054,945
Deferred bond issue costs	189,330,671
Total assets	2,554,725,933
LIABILITIES:	
Accounts payable	20,370
Liabilities payable from restricted assets:	
Accounts payable	5,093,547
Accrued interest payable	140,215,814
Deferred revenue	95,910,196
Interest rate swap liablity	242,967,718
Bonds payable due in more than one year	13,855,454,718
Total liabilities	14,339,662,363
NET DEFICIT — Unrestricted	$ (11,784,936,430)

See notes to basic financial statements.

PUERTO RICO SALES TAX FINANCING CORPORATION
(A Component Unit of the Commonwealth of Puerto Rico)

STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2010

		Program Revenues		Net Revenue
Functions/Programs	Expenses	Investment Earnings	Pledged Sales Tax from the Commonwealth	(Expenses) and Changes in Net Deficit
GOVERNMENTAL ACTIVITIES:				
Payment of obligations of the Commonwealth of Puerto Rico	$ 2,899,135,594	$ 20,038	$ -	$ (2,899,115,556)
Interest on long-term debt	683,485,905	(69,600,216)	550,846,020	(202,240,101)
Total governmental activities	$ 3,582,621,499	$ (69,580,178)	$ 550,846,020	(3,101,355,657)
GENERAL EXPENSES — Professional fees and other				(999,247)
CHANGE IN DEFICIT				(3,102,354,904)
DEFICIT — Beginning of year (As previously reported)				(8,558,276,613)
CUMULATIVE EFFECT OF ADOPTION OF ACCOUNTING STANDARD				(124,304,913)
DEFICIT — Beginning of year (As restated)				(8,682,581,526)
DEFICIT — End of year				$(11,784,936,430)

See notes to basic financial statements.

PUERTO RICO SALES TAX FINANCING CORPORATION
(A Component Unit of the Commonwealth of Puerto Rico)

BALANCE SHEET — GOVERNMENTAL FUNDS
AS OF JUNE 30, 2010

	General Fund	Debt Service Fund	Total Governmental Funds
ASSETS			
Interest-bearing deposits with Government Development Bank of Puerto Rico	$ 18,111,839	$ 13,983,950	$ 32,095,789
Cash held by trustee		14,719,042	14,719,042
Pledged sales tax receivable		103,647,532	103,647,532
Accrued interest receivable	1,489	31	1,520
Investments	882,079,352	1,285,797,082	2,167,876,434
TOTAL ASSETS	$ 900,192,680	$ 1,418,147,637	$ 2,318,340,317
LIABILITIES AND FUND BALANCES			
Accounts payable	$ 20,370	$ -	$ 20,370
Accounts payable from restricted assets		5,093,547	5,093,547
Deferred revenue		103,647,532	103,647,532
Total liabilities	20,370	108,741,079	108,761,449
FUND BALANCES:			
Reserved for debt service		1,309,406,558	1,309,406,558
Designated	900,191,191		900,191,191
Unreserved	(18,881)		(18,881)
Total fund balances	900,172,310	1,309,406,558	2,209,578,868
TOTAL LIABILITIES AND FUND BALANCES	$ 900,192,680	$ 1,418,147,637	$ 2,318,340,317

See notes to basic financial statements.

PUERTO RICO SALES TAX FINANCING CORPORATION
(A Component Unit of the Commonwealth of Puerto Rico)

RECONCILIATION OF BALANCE SHEET OF GOVERNMENTAL FUNDS TO THE STATEMENT OF NET DEFICIT
AS OF JUNE 30, 2010

FUND BALANCES OF GOVERNMENTAL FUNDS	$ 2,209,578,868
AMOUNTS REPORTED FOR GOVERNMENTAL ACTIVITIES IN THE STATEMENT OF NET DEFICIT ARE DIFFERENT BECAUSE:	
Bond issue costs are paid from current available resources in the governmental funds financial statements; however, these costs are capitalized and amortized over the life of the bonds and are included in the statement of net deficit	189,330,671
Deferred outflow of resources are not available to pay for current period expenditures and, therefore, are not reported in the funds	47,054,945
Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the funds	7,737,336
Accrued interest payable is not due and payable in the current period, and therefore, is not reported in the fund financial statements	(140,215,814)
Bonds payable and interest rate swap liability are not due and payable in the current period, and therefore, are not reported in the funds	(14,098,422,436)
DEFICIT OF GOVERNMENTAL ACTIVITIES	$ (11,784,936,430)

See notes to basic financial statements.

PUERTO RICO SALES TAX FINANCING CORPORATION

(A Component Unit of the Commonwealth of Puerto Rico)

STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES — GOVERNMENTAL FUNDS FOR THE YEAR ENDED JUNE 30, 2010

	General Fund	Debt Service Fund	Total Governmental Funds
REVENUES:			
Pledged sales taxes from the Commonwealth	$ -	$ 550,264,000	$ 550,264,000
Investment earnings	1,979,372	48,310	2,027,682
Total revenues	1,979,372	550,312,310	552,291,682
EXPENDITURES:			
General government	33,961	12,452	46,413
Payment of obligations of the Commonwealth of Puerto Rico	2,899,135,594		2,899,135,594
Debt service:			
Principal		809,124,645	809,124,645
Interest		375,943,774	375,943,774
Bond issue costs		42,470,720	42,470,720
Total expenditures	2,899,169,555	1,227,551,591	4,126,721,146
EXCESS OF EXPENDITURES OVER REVENUES	(2,897,190,183)	(677,239,281)	(3,574,429,464)
OTHER FINANCING SOURCES AND (USES) OF FUNDS:			
Proceeds from bonds issued		4,297,451,868	4,297,451,868
Premium on bonds issued		16,873,700	16,873,700
Discount on bonds issued		(52,664,304)	(52,664,304)
Proceeds from demand notes issued		35,973,790	35,973,790
Payment for refunding of bonds		(750,297,165)	(750,297,165)
Transfer in (out)	1,750,542,196	(1,750,542,196)	
Total other financing sources	1,750,542,196	1,796,795,693	3,547,337,889
NET CHANGE IN FUND BALANCES	(1,146,647,987)	1,119,556,412	(27,091,575)
FUND BALANCES — Beginning of year	2,046,820,297	189,850,146	2,236,670,443
FUND BALANCES — End of year	$ 900,172,310	$ 1,309,406,558	$ 2,209,578,868

See notes to basic financial statements.

PUERTO RICO SALES TAX FINANCING CORPORATION
(A Component Unit of the Commonwealth of Puerto Rico)

RECONCILIATION OF THE STATEMENT OF REVENUES, EXPENDITURES, AND CHANGES IN FUND BALANCES OF GOVERNMENTAL FUNDS TO THE STATEMENT OF ACTIVITIES
FOR THE YEAR ENDED JUNE 30, 2010

NET CHANGE IN FUND BALANCES OF GOVERNMENTAL FUNDS	$	(27,091,575)
AMOUNTS REPORTED FOR GOVERNMENTAL ACTIVITIES IN THE STATEMENT OF ACTIVITIES ARE DIFFERENT BECAUSE:		
Interest on bonds payable not yet due reported in the statement of activities does not require the use of current financial resources and, therefore, is not reported as expenditure in the governmental funds		(116,438,651)
Net change in fair value of investment derivative instruments does not require the use of current financial resources and, therefore, are not reported as investment revenue in the funds		(71,607,860)
Revenues in the statement of activities that do not provide current financial resources are not reported as revenues in the governmental funds		582,020
The issuance of long-term debt (e.g., bonds, notes) provides current financial resources to governmental funds, while the repayment of the principal of long-term debt consumes the current financial resources of governmental funds. Neither transaction, however, has any effect on the net deficit. Also, governmental funds report the effect of issuance costs, premiums, discounts, and similar items when debt is first issued, whereas these amounts are deferred and amortized in the statement of activities. This amount is the net effect of these differences in the treatment of long-term debt and related items		(2,887,798,838)
CHANGE IN NET DEFICIT OF GOVERNMENTAL ACTIVITIES	$	(3,102,354,904)

See notes to basic financial statements.

1. REPORTING ENTITY

Puerto Rico Sales Tax Financing Corporation (the "Corporation") is a component unit of the Commonwealth of Puerto Rico (the "Commonwealth") and an affiliate of Government Development Bank for Puerto Rico (the "Bank"), another component unit of the Commonwealth. The Corporation was created under Act No. 91 of the Legislative Assembly of the Commonwealth (the "Legislative Assembly"), approved on May 13, 2006, as amended by Act No. 291, approved on December 26, 2006, Act No. 56, approved on July 6, 2007, Act No. 1, approved on January 14, 2009, Act No. 7, approved on March 9, 2009 ("Act 7"), and Act No. 18, approved on May 22, 2009 (collectively, "Act 91"). The Corporation was originally created for the purpose of financing the payment, retirement or defeasance of certain debt obligations of the Commonwealth outstanding as of June 30, 2006 (the "2006 Appropriation Debt").

The Commonwealth imposes a sales and use tax on a broad range of goods and services. The total tax imposed is 7% and is allocated as follows: 5.5% for the benefit of the Commonwealth (the "Commonwealth Sales Tax"), and 1.5% for the municipalities of the Commonwealth.

Act 91 established the Dedicated Sales Tax Fund, a special fund held and owned by the Corporation separate and apart from the Commonwealth's General Fund. Act 91 requires that the following amounts be deposited in the Dedicated Sales Tax Fund in each fiscal year, whichever is greater: (i) a minimum fixed amount, referred to as the Pledged Sales Tax Base Amount, and (ii) the product of the amount of the Commonwealth Sales Tax collected during such fiscal year multiplied by a fraction, the numerator of which is two point seventy-five percent (2.75%) and the denominator of which is the rate of the Commonwealth Sales Tax (the greater of (i) and (ii) being referred to as the Pledged Sales Tax). In each fiscal year, the first collections of the Commonwealth Sales Tax are deposited in the Dedicated Sales Tax Fund and applied to fund the Pledged Sales Tax Base Amount. The Pledged Sales Tax Base Amount for the fiscal year ended June 30, 2010, was $550,264,000. The Pledged Sales Tax Base Amount increases each fiscal year thereafter at a statutory rate of 4% up to $1,850,000,000. Under Act 91, the moneys on deposit in the Dedicated Sales Tax Fund may be used for the payment of the Corporation's bonds or satisfaction of the Authorized Uses.

During 2009, the Legislative Assembly expanded the purposes of the Corporation. The Corporation is authorized to pay or finance, in whole or in part, or fund, in addition to the 2006 Appropriation Debt: (i) the debt of the Secretary of the Treasury of the Commonwealth (the "Secretary of the Treasury") with the Bank in the amount of $1 billion, a portion of the proceeds of which were used to cover the budgetary deficit of the Commonwealth for fiscal year 2009, (ii) certain financing granted to the Secretary of the Treasury by the Bank payable from future Commonwealth general obligation bonds, and any debt of the Commonwealth outstanding as of December 31, 2008, that did not have a source of repayment or was payable from budgetary appropriations, (iii) a portion of the accounts payable to suppliers of the Commonwealth, (iv) operational expenses of the Commonwealth for fiscal years 2009, 2010, and 2011, (v) operational expenses of the Commonwealth for fiscal year 2012, to the extent included in the annual budget of the Commonwealth, (vi) the Puerto Rico Economic Stimulus Fund, (vii) the Commonwealth Emergency Fund in order to cover expenses resulting from catastrophic events such as hurricanes or floods, and (viii) the Economic Cooperation and Public Employees Alternatives Fund (all such uses, together with the 2006 Appropriation Debt, the "Authorized Uses").

Regardless of the level of Commonwealth Sales Tax collections, Act 91 requires that in each fiscal year all collections of the Commonwealth Sales Tax be deposited in the Dedicated Sales Tax Fund until an amount equal to the Pledged Sales Tax base amount is so deposited before any collections of Commonwealth Sales Tax are deposited in the Commonwealth's General Fund.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

The accounting and reporting policies of the Corporation conform to accounting principles generally accepted in the United States of America, as applicable to governmental entities. The Corporation follows Governmental Accounting Standards Board (GASB) under the hierarchy established by Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, in the preparation of its basic financial statements.

Following is a description of the Corporation's most significant accounting policies:

(a) Government-Wide and Fund Financial Statements:

Government-Wide Financial Statements — The statement of net deficit and the statement of activities report information on all activities of the Corporation. The Corporation's activities consist only of governmental activities. The effect of interfund balances has been removed from the statement of net deficit. Governmental activities are financed through revenue from the Commonwealth Sales Tax deposited in the Dedicated Sales Tax Fund and other financing sources.

The statement of net deficit presents the Corporation's assets and liabilities, with the difference reported as net deficit. Net assets (deficit) are reported in two categories:

- Restricted Net Assets — Result when constraints placed on net assets use are either externally imposed by creditors, grantors, contributors, and the like, or imposed by law through constitutional provisions or enabling legislation.

- Unrestricted Net Assets — Consist of net assets that do not meet the definition in the preceding category. Unrestricted net assets often are designated, in order to indicate that management does not consider them to be available for general operations. Unrestricted net assets often have constraints on use that are imposed by management, but such constraints may be removed or modified.

The statement of activities demonstrates the degree to which direct expenses of a given function or segment are offset by program revenues. Direct expenses are those that are clearly identifiable within a specific function. Program revenues consist of investment earnings (including the change in fair value of investment derivatives) and the Pledged Sales Tax. Other items not meeting the definition of program revenues are reported as general revenues.

Governmental Fund's Financial Statements — Separate financial statements are provided for governmental funds. Major individual governmental funds are reported as separate columns in the fund financial statements. All funds of the Corporation are major funds.

(b) *Measurement Focus, Basis of Accounting and Financial Statement Presentation* — The accounts of the Corporation are organized on the basis of funds, each of which is considered a separate accounting entity. The operations of each fund are accounted for with a separate set of self-balancing accounts that comprise its assets, liabilities, fund balances, revenue, and expenditures, as appropriate. Government resources are allocated to and accounted for in individual funds based upon the purpose for which they are to be spent and the means by which spending activities are controlled.

Government-Wide Financial Statements — Government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenue is recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows.

Governmental Fund's Financial Statements — The governmental fund's financial statements are reported using the current financial resources measurement focus and the modified accrual basis of accounting. Revenues are recognized when they become measurable and available.

Revenue resulting from the Commonwealth Sales Tax is recognized on an annual basis, upon collection or when the Commonwealth is obligated to make the payments. Interest income is recognized when earned, since it is available and measurable. Expenditures are recorded when the related liability is incurred. An exception to this general rule includes principal and interest on general long-term debt, which is recognized when due. Revenue is considered to be available when it is collectible within the current period or soon enough thereafter to pay liabilities of the current period. For this purpose, the Corporation considers revenues to be available if they are collected within 30 days at the end of the current fiscal year-end. Expenditures generally are recorded when a liability is incurred as under accrual accounting, except that interest on general long-term obligations is generally recognized when paid, and debt service principal expenditures and claims are recorded only when payment is due.

(c) *Fund Accounting* — The financial activities of the Corporation are recorded in individual funds, each of which is deemed to be a separate accounting entity. Fund accounting is designed to demonstrate legal compliance and to aid financial management by segregating transactions related to certain government functions or activities. A fund is a separate accounting entity with a self balancing set of accounts. The financial activities of the Corporation that are reported in the accompanying basic financial statements have been classified into the following major governmental funds:

General Fund — The general fund of the Corporation is used to account for all financial resources, except those required to be accounted for in another fund.

Debt Service Fund — The debt service fund is used to account for the Commonwealth Sales Tax deposited in the Dedicated Sales Tax Fund for the payment of interest and principal on long-term obligations.

(d) *Budgetary Accounting* — The Corporation is not required to submit a budget for approval by the Legislative Assembly; consequently, no formal budgetary accounting procedures are followed.

(e) *Investments and Investment Contracts* — Investments and investment contracts are carried at fair value, except for money market instruments with a remaining maturity at the time of purchase of one year or less and investment positions in 2a7 (Securities and Exchange Commission Rule 2a7 of the Investment Company Act of 1940) like external investment pools, which are carried at cost or the pool's share price. Fair value is determined based on quoted market prices.

(f) *Restricted Assets* — Certain resources are set aside for the repayment of bonds payable or for the Authorized Uses. These assets are generally classified as restricted assets on the accompanying Statement of Net Deficit, except when liabilities exceed assets, in which case the excess is classified as unrestricted.

(g) *Deferred Bond Issue Costs and Premium/Discount on Bonds* — Deferred bond issue costs and premium/discounts on bonds are amortized on a systematic manner over the life of the debt in the government-wide financial statements. Deferred bond issue costs and premium/discounts are recognized in the period when the related long-term debt is issued in the governmental funds financial statements, and therefore are not accounted for in subsequent periods.

(h) *Inter-Fund Transactions* — The Corporation has operating transfers which are legally required transfers that are reported when incurred as "Transfers-in" by the recipient fund and as "Transfers-out" by the disbursing fund.

(i) *Reservations of Fund Balance* — Reservations of fund balance represent portions of fund balances that are legally segregated for a specific future use or are not appropriated for expenditure. The Corporation has reservations of fund balance, which represent net assets available to finance future debt service payments or Authorized Uses.

(j) *Refundings* — Refundings involve the issuance of new debt whose proceeds are used to repay immediately (current refunding) or at a future time (advance refunding) previously issued debt. The difference between the reacquisition price and the net carrying amount of the old debt is deferred and amortized as a component of interest expense over the remaining life of the old debt or the life of the new debt, whichever is shorter. The deferred amount is recorded on the statement of net deficit as an addition to or deduction from the new debt.

(k) *Deferred Revenue* — Deferred revenue represents resources that do not yet meet the criteria for revenue recognition.

Effective July 1, 2009, the Corporation adopted GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. This statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. This statement provides that derivative instruments, with the exception of synthetic guaranteed investment contracts that are fully benefit-responsive, are reported at fair value. The changes in fair value of derivative instruments that are classified as hedging derivative instruments are reported in the statement of net assets as deferrals. The changes in fair value of derivative instruments that are used for investment purposes or that are reported as investment derivative instruments because of ineffectiveness are reported within the investment revenue classification.

Derivative instruments associated with hedgeable items that are determined to be effective in reducing exposures to identified financial risks are considered hedging derivative instruments. Effectiveness is determined by considering whether the changes in cash flows or fair values of the potential hedging derivative instrument substantially offset the changes in cash flows or fair values of the hedgeable item. This statement describes the methods of evaluating effectiveness. If the derivative is effective, hedge accounting is applied. Under hedge accounting, the changes in fair values of the hedging derivative instrument are reported as either deferred inflows or deferred outflows in the Corporation's statement of net assets.

This statement also provides disclosures required for derivative instruments. The objectives, terms, and risks of hedging derivative instruments are required disclosures. Disclosures also include a summary of derivative instrument activity that provides an indication of the location of fair value amounts reported on the financial statements. The disclosures for investment derivative instruments are similar to the disclosures of other investments.

The effect of adopting GASB Statement No. 53 was to record a cumulative effect adjustment of $124.3 million that was charged to net deficit of the Corporation at July 1, 2009.

Future Adoption of Accounting Pronouncements — The GASB has issued the following statements:

GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, which is effective for periods beginning after June 15, 2010.

GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employers Plans*, which is effective for periods beginning after June 15, 2011.

GASB Statement No. 59, *Financial Instruments Omnibus*, which is effective for periods beginning after June 15, 2010.

Management is evaluating the impact that these statements will have on the Corporation's basic financial statements.

3. CUSTODIAL CREDIT RISK

Custodial credit risk is the risk that in the event of a bank failure, the Corporation's deposit may not be returned to it. The Corporation does not have a deposit policy for custodial credit risk. As of June 30, 2010, all of the Corporation's bank balance, aggregating approximately $32,095,789, which equals the book balance, was exposed to custodial credit risk since such deposits, all of which are maintained at the Bank, are uninsured and uncollateralized.

4. TRANSACTIONS WITH THE BANK, PUERTO RICO PUBLIC FINANCE CORPORATION, AND THE COMMONWEALTH

The Corporation is an affiliate of the Bank. During the year ended June 30, 2010, the Bank provided certain management and administrative services to the Corporation at no cost. During the year ended June 30, 2010, the Corporation issued demand notes and bond anticipation notes to the Bank amounting to approximately $208 million. These notes were repaid with the issuance of sales tax revenue bonds issued in fiscal year 2010. In connection with the issuance of bonds during the year ended June 30, 2010, the Corporation was charged by the Bank fees amounting to approximately $7,592,000.

In addition, during the year ended June 30, 2010, the Corporation incurred interest expense related to bonds and notes payable issued to the Bank and to the Puerto Rico Public Finance Corporation (PFC), a component unit of the Bank, amounting to approximately $3,526,000 and $4,678,000, respectively.

In accordance with Act 91, the Corporation made payments to the Commonwealth and its agencies and instrumentalities or on their behalf amounting to approximately $2.9 billion for Authorized Uses. In addition, the Corporation advanced approximately $14.6 million to the Commonwealth in September 2009 to cover debt service requirement of certain Commonwealth's outstanding debt. Such advance was repaid in November 2009.

At June 30, 2010, the Corporation has an account receivable from the Commonwealth amounting to approximately $7.7 million related to sales taxes due in excess of the Pledged Sales Tax Base Amount for fiscal year 2009.

5. INVESTMENTS AND INVESTMENT CONTRACTS

In accordance with investment guidelines promulgated by the Bank for agencies and public corporations of the Commonwealth under the authority provided by Act No. 113 of August 3, 1995, and Executive Order 1995-50A (the "investment guidelines"), the Corporation is authorized to purchase or enter into the following investment instruments:

- US Government and Agencies Obligations
- Certificates of deposit
- Bankers acceptances
- Commercial paper
- Participations in the Puerto Rico Government Investment Trust Fund (PRGITF)
- Obligations of the Commonwealth of Puerto Rico, its agencies, municipalities, public corporations, and instrumentalities
- Obligations of state and local governments of the United States of America
- Mortgage and asset-backed securities
- Corporate debt, including investment contracts
- External investment pools

The investment guidelines also establish limitations and other guidelines.

Investments held by the debt service fund are purchased following the provisions of the related trust indenture.

The following table summarizes the type and maturities of investments held by the Corporation at June 30, 2010. Investments by type in any one issuer representing 5% or more of total investments have been separately disclosed.

Investment Type		**Due within One Year**
U.S. Treasury bills	$	266,311,322
Corporate debt — General Electric Capital Corp.		31,011,000
External investment pools:		
Dreyfus Government Cash Management		982,936,893
Puerto Rico Government Investment Trust Fund		887,617,219
Total investments	$	2,167,876,434

Investments in external investments pools consist of $887,617,219 invested in PRGITF, an internal investment pool of the Commonwealth, and $982,936,889 invested in Dreyfus Government Cash

Management (Dreyfus) with the Bank of New York Mellon, which is an investment pool registered with the Securities and Exchange Commission.

Investments in U.S. Treasury bills carry the explicit guarantee of the U.S. government. As of June 30, 2010, the credit rating of PRGITF, Dreyfus and General Electric Capital Corp. (GE), was AAA, AAAm, and AA+, respectively, by Standard & Poor's. The investment in PRGITF was held by the Corporation, while the investments in Dreyfus and GE were held by Bank of New York Mellon, as trustee, in the name of the Corporation.

As of June 30, 2010, investments in PRGITF and Dreyfus amounting to approximately $1.56 billion will be used to fund Authorized Uses and, accordingly, have been presented as a restricted investment in the general fund.

6. BONDS AND NOTES PAYABLE

Short-Term Debt — During the year ended June 30, 2010, the Corporation issued demand notes and bond anticipation notes to the Bank and another financial institution amounting to approximately $708 million. These notes were repaid with the issuance of sales tax revenue bonds issued in fiscal year 2010, as explained below.

Bonds Payable — On February 9, 2010, the Corporation issued Sales Tax Revenue Bonds, First Subordinate Series 2010A amounting to approximately $1,824 million. The proceeds from the issuance of the Series 2010A bonds were mainly used to (1) repay bond anticipation notes issued to a financial institution, (2) cover operational expenses of the Commonwealth for fiscal years 2010 and 2011, and (3) fund the Puerto Rico Economic Stimulus Fund.

On June 30, 2010, the Corporation issued Sales Tax Revenue Bonds, First Subordinate Series 2010C, Series 2010D (Issuer Subsidy Build America Bonds) and Series 2010E (Issuer Subsidy Recovery Zone Economic Development Bonds) amounting to approximately $1,619 million, $89.4 million, and $92.8 million, respectively. Upon compliance with certain requirements of the United States Internal Revenue Code, the Corporation will receive a subsidy payment from the U.S. federal government equal to 35% and 45% of the amount of each interest payment on the Series 2010D bonds and the Series E bonds, respectively.

The proceeds from the issuance of the Series 2010 C, Series 2010D and Series 2010E were mainly used to (1) repay demand notes issued to the Bank, (2) cover operational expenses of the Commonwealth for fiscal year 2011, (3) fund the Puerto Rico Stabilization Fund and (4) provide $732,797,165, along with $17,500,000 of other funds, to purchase U.S. Government State and Local Government Series securities that were placed in an irrevocable trust with an escrow agent for the purpose of generating resources for all future debt services payments of the $700,000,000 Series 2009A mandatory tender notes outstanding at June 30, 2010 (the "Refunded Bonds"), which are subject to mandatory tender for purchase on August 1, 2011. Accordingly, the Refunded Bonds are considered to be defeased and the liability has been removed from the statement of net assets. In the event the Refunded Bonds were not remarketed on August 1, 2011, the interest rate would have increased from five percent (5%) to ten percent (10%). The reacquisition price exceeded the net carrying amount of the old debt by approximately $40,850,000, of which $39,899,000 are being netted against the new debt and amortized over the remaining life of the Refunded Bonds, which is shorter than the life of the new debt issued. This advance refunding was undertaken to reduce the total debt service payments over the next 30 years by $628 million (assuming the Refunded Bonds interest rate would have increased to 10% effective August 1, 2011), and resulted in an economic gain of $370 million.

Note Payable to Puerto Rico Public Finance Corporation — At June 30, 2009, the Corporation had a note payable due to PFC amounting to approximately $101 million. This note was repaid in fiscal year 2010.

As of June 30 2010, bonds and note payable of the Corporation consist of the following (in thousands):

Description	Face/Effective Interest Rate	Amount
Sales Tax Revenue Bonds, Series 2007A:		
Capital Appreciation Bonds due from August 1, 2040 to August 1, 2056	4.96%–5.34%	$ 1,931,929
Fixed Rate Bonds due on August 1, 2057, including unamortized premium of $15,241	5.25%	579,126
LIBOR-Based Adjustable Rate Bonds due on August 1, 2057	1.16%	136,000
Sales Tax Revenue Bonds, Series 2007B:		
Capital Appreciation Bonds due from August 1, 2027 to August 1, 2032	6.20%–6.25%	175,966
Fixed Rate Bonds due from August 1, 2033 to August 1, 2057 — net of unamortized discount of $2,752	6.05%–6.35%	1,183,248
Sales Tax Revenue Bonds, Series 2007C:		
Capital Appreciation Bonds due from August 1, 2022 to August 1, 2038	6.10%	98,613
Term Bonds due from August 1, 2022 to August 1, 2038	6.00%	415,305
Sales Tax Revenue Bonds, Series 2008A:		
Capital Appreciation Bonds due from August 1, 2024 to August 1, 2036	6.23%	280,835
Term Bonds due from August 1, 2027 to August 1, 2038	6.13%	488,885
Sales Tax Revenue Bonds, First Subordinate Series 2009A:		
Fixed Rate Bonds due from August 1, 2015 to August 1, 2029	3.75%–6.13%	1,121,792
Term Bonds due from August 1, 2036 to August 1, 2044, including unamortized premium of $15,280 and net of unamortized discount of $14,638	5.75%–6.50%	1,782,960
Capital Appreciation Bonds due from August 1, 2030 to August 1, 2034	6.88%–7.13%	149,540
Convertible Capital Appreciation Bonds due on August 1, 2030 to August 1, 2032 (1)	6.75%	367,320
Sales Tax Revenue Bonds, First Subordinate Series 2009B:		
Fixed Rate Bonds due from August 1, 2025 to August 1, 2039	6.05%–6.35%	957,410
Capital Appreciation Bonds due from August 1, 2033 to August 1, 2035	7.38% to 7.48%	57,694
Convertible Capital Appreciation Bonds due from August 1, 2025 to August 1, 2031 (2)	6.90%–7.00%	221,880
Sales Tax Revenue Bonds, First Subordinate Series 2009C — Fixed Rate Bonds due on August 1, 2057, including unamortized refunding gain of $112,143	5.75%	350,018
Sales Tax Revenue Bonds, First Subordinate Series 2010A:		
Fixed Rate Bonds due from August 1, 2016 to August 1, 2040 — net of unamortized discount of $1,202	3.38%–5.63%	305,408
Term Bonds due from August 1, 2036 to August 1, 2044 — net of unamortized discount of $24,612	5.25%–5.50%	1,212,728
Capital Appreciation Bonds due from August 1, 2031 to August 1, 2036	6.65%–6.77%	133,259
Convertible Capital Appreciation Bonds due on August 1, 2029 to August 1, 2033 (3)	6.13%–6.25%	153,676
Sales Tax Revenue Bonds, First Subordinate Series 2010C:		
Fixed Rate Bonds due from August 1, 2035 to August 1, 2042, including unamortized premium of $15,511 and net of unamortized discount of $813	5.13%–6.50%	462,358
Term Bonds due from August 1, 2033 to August 1, 2041 — net of unamortized discount of $24,548 and unamortized refunding loss of $39,899	5.00%–5.50%	1,009,578
Capital Appreciation Bonds due from August 1, 2037 to August 1, 2039	6.63%	97,737
Sales Tax Revenue Bonds, First Subordinate Series 2010D — Fixed Rate Bonds due on August 1, 2042	5.75%	89,435
Sales Tax Revenue Bonds, First Subordinate Series 2010E — Fixed Rate Bonds due on August 1, 2042	5.75%	92,755
Bonds and note payable — net		$ 13,855,455

(1) Convertible to fixed-rate interest bonds on August 1, 2016.
(2) Convertible to fixed-rate interest bonds on August 1, 2016 and August 1, 2020 for bonds maturing on August 1, 2031.
(3) Convertible to fixed-rate interest bonds on August 1, 2019.

Bonds and notes payable activity for the year ended June 30, 2010, is as follows (in thousands):

Description	Balance at June 30, 2009	Issuances	Other Increases	Reductions	Payments	Balance at June 30, 2010
Notes payable	$ 101,051	$ 708,074	$ -	$ -	$ (809,125)	$ -
Bonds payable	10,724,887	3,625,352	187,544	(700,000)		13,837,783
Less:						
Unamortized bond premium (discount)	(18,870)	(35,791)		89		(54,572)
Refunding loss		(39,899)				(39,899)
Refunding gain	114,523			(2,380)		112,143
Bonds and note payable — net	$10,921,591	$ 4,257,736	$ 187,544	$ (702,291)	$ (809,125)	$13,855,455

No principal payments of bonds and note payable are due within one year.

As of June 30, 2010, debt service requirements for bonds outstanding were as follows:

Year Ending June 30	Principal	Interest	Interest Subsidy (1)	Total
2011	$ -	$ 539,804,136	$ (3,511,596)	$ 536,292,540
2012		577,465,996	(4,199,915)	573,266,081
2013		577,465,996	(4,199,915)	573,266,081
2014		577,465,996	(4,199,915)	573,266,081
2015		577,465,996	(4,199,915)	573,266,081
2016–2020	231,460,000	3,050,831,773	(20,999,575)	3,261,292,198
2021–2025	583,575,000	3,175,381,803	(20,999,575)	3,737,957,228
2026–2030	2,014,240,000	2,905,244,541	(20,999,575)	4,898,484,966
2031–2035	3,575,745,000	2,387,353,834	(20,999,575)	5,942,099,259
2036–2040	5,020,606,000	1,693,037,767	(20,999,575)	6,692,644,192
2041–2045	5,845,775,000	616,946,070	(9,449,809)	6,453,271,261
2046–2050	3,955,758,317	287,801,839		4,243,560,156
2051–2055	4,882,088,350	287,801,839		5,169,890,189
2056–2058	3,393,564,581	137,685,438		3,531,250,019
	29,502,812,248	$17,391,753,024	$ (134,758,940)	$46,759,806,332
Plus (less):				
Unamortized premium	63,247,781			
Unamortized discount	(117,819,754)			
Deferred refunding gain	112,143,136			
Deferred refunding loss	(39,899,101)			
Unaccreted interest	(15,665,029,592)			
Bonds payable	$13,855,454,718			

(1) Sales Tax Revenue Bonds, First Subordinate Series 2010D and 2010E were issued as Build America Bonds. The Corporation will receive a subsidy payment from the federal government equal to 35% and 45%, respectively, of the amount of each interest payment.

At June 30, 2010, the Corporation has $136,000,000 of LIBOR based adjustable rate bonds maturing on August 1, 2057. As explained below, the Corporations has entered into a $136,000,000 interest rate swap, whereby it receives the same rate paid on the adjustable rate bonds and pays a fixed rate of 4.92% through August 1, 2057. Accordingly, the Corporation has synthetically fixed the interest rate on the adjustable rate bonds. Assuming the rate effective as of June 30, 2010 remains the same, debt service requirements for the adjustable rate bonds and net swap payments for their term, are as follows:

Year Ending June 30	Adjustable- Rate Bonds Principal	Adjustable- Rate Bonds Interest	Interest Rate Swaps, Net	Total
2011	$ -	$ 1,578,593	$ 5,112,607	$ 6,691,200
2012		1,578,593	5,112,607	6,691,200
2013		1,578,593	5,112,607	6,691,200
2014		1,578,593	5,112,607	6,691,200
2015		1,578,593	5,112,607	6,691,200
2016 - 2020		7,892,964	25,563,036	33,456,000
2021 - 2025		7,892,964	25,563,036	33,456,000
2026 - 2030		7,892,964	25,563,036	33,456,000
2031 - 2035		7,892,964	25,563,036	33,456,000
2036 - 2040		7,892,964	25,563,036	33,456,000
2041 - 2045		7,892,964	25,563,036	33,456,000
2046 - 2050		7,892,964	25,563,036	33,456,000
2051 - 2055		7,892,964	25,563,036	33,456,000
2056 - 2058	136,000,000	3,551,834	13,176,166	152,728,000
Total	$ 136,000,000	$ 74,588,511	$ 243,243,489	$ 453,832,000

The Corporation's outstanding bonds are payable from amounts deposited in the Dedicated Sales Tax Fund in each fiscal year. The minimum amount to be deposited is the Pledged Sales Tax Base Amount, which for the fiscal year ended June 30, 2010, was $550,264,000. The Pledged Sales Tax Base Amount increases each fiscal year thereafter at a statutory rate of 4% up to $1,850,000,000. At June 30, 2010, the Pledged Sales Tax Base Amount, by year, is as follows:

Year Ending June 30	Amount
2011	$ 572,274,560
2012	595,165,542
2013	618,972,164
2014	643,731,051
2015	669,480,293
2016–2020	3,771,166,061
2021–2025	4,588,200,134
2026–2030	5,582,247,010
2031–2035	6,791,657,026
2036–2040	8,263,089,233
2041–2045	9,250,000,000
2046–2050	9,250,000,000
2051–2055	9,250,000,000
2056–2058	5,550,000,000
	$65,395,983,074

7. DERIVATIVE INSTRUMENTS

By using derivative financial instruments to hedge the exposure to changes in interest rates, the Corporation exposes itself to interest rate risk, credit risk, and termination risk.

Interest rate risk is the adverse effect on the value of a financial instrument that results from a change in interest rates. The Corporation is exposed to interest rate risk on its pay-fixed, receive-variable swap; as LIBOR decreases, the Corporation's net payment on the swap increases. At the same time, interest payments on the hedged adjustable rate bonds decrease. The interest rate risk associated with interest rate swap contracts is managed by establishing and monitoring parameters that limit the types and degree of interest rate risk that may be undertaken.

Credit risk is the failure of the counterparty (or its guarantor) to perform under the terms of the derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Corporation, which creates credit risk for the Corporation. When the fair value of a derivative contract is negative, the Corporation owes the counterparty and, therefore, does not possess credit risk. The Corporation minimizes the credit risk in derivative instruments by entering into transactions with counterparties whose credit rating is acceptable under the investment policies of the Corporation.

Termination risk is the possibility that a hedging derivative instrument's unscheduled end will affect the Corporation's liability strategy or will present the Corporation with potentially significant unscheduled termination payments to the counterparty. The Corporation or its counterparties may terminate a derivative instrument if the other party fails to perform under the terms of the contract. The Corporation is at risk that counterparty will terminate a swap at a time when the Corporation owes it a termination payment. The Corporation has mitigated this risk by specifying that the counterparty has the right to terminate only as a result of certain events, including: a payment default by the Corporation; insolvency of the Corporation (or similar events); or a downgrade of the Corporation's credit rating below BBB+ or Baa1. If at the time of termination, an investment derivative instrument is in a liability position, the Corporation would be liable to the counterparty for a payment equal to the liability, subject to netting arrangements.

The Corporation has entered into an interest rate exchange agreement (swap) with a counterparty in connection with the issuance of LIBOR-Based Adjustable Rate Bonds within the Sales Tax Revenue Bonds Series 2007A (the "Adjustable Rate Bonds"). The Adjustable Rate Bonds expose the Corporation to variability in interest payments due to changes in interest rates. Management believes that it is prudent to limit the variability of interest payments on the Adjustable Rate Bonds. To meet this objective, management entered into an interest rate swap agreement to manage fluctuations in cash flows resulting from interest rate risk. This swap effectively changes the variable rate cash flow exposure on the Adjustable Rate Bonds to fixed cash flows. Under the terms of the interest rate swap, the Corporation receives variable interest rate payments equal to the interest payment on the Adjustable Rate Bonds, and makes fixed interest rate payments, thereby creating the equivalent of a fixed rate debt. At June 30, 2010, the credit rating of the counterparty to this swap agreement was A by Standard & Poor's.

The Corporation is also a party to two forward swap agreements, both with effective date on February 1, 2012, in an aggregate notional amount of $907 million. The Corporation entered into these forward swap agreements in connection with the expected issuance of variable rate bonds, the proceeds of which are to be used to repay certain mandatory tender bonds issued by PFC. Pursuant to the terms of the agreements, on the effective date, the Corporation will pay a fixed interest rate of 3.95%, and will receive 67% of the three month LIBOR until its maturity on August 1, 2040. The recent U.S. financial market crisis has resulted in a significant reduction in the availability of credit/liquidity facilities to support variable rate bonds, and a related increase in the price of these facilities when they can be obtained. As a result, the occurrence of this expected transaction is not deemed probable and, accordingly, these forward swap agreements have been classified as investment derivative instruments. The credit ratings of the counterparty to these forward swap agreements were A and BBB by Standard & Poor's.

The fair values and notional amounts of derivative instruments outstanding at June 30, 2010, classified by type, are as follows:

Notional Amount (In thousands)	Fair Value (In thousands)	Change in Fair Value	Floating Rate Indicator	Rate at June 30, 2010 Receives Type	Receives Rate	Pays Type	Pays Rate
Hedging Derivative Instrument:							
$136,000	$ 47,055	$ (12,182)	67% of 3m LIBOR plus .93	Variable	1.161 %	Fixed	4.920 %
Investment Derivative Instruments:							
$453,500	$ 97,759	$ (35,056)	67% of 3m LIBOR	Variable	TBD	Fixed	3.950 %
453,500	98,154	(36,552)	67% of 3m LIBOR	Variable	TBD	Fixed	3.950 %
$907,000	$195,913	$ (71,608)					

TBD - To be determined at effective date.

The fair values of the interest rate swaps were estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

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