

In the opinion of Stradley Ronon Stevens & Young, LLP, Bond Counsel, under existing law as presently enacted and construed, and subject to continuing compliance by the Commonwealth with the requirements of the federal tax laws, interest on the Bonds is excluded from gross income for federal income tax purposes and is not an item of tax preference for purposes of either individual or corporate federal alternative minimum tax; however, interest paid to certain corporate holders of the Bonds may be subject to alternative minimum tax and certain other taxes imposed on certain corporations under certain circumstances. Under the laws of the Commonwealth of Pennsylvania, as currently enacted and construed, the Bonds are exempt from personal property taxes in Pennsylvania and the interest on the Bonds is exempt from Pennsylvania personal income tax and corporate net income tax. For a further discussion and other tax aspects see "TAX MATTERS" herein.



**\$950,670,000**  
**Commonwealth of Pennsylvania**  
**General Obligation Bonds**  
\$700,000,000 Second Series of 2006  
\$250,670,000 First Refunding Series of 2006

**Dated: Date of Issuance and Delivery**

**Due: March 1 and September 1, as shown on inside cover**

The Bonds will be issued only in book-entry form initially registered in the name of Cede & Co., as nominee for The Depository Trust Company ("DTC"), New York, New York. DTC will act as securities depository for the Bonds. Interest on the Bonds will be payable semi-annually on March 1 and September 1, commencing March 1, 2007 for the First Refunding Series Bonds and September 1, 2007 for the Second Series Bonds. Manufacturers and Traders Trust Company, Harrisburg, Pennsylvania, is the Loan and Transfer Agent for the Bonds. Principal of and interest and redemption premium, if any, on the Bonds are payable to Cede & Co. See "THE BONDS – Book-Entry Only System."

The Bonds are subject to redemption as set forth herein. See "THE BONDS – Optional Redemption."

The Bonds are direct and general obligations of the Commonwealth and the full faith and credit of the Commonwealth are pledged for the payment of principal of and interest on the Bonds.

**This cover page contains certain information for quick reference only. It is not a summary of the issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision regarding the Bonds.**



The scheduled payment of principal of and interest on the Second Series of 2006 Bonds maturing on March 1 of the years 2024-2026 (the "Insured Bonds" as indicated by an "\*" in the table on the following page), when due, will be guaranteed under an insurance policy to be issued concurrently with the delivery of the Insured Bonds by CIFG Assurance North America, Inc.. See Appendix I herein titled "THE CIFG ASSURANCE NORTH AMERICA INSURANCE POLICY."

The Bonds are offered when, as and if issued, and are subject to the receipt of the legal opinions of the Attorney General of the Commonwealth of Pennsylvania and of Stradley Ronon Stevens & Young, LLP, Philadelphia, Pennsylvania, Bond Counsel. The Commonwealth expects that the Bonds will be available in definitive form for delivery through the facilities of DTC on or about December 21, 2006.

Dated: December 5, 2006

**\$950,670,000**  
**Commonwealth of Pennsylvania**  
**General Obligation Bonds**  
**\$700,000,000 Second Series of 2006**  
**\$250,670,000 First Refunding Series of 2006**

*MATURITY SCHEDULE*  
(Base CUSIP Number: 709141)

Second Series of 2006					First Refunding Series of 2006				
Due March 1	Principal Amount	Interest Rate	Yield or Price	CUSIP Number	Due September 1	Principal Amount	Interest Rate	Yield or Price	CUSIP Number
2007	...	...	...	...	2007	\$50,000	4.000%	3.480%	5F8
2008	\$14,885,000	5.000%	3.490%	5W1	2008	10,625,000	4.750	3.480	5G6
2009	22,435,000	5.000	3.490	5X9	2009	10,375,000	4.750	3.480	5H4
2010	23,555,000	5.000	3.490	5Y7	2010	10,110,000	4.750	3.480	5J0
2011	24,735,000	5.000	3.480	5Z4	2011	1,315,000	4.000	3.500	5K7
2012	25,970,000	5.000	3.490	6A8	2012	1,365,000	4.000	3.500	5L5
2013	27,270,000	5.000	3.500	6B6	2013	1,425,000	4.000	3.500	5M3
2014	28,630,000	5.000	3.550	6C4	2014	14,995,000	4.750	3.550	5N1
2015	30,065,000	5.000	3.590	6D2	2015	1,570,000	4.000	3.590	5P6
2016	31,565,000	5.000	3.630	6E0	2016	45,070,000	4.000	3.630	5Q4
2017	33,145,000	5.000	3.670	6F7	2017	30,865,000	4.000	3.720	5R2
2018	34,800,000	5.000	3.710	6G5	2018	16,035,000	4.000	3.860	5S0
2019	36,545,000	5.000	3.750	6H3	2019	15,925,000	4.000	3.980	5T8
2020	38,370,000	5.000	3.780	6J9	2020	53,530,000	4.000	4.080	5U5
2021	40,290,000	4.100	4.110	6K6	2021	37,415,000	4.000	4.110	5V3
2022	42,300,000	4.125	4.140	6L4	2022	...	...	...	...
2023	44,420,000	5.000	3.850	6M2	2023	...	...	...	...
2024	46,640,000*	4.250	4.150	6N0	2024	...	...	...	...
2025	48,970,000*	4.250	4.190	6P5	2025	...	...	...	...
2026	51,420,000*	4.500	4.210	6Q3	2026	...	...	...	...
2027	53,990,000	4.750	4.080	6R1	2027	...	...	...	...

The interest rates shown above are the interest rates per annum payable by the Commonwealth on the Bonds of each maturity date as indicated. The yields shown above for each maturity were furnished to the Commonwealth by the group of banks and investment banking firms who purchased the Bonds from the Commonwealth on December 5, 2006, and may not reflect the current market prices of the Bonds. All information concerning the re-offering of the Bonds should be obtained from the underwriters and not from the Commonwealth.



**THE ISSUING OFFICIALS**

*Governor* .....*EDWARD G. RENDELL*  
*State Treasurer* .....*ROBERT P. CASEY, Jr.*  
*Auditor General* .....*JACK WAGNER*

**OFFICE OF THE BUDGET**

*Secretary* .....*MICHAEL J. MASCH*

**Attorney General of the Commonwealth of Pennsylvania:**

Tom Corbett

**Bond Counsel:**

Stradley Ronon Stevens & Young LLP  
Philadelphia, Pennsylvania

**Special Disclosure Counsel:**

Hunton & Williams  
Richmond, Virginia

No dealer, broker, salesperson or other person has been authorized to give any information or to make any representations, other than as contained in this Official Statement, in connection with the offering contained herein, and, if given or made, such other information or representations must not be relied upon as having been authorized by the Commonwealth of Pennsylvania. This Official Statement does not constitute an offer to sell, or a solicitation of an offer to buy, nor shall there be any sale of the Bonds by any person in any jurisdiction where such sale would be unlawful.

Except as otherwise noted, the information herein speaks as of its date and is as of the date of this Official Statement and is subject to change without notice and neither the delivery of this Official Statement nor any sale made hereunder shall, in any circumstances, create any implication that there has been no change in the affairs of the Commonwealth of Pennsylvania since the date hereof.

The order and placement of the information this Official Statement, including the Appendices hereto and the information incorporated herein by reference, are not to be deemed to be a determination of relevance, materiality or importance, and this Official Statement, including the Appendices, and the information incorporated herein by reference, must be considered in its entirety.

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**SUMMARY INFORMATION**

THIS SUMMARY STATEMENT IS SUBJECT IN ALL RESPECTS TO THE MORE COMPLETE INFORMATION CONTAINED IN THIS OFFICIAL STATEMENT. OFFERING OF THE BONDS TO THE POTENTIAL PURCHASERS IS MADE ONLY BY MEANS OF THIS ENTIRE OFFICIAL STATEMENT, INCLUDING THE COVER AND APPENDICES HERETO AND THE INFORMATION INCORPORATED BY REFERENCE.

**Issuer** ..... Commonwealth of Pennsylvania

**Offering** ..... \$950,670,000 Commonwealth of Pennsylvania, General Obligation Bonds, consisting of \$700,000,000 Second Series of 2006 (the “Second Series Bonds”) and \$250,670,000 First Refunding Series of 2006 (the “First Refunding Series Bonds,” and collectively with the Second Series Bonds, the “Bonds”).

**Dated Date**..... Date of Issuance and Delivery

**Security**..... General obligations of the Commonwealth of Pennsylvania; full faith and credit pledged

**Use of Proceeds** ..... The Commonwealth of Pennsylvania is issuing the Bonds for the following purpose:

<u>Purpose</u>	<u>Principal Amount</u>
<b><u>Second Series Bonds</u></b>	
Capital Facilities Projects.....	\$608,000,000
Pennvest Projects .....	50,000,000
Pennworks Projects.....	15,000,000
Growing Greener Projects.....	27,000,000
<b><u>First Refunding Series Bonds</u></b>	
Refunding.....	\$250,670,000

**Redemption** ..... The Second Series Bonds maturing on or after March 1, 2018 are subject to optional redemption in whole or in part (and if in part, in part within one or more maturities) at any time on and after March 1, 2017 at a redemption price equal to the principal amount thereof, plus accrued interest to the date fixed for redemption. The First Refunding Series Bonds maturing on or after September 1, 2017 are subject to optional redemption in whole or in part (and if in part, in part within one or more maturities) at any time on and after September 1, 2016 at a redemption price equal to the principal amount thereof, plus accrued interest to the date fixed for redemption.

**Authorized Denominations** ... \$5,000 or integral multiples thereof.

**Form of Bonds** ..... Bonds are issued in fully registered form through a book-entry only system.

**Loan & Transfer Agent** ..... Manufacturers and Traders Trust Company, Harrisburg, Pennsylvania.

**Legal Opinions** ..... Stradley Ronon Stevens & Young LLP, Bond Counsel.  
Tom Corbett, Attorney General of the Commonwealth of Pennsylvania.

**Bond Ratings** ..... Moody’s Investors Service .....Aa2  
Standard & Poor’s Rating Services, a division  
of the McGraw-Hill Companies.....AA  
Fitch Ratings.....AA

**Official Statement**  
**\$950,670,000**  
**Commonwealth of Pennsylvania**  
**General Obligation Bonds**  
**\$700,000,000 Second Series of 2006**  
**\$250,670,000 First Refunding Series of 2006**

**INTRODUCTION**

This Official Statement of the Commonwealth of Pennsylvania (the “Commonwealth”), including the cover page and appendices, presents certain information in connection with the issuance of \$950,670,000 aggregate principal amount of the Commonwealth’s general obligation Bonds consisting of \$700,000,000 aggregate principal amount of the Commonwealth of Pennsylvania General Obligation Bonds, Second Series of 2006 (the “Second Series Bonds”) and \$250,670,000 aggregate principal amount of the Commonwealth of Pennsylvania General Obligation Bonds, First Refunding Series of 2006 (the “First Refunding Series Bonds” and collectively with the Second Series Bonds, the “Bonds”). The Second Series Bonds are being issued to finance various Commonwealth capital projects and environmental improvement programs. The First Refunding Series Bonds are being issued to refund certain outstanding bond issues of the Commonwealth. See “USE OF PROCEEDS.”

The Bonds are general obligations of the Commonwealth to which the full faith and credit of the Commonwealth are pledged. See “SECURITY AND SOURCE OF PAYMENT FOR BONDS.” Principal of and interest payments on the Bonds will be paid from the General Fund. See “COMMONWEALTH FINANCIAL PERFORMANCE” and “COMMONWEALTH FINANCIAL STRUCTURE AND PROCEDURES.”

When issued, the Bonds will be registered in the name of Cede & Co., as nominee for The Depository Trust Company, securities depository for the Bonds under a book-entry only registration system. See “THE BONDS — Book-Entry Only System” and Appendix D.

The Bonds are authorized investments for fiduciaries and personal representatives, as defined in the Probate, Estates and Fiduciaries Code within the Commonwealth; are legal investments for Pennsylvania banks, trust companies, bank and trust companies, savings banks, and insurance companies; and are acceptable as security for deposits of the funds of the Commonwealth. See “LEGALITY FOR INVESTMENT.”

Except where otherwise expressly noted, the financial and other information provided in this Official Statement is generally derived from the records of the Commonwealth. All financial information should be considered as unaudited unless otherwise specifically identified. All estimates and assumptions are based on the best information available but do not constitute factual information. All estimates of future performance or events constituting “forward-looking statements” may or may not be realized because of a wide variety of economic and other circumstances. Included in such forward-looking statements are numbers and other information from budgets for current and future fiscal years. The references to, and summaries of, Constitutional and statutory provisions of the Commonwealth and to bond resolutions and other documents are qualified in their entirety by reference to the complete provisions of such documents and to any judicial interpretations thereof.

**THE BONDS**

**Description of the Bonds**

The Bonds will be dated the date of issuance and delivery, will bear interest initially from such date, at the rate per annum for each maturity as specified on the cover page hereof, will be payable semi-annually on each March 1 and September 1, commencing March 1, 2007 for the First Refunding Series Bonds and September 1, 2007 for the Second Series Bonds, calculated on the basis of a 360-day year of twelve 30-day months, and will mature in the amounts and on the dates as set forth on the cover page hereof.

The Resolutions (as hereinafter defined) and all provisions thereof are incorporated by reference in the text of the Bonds, including, without limitation, those provisions setting forth the conditions under which the Resolutions may be modified. The Bonds provide that each registered owner, Beneficial Owner, DTC Participant or Indirect Participant (as hereinafter defined) in DTC, by acceptance of a Bond (including receipt of a book-entry credit evidencing an interest therein), assents to all of such provisions as an explicit and material portion of the consideration running to the Commonwealth to induce it to adopt the Resolutions and to issue such Bond. Copies of the Resolutions, including the full text of the form of the Bonds, are on file at the designated office of Manufacturers and Traders Trust Company, as Loan and Transfer Agent (“Loan and Transfer Agent”).

Interest on the Bonds will be payable by check or draft mailed or other transfer made to the persons in whose names the Bonds shall be registered at the close of business on the fifteenth day (whether or not a business day) of the calendar month next preceding each interest payment date (the “Record Date”). Any interest on any Bond not timely paid or duly provided for shall cease to be payable to the person who is the registered owner as of the regular Record Date, and shall be payable to the person who is the registered owner at the close of business on a special record date for the payment of such defaulted interest. A special record date shall be a date not more than fifteen nor less than ten days prior to the date of the proposed payment and shall be fixed whenever moneys become available for payment of the defaulted interest. Notice of a special record date shall be given to registered owners of the Bonds not less than fifteen days prior thereto.

Whenever the due date for payment of interest on or principal of the Bonds or the date fixed for redemption of any Bond shall be a Saturday, a Sunday, a legal holiday or a day on which banks in the Commonwealth are required or authorized by law (including by executive order) to close, then payment of such interest, principal or redemption price need not be made on such date, but may be made on the next succeeding day which is not a Saturday, a Sunday, a legal holiday or a day upon which banks in the Commonwealth are required or authorized by law (including by executive order) to close, with the same force and effect as if made on the due date for payment of principal, interest or redemption price, and no interest shall accrue thereon for any period after such due date.

#### **Book-Entry Only System**

The Depository Trust Company, New York, New York (“DTC”) will act as securities depository for the Bonds pursuant to a book-entry only system. Information regarding DTC and its book-entry system, provided by DTC, appears as Appendix D. Such information has been provided by DTC, and the Commonwealth does not assume any responsibility for the accuracy or completeness of such information. The Commonwealth may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, Bond certificates will be printed and delivered.

**For so long as the Bonds are registered in the name of DTC, or its nominee Cede & Co., the Commonwealth and the Loan and Transfer Agent will treat Cede & Co. as the registered owner of the Bonds for all purposes, including payments, notices and voting.**

**Neither the Commonwealth nor the Loan and Transfer Agent shall have any responsibility or obligation to any Direct or Indirect Participant or Beneficial Owner (as defined in Appendix D) with respect to (i) the accuracy of any records maintained by DTC or any Direct or Indirect Participant with respect to any beneficial ownership interest in any Bonds; (ii) the payment by any Direct or Indirect Participant of any amount due to any Beneficial Owner in respect of the principal of, premium, if any, and interest on the Bonds; (iii) the delivery or timeliness of delivery by any Direct or Indirect Participant of any notice to any Beneficial Owner with respect to the Bonds, including, without limitation, any notice of redemption; or (iv) other action taken by DTC or Cede & Co., including the effectiveness of any action taken pursuant to an Omnibus Proxy.**

**Payments made by or on behalf of the Commonwealth to DTC or its nominee shall satisfy the Commonwealth’s payment obligations with respect to the Bonds to the extent of such payments.**



## **Optional Redemption**

The Second Series Bonds maturing in the years 2008 to 2017, inclusive, are not subject to redemption. The Second Series Bonds, or portions thereof in integral multiples of \$5,000, maturing on and after March 1, 2018, are subject to redemption at the option of the Commonwealth prior to scheduled maturity on or after March 1, 2017, as a whole or in part at any time and from time to time, in any order of maturity determined by the Commonwealth and by lot within a maturity in such manner as the Commonwealth in its discretion may determine, on at least 30 days' (but not more than 60 days') notice, at a redemption price equal to par (100% of stated principal amount) plus accrued interest to the date fixed for redemption.

The First Refunding Series Bonds maturing in the years 2007 to 2016, inclusive, are not subject to redemption. The First Refunding Series Bonds, or portions thereof in integral multiples of \$5,000, maturing on and after September 1, 2017, are subject to redemption at the option of the Commonwealth prior to scheduled maturity on or after September 1, 2016, as a whole or in part at any time and from time to time, in any order of maturity determined by the Commonwealth and by lot within a maturity in such manner as the Commonwealth in its discretion may determine, on at least 30 days' (but not more than 60 days') notice, at a redemption price equal to par (100% of stated principal amount) plus accrued interest to the date fixed for redemption. As long as the Bonds are registered pursuant to a book-entry only system, notice of redemption will be given, as required by DTC's (or any successor depository's) procedures, to DTC, its nominee, or successor securities depository as registered owner of the Bonds. So long as Cede & Co. is the registered owner of the Bonds, the Commonwealth will not be responsible for mailing notices of redemption to anyone other than DTC or its nominee.

Notice of redemption shall be given by the Loan and Transfer Agent via first-class mail not less than 30 days, nor more than 60 days, prior to the date fixed for redemption to the persons in whose names the Bonds to be redeemed are registered at the close of business on the fifth (5<sup>th</sup>) business day prior to such mailings; provided, however, that any defect in the notice or in the mailing thereof with respect to any registered owner shall not affect the validity of the proceedings for such redemption as to any other registered owner. Deposit of any such notice in the United States mail shall constitute constructive receipt of such notice by the registered owner to whom such notice is sent. Notice having been given as aforesaid and provision having been made for redemption from funds on deposit with the Loan and Transfer Agent, no interest on Bonds, or portions thereof, called for redemption shall accrue after the date fixed for redemption, and the registered holders of the Bonds, or portions thereof, called for redemption shall thereafter have no further right except to receive payment of the redemption price plus accrued interest to the redemption date.

In addition to the notice of redemption to the registered owners of the Bonds, the Loan and Transfer Agent shall cause copies of the original redemption notice to be sent by facsimile transmission, overnight delivery or certified mail with return receipt requested (or other similar means that can provide evidence of receipt) to all registered securities depositories then in the business of holding obligations similar to the Bonds, and to two or more national information services that disseminate redemption information; provided however, that failure to send such copies of the original redemption notice or any defect therein shall not affect the validity of the redemption proceedings.

## **SECURITY AND SOURCE OF PAYMENT FOR BONDS**

The Bonds are direct and general obligations of the Commonwealth to which the full faith and credit of the Commonwealth have been pledged for the payment of the interest thereon as it becomes due and the payment of the principal thereof at maturity or prior redemption. The various acts authorizing the incurrence of debt by the Commonwealth require the General Assembly to appropriate annually the moneys necessary to pay such interest and principal for which other provisions are not made. See the statutes described in the subsection "Authorization" below. Principal of and interest payments on the Bonds will be made from the General Fund.

The Constitution of the Commonwealth of Pennsylvania (the "Constitution") places a claim on revenues of the Commonwealth as security for the payment of principal of and interest on all debt of the Commonwealth. Article VIII, Section 7(d) of the Constitution provides that, if sufficient funds are not appropriated for the timely payment of the interest on and principal of all Commonwealth debt, the State Treasurer shall set apart from the first revenues thereafter received applicable to the appropriate fund, a sum sufficient to pay such interest and principal, and shall so apply the money so set apart.

The State Treasurer may be required to set aside and apply such revenues at the suit of any holder of Commonwealth obligations.

For a description of the constitutional provisions relating to the Bonds, see Appendix E. The proposed form of the opinion of the Attorney General is in Appendix F and the proposed form of the opinion of Bond Counsel is in Appendix G.

**Authorization**

The Bonds are authorized and issued pursuant to and in full compliance with the provisions, restrictions and limitations of Sections 7 and 16 of Article VIII of the Constitution; the laws of the Commonwealth, including the Capital Facilities Debt Enabling Act, Act No. 1999-1, approved February 9, 1999, as amended, annual capital budget bills and various bond authorization bills enacted by the General Assembly, including but not limited to: the Pennsylvania Infrastructure Investment Authority Act, Act No. 1988-16, approved March 1, 1988 (the “1988 Pennvest Act”); the Small Water Systems Assistance Act, Act No.1992-5, approved March 16, 1992 (the “1992 Pennvest Act” and collectively with the 1988 Pennvest Act, the “Pennvest Acts”); constitutional referendum questions approved by the voters of the Commonwealth on April 26, 1988 (the “1988 Referendum”) and April 28, 1992 (the “1992 Referendum” and collectively with the 1988 Referendum, the “Pennvest Referenda”); Act No. 2004-218, approved November 30, 2004 (the “Pennworks Act”); the Water and Wastewater Treatment Project Bond Act, Act No. 2004-10, approved February 12, 2004 (the “Water and Wastewater Treatment Project Bond Act” and collectively with the Pennworks Act, the “Pennworks Acts”); a constitutional referendum question approved by the voters of the Commonwealth on April 27, 2004 (the “Pennworks Referendum”); the Growing Greener Environmental Stewardship and Watershed Protection Enhancement Authorization Act, Act No. 2005-1, approved April 13, 2005 (the “Growing Greener Environmental Stewardship and Watershed Protection Enhancement Authorization Act ”); Act No. 2005-45, approved July 13, 2005 (collectively with the Growing Greener Environmental Stewardship and Watershed Protection Enhancement Authorization Act, the “Growing Greener II Acts”); a constitutional referendum question approved by the voters of the Commonwealth on May 17, 2005 (the “Growing Greener Referendum”) as well as additional bond authorization bills referenced in the Resolutions; defined hereafter. The Bonds are also authorized and issued pursuant to resolutions adopted by the Governor, the State Treasurer, and the Auditor General (the “Issuing Officials”) on November 28, 2006, and December 5, 2006 (collectively, the “Resolutions”).

**Debt Limits**

The Constitution (Article VIII, Section 7(a)) permits debt to be incurred (i) for purposes itemized in law and approved by voter referendum, (ii) without approval of the electorate for the rehabilitation of areas affected by man-made or natural disasters, and (iii) for capital facilities projects specifically itemized in a capital budget if such debt does not cause the amount of all net debt outstanding (as defined for purposes of that Section) to exceed one and three quarters times (1.75x) the average of the annual tax revenues of the Commonwealth deposited in all funds in the previous five fiscal years, as certified by the Auditor General (the “Constitutional Debt Limit”). The most recent semi-annual computation of the Constitutional Debt Limit and the amount of net debt outstanding subject to such limit is shown in Table 1:

**Table 1**  
**Constitutional Debt Limit<sup>(a)</sup>**  
**November 9, 2006**  
(In Millions)

Average Annual Tax Revenues Fiscal 2001-2006.....	\$ 27,536.5
Times 1.75.....	48,188.9
Less: Net Debt Outstanding <sup>(b)</sup> .....	<u>6,399.7</u>
Debt Issuable Within Limit .....	<u>\$ 41,789.2</u>

<sup>(a)</sup> As certified by the Auditor General on November 9, 2006 (Appendix A).

<sup>(b)</sup> After credit for refunded debt.

The capital debt authorizations for the various categories of capital facilities projects is shown in Table 2.

**Table 2**  
**Aggregate Capital Debt Authorization**  
(In Millions)

<u>Capital Facilities Projects Category</u>	<u>Debt Authorized</u>	<u>Issued<sup>(a)</sup></u>	<u>Authorized But Unissued</u>	<u>Pro Forma Remaining Debt Authorized After Issuance Of the Bonds</u>
Buildings and Structures .....	\$ 21,607.3	\$ 6,931.5	\$ 14,675.8	\$ 14,375.8
Furniture and Equipment.....	875.8	381.5	494.3	494.3
Transportation Assistance .....	8,575.1	2,497.8	6,077.3	6,002.3
Redevelopment Assistance.....	21,489.4	1,799.0	19,690.4	19,457.4
Community Colleges.....	35.8	28.0	7.8	7.8
Highway and Highway Bridge .....	17,931.0	2,012.5	15,918.5	15,918.5
Advance Construction Interstate .....	450.0	450.0	0	0
Flood Control .....	379.9	53.8	326.2	326.2
Site Development .....	150.0	150.0	0	0
Total.....	<u>\$ 71,494.3</u>	<u>\$ 14,304.1</u>	<u>\$ 57,190.3</u>	<u>\$ 56,582.3</u>

<sup>(a)</sup> Not all are outstanding.

The amount of debt that may be issued in any given fiscal year for capital projects authorized in current or previous capital budgets is enacted annually by the General Assembly and approved by the Governor. The fiscal year 2007 capital budget provides that such budget will be in effect until the fiscal year 2008 capital budget is enacted. The maximum amount of debt currently authorized by the fiscal year 2007 capital budget is as shown in Table 3.

**Table 3**  
**Fiscal Year 2007 Capital Budget Debt Limits**  
(In Millions)

<u>Capital Facilities Projects Category</u>	<u>Limits</u>	<u>Issued to Date</u>	<u>Remaining Issuable Within Limit</u>	<u>Pro Forma Remaining After Issuance Of the Bonds</u>
Buildings and Structures .....	\$ 445.0	\$ 0.0	\$ 445.0	\$ 145.0
Furniture and Equipment.....	5.0	0.0	5.0	5.0
Transportation Assistance .....	155.0	0.0	155.0	80.0
Redevelopment Assistance.....	400.0	0.0	400.0	167.0
Flood Control .....	10.0	0.0	10.0	10.0
Total.....	<u>\$ 1,015.0</u>	<u>\$ 0.0</u>	<u>\$ 1,015.0</u>	<u>\$ 407.0</u>

<sup>(a)</sup> The fiscal year 2007 capital budget debt limits became effective on November 22, 2006, and will remain in force until the fiscal year 2008 capital budget debt limit becomes effective.

Upon issuance of \$608.0 million aggregate principal amount of the Second Series Bonds under the Capital Budget, \$407.0 million principal amount of debt will remain authorized and unissued thereunder.

The 1988 Referendum and the 1988 Pennvest Act authorized the issuance of \$300.0 million aggregate principal amount of debt, all of which has heretofore been issued, for the purpose of making loans for water supply, storm water control and sewage treatment systems. See "USE OF PROCEEDS - Pennvest Loans." The 1992 Referendum and the 1992 Pennvest Act authorized the issuance of \$350.0 million aggregate principal amount of debt

for the purpose of making loans for water supply, storm water control and sewage treatment systems. See “USE OF PROCEEDS - Pennvest Loans.” To date, \$133.0 million principal amount of bonds has been issued pursuant to the authority of the 1992 Referendum and the 1992 Pennvest Act. Upon the issuance of \$50.0 million of the Second Series Bonds pursuant to the 1992 Referendum and the 1992 Pennvest Act, \$167.0 million principal amount of debt will remain authorized and unissued thereunder.

The Pennworks Acts authorized the issuance of \$250.0 million aggregate principal of debt for the purpose of making grants and loans for construction, expansion or improvement of water and wastewater infrastructure, including water supply and sewage treatment systems. See “USE OF PROCEEDS - Pennworks.” To date, \$50.0 million principal amount of bonds have been issued pursuant to the authority of the Pennworks Acts. Upon the issuance of \$15.0 million of the Second Series Bonds pursuant to the Pennworks Act, \$185.0 million principal amount of debt will remain authorized and unissued thereunder.

The Growing Greener II Acts authorized the issuance of \$625.0 million aggregate principal of debt for the purpose of the maintenance and protection of the environment, open space and farmland preservation, watershed protection, abandoned mine reclamation, acid mine drainage remediation and other environmental initiatives. See “USE OF PROCEEDS-Growing Greener.” To date, \$183.0 million principal amount of the bonds have been issued pursuant to the authority of the Growing Greener II Acts. Upon the issuance of \$27.0 million of the Second Series Bonds pursuant to the Growing Greener II Acts, \$415.0 million principal amount of debt will remain authorized and unissued thereunder.

For a discussion of the Commonwealth’s outstanding debt and projected future issuance of general obligation debt, see “OUTSTANDING INDEBTEDNESS OF THE COMMONWEALTH.”

## **USE OF PROCEEDS**

The Commonwealth is issuing the Bonds for the following purposes:

- (i) Proceeds of the Second Series Bonds will be used to provide for the construction, acquisition and major rehabilitation of capital facilities projects as described below under “Capital Facilities”;
- (ii) Proceeds of the Second Series Bonds will be used to provide for Pennvest loans as described below under “Pennvest Loans”;
- (iii) Proceeds of the Second Series Bonds will be used to provide for Pennworks Acts grants and loans described below under “Pennworks Acts”;
- (iv) Proceeds of the Second Series Bonds will be used to provide for maintenance and protection of the environment, open space and farmland preservation, watershed protection, abandoned mine reclamation, acid mine drainage remediation and other environmental initiatives as described below under “Growing Greener”; and
- (v) Proceeds of the First Refunding Series Bonds will be used to refund all or a portion of certain maturities of Commonwealth of Pennsylvania General Obligation bonds (the “Prior Bonds”) as described under “Plan of Refunding.”

The proceeds received from the sale of the Bonds (including bond premium, if any), after paying the costs of issuance, will be applied by the Commonwealth to fund the programs described below.

### **Capital Facilities**

Of the \$700,000,000 aggregate principal amount of the Second Series Bonds issued, \$608.0 million will be deposited into the Capital Facilities Fund and applied to defray the costs of issuance of the Second Series Bonds and the financial costs of various capital facilities projects of the Commonwealth. Of the \$608,000,000 aggregate principal amount of the Second Series Bonds issued for capital facilities projects, approximately: (i) \$300,000,000 aggregate principal amount of the Bonds is to be allocated to the Department of General Services and used to pay for the construction and major rehabilitation of public buildings for the Commonwealth and its institutions; (ii) \$233,000,000

aggregate principal amount of the Bonds is to be allocated to the Department of Community and Economic Development to fund redevelopment assistance projects; and (iii) \$75,000,000 aggregate principal amount of the Bonds is to be allocated to the Department of Transportation to fund transportation assistance projects. Pending application to the above purposes, the proceeds of the Second Series Bonds allocated to these purposes will be held by the State Treasurer in the Capital Facilities Fund and invested in accordance with applicable state and federal laws.

### **Pennvest Loans**

A portion of the proceeds of the Second Series Bonds is dedicated to the purposes of the Pennvest Acts for loans to local governments and authorities to acquire, repair, construct, reconstruct, rehabilitate, extend and improve water supply, storm water control and sewage treatment systems and to pay the costs of issuance of the Second Series Bonds allocated to such purposes. The proceeds of \$50.0 million aggregate principal amount of the Second Series Bonds issued under the authority of the Pennvest Acts shall be paid into the special funds established in the State Treasury for the purposes of the Pennvest Acts in such amounts as may be specified by the Board of the Pennsylvania Infrastructure Investment Authority (the “Pennvest Authority”). The Pennvest Acts provide a program for financing drinking water and sewage treatment facilities in Pennsylvania to protect public health, to maintain environmental quality and to promote economic development. The Pennvest Authority also administers the Commonwealth’s water pollution control revolving fund for the purpose of the federal Water Quality Act of 1987. Initial capital for the Pennvest Authority was provided from \$650 million of general obligation debt authorized by the Commonwealth’s voters through the Pennvest Referenda, \$150 million of capital budget authorization, and the remaining \$166 million of debt authorization from the Water Facilities Restoration Act, Act No. 1981-88, approved July 12, 1981 and a 1981 referendum that was reallocated to the Pennvest Authority in March 1988. Pending application to the above purposes, the proceeds of the Second Series Bonds allocated to these purposes will be held by the State Treasurer in the Pennvest Bond Fund and invested in accordance with applicable state and federal laws.

### **Pennworks**

A portion of the proceeds of the Second Series Bonds is dedicated to the purposes of the Pennworks Act and to pay the costs of issuance of the Second Series Bonds allocated to such purposes. The proceeds from \$15 million aggregate principal amount of the Second Series Bonds to be issued for the Pennworks Act will be deposited into the Water Supply and Wastewater Treatment Fund and applied to defray the financial costs to making grants and loans for construction, expansion or improvement of water and wastewater infrastructure, including water supply and sewage treatment systems. Pending application to the above purposes, the proceeds of the Second Series Bonds allocated to these purposes will be held by the State Treasurer in the Water Supply and Wastewater Treatment Fund and invested in accordance with applicable state and federal laws.

### **Growing Greener**

A portion of the proceeds of the Second Series Bonds is dedicated to the purposes of the Growing Greener II Acts and to pay the costs of issuance of the Second Series Bonds allocated to such purposes. The proceeds from \$27 million aggregate principal amount of the Second Series Bonds to be issued for the Growing Greener II Acts will be deposited into the Growing Greener Bond Fund and applied to the costs of maintenance and protection of the environment, open space and farmland preservation, watershed protection, abandoned mine reclamation, acid mine drainage remediation and other environmental initiatives. Pending application to the above purposes, the proceeds of the Second Series Bonds allocated to these purposes will be held by the State Treasurer in the Growing Greener Bond Fund and invested in accordance with applicable state and federal laws.

### **Plan of Refunding**

Through the First Refunding Series Bonds the Commonwealth is refunding the Prior Bonds in order to reduce debt service payable by the Commonwealth on its Prior Bonds. Because interest rates were higher at the time the Prior Bonds were sold, the Commonwealth anticipates interest savings from the refunding. The Prior Bonds currently scheduled to be refunded (the “Refunded Bonds”) are as follows:

<u>Principal Amount to be Refunded</u>	<u>Bond Series</u>	<u>Date of Issue</u>	<u>Bonds Maturing on</u>	<u>Date of Redemption</u>
\$34,975,000	First Refunding Series of 1996	May 15, 1996	November 15, 2008-2010	January 20, 2007
13,500,000	Third Series of 1998	December 1, 1998	December 1, 2014	December 1, 2008
16,275,000	First Series of 2001	January 15, 2001	January 15, 2021	January 15, 2011
75,250,000	Second Series of 2001	September 15, 2001	September 15, 2016 & 2018-2021	September 15, 2011
42,350,000	First Series of 2002	February 1, 2002	February 1, 2021-2022	February 1, 2012
56,885,000	First Series of 2003	January 1, 2003	January 1, 2017-2018	January 1, 2013

This refunding in advance of maturity of the Prior Bonds will be accomplished by applying a portion of the proceeds from the sale of the First Refunding Series Bonds to the purchase of certain direct obligations of the U. S. Government to be held in escrow (the “Escrow Obligations”), in an aggregate principal amount which at all times shall be sufficient, together with the interest to accrue thereon, to pay the principal of the Refunded Bonds, the redemption premium, if any, and the interest due and to become due thereon on the respective redemption dates as shown above (the “Required Deposit”). Such Escrow Obligations will be deposited with the State Treasurer of the Commonwealth of Pennsylvania, to be applied solely to the payment of the principal and redemption price of and interest on the Refunded Bonds on the redemption date shown above. Initially, the Escrow Obligations are expected to consist of United States Treasury State and Local Government Series obligations. Applicable law and the Resolutions permit the State Treasurer to substitute new Escrow Obligations meeting the requirements of the Required Deposit at the time of any such substitution upon fulfillment of certain conditions, including the receipt of an opinion of Bond Counsel and certain certifications. The refunding of the Prior Bonds will take place as described above only if the First Refunding Series Bonds are issued. **Selection of the Prior Bonds to be refunded will be determined by market conditions at the time of pricing, and there is no certainty that any Prior Bonds will be refunded.** The Commonwealth will send out required notices of redemption as provided in the documentation relating to the Prior Bonds, and holders of the Prior Bonds should rely solely on such redemption notices.

## COMMONWEALTH GOVERNMENT

The Commonwealth is organized into three separate branches of government — executive, legislative and judicial — as defined in the Constitution. Five officials of the Commonwealth’s executive branch are elected in statewide elections for four-year terms expiring on the dates shown below.

<u>Name</u>	<u>Office</u>	<u>Term Expires</u>
Edward G. Rendell	Governor	January 16, 2007
Catherine Baker Knoll	Lieutenant Governor	January 16, 2007
Tom Corbett	Attorney General	January 20, 2009
Robert P. Casey, Jr.	State Treasurer	January 20, 2009
Jack Wagner	Auditor General	January 20, 2009

In elections held on November 7, 2006 for the Offices of Governor and Lieutenant Governor for terms expiring January 16, 2007, the present Governor and Lieutenant Governor were re-elected for a second term. The Constitution limits officeholders to no more than two successive terms in an office. A more detailed description of the Commonwealth’s government and fiscal administration is included in Appendix C.

### Commonwealth Employees

Employees are permitted to organize and bargain collectively. As of July 2006, 82.4 percent of the full-time salaried employees under the Governor’s jurisdiction were covered by collective bargaining agreements or memoranda of understanding. Approximately 45.2 percent of state employees are represented by the American Federation of State, County and Municipal Employees (“AFSCME”). Approximately 65 percent of state employees, represented by the AFSCME, Pennsylvania Social Services Union and other unions, are covered by contracts effective July 1, 2003 and

expiring on June 30, 2007. These contracts provide 6.5 percent salary increases over their four-year life. Interest arbitration awards cover four other unions. Two of the awards expire June 30, 2007 and provide 7 percent increases over their four year terms. The other two awards expire June 30, 2008 and provide, respectively, a 14 percent increase over their four year life, and a 10 percent increase over a three year term. Approximately 130 employees whose contract expired in June 2003 continue to work while negotiations continue. Table 4, on the following page, presents the number of approved and filled positions under the Governor’s jurisdiction for the period 2002 through 2006.

Negotiations have begun for the collective bargaining agreements which are set to expire on June 30, 2007.

**Table 4**  
**Filled Salaried Positions and Employees**  
**Under the Governor’s Jurisdiction**<sup>(a)</sup>  
**2002-2006**

<u>As of</u> <u>July 1</u>	<u>Total Full and</u> <u>Part Time</u> <u>Filled Salaried</u> <u>Positions</u>	<u>Total</u> <u>Full Time</u> <u>Salaried</u> <u>Employees</u>	<u>Civil Service</u> <u>Salaried</u> <u>Positions</u>	<u>Civil Service</u> <u>As a % of Total</u> <u>Filled Salaried</u> <u>Positions</u>
2002 .....	80,146	79,665	56,296	70.2
2003 .....	78,691	78,691	54,817	69.7
2004 .....	76,410	76,087	52,869	69.5
2005 .....	77,041	76,726	53,163	69.0
2006 .....	78,733	78,366	54,428	69.1

<sup>(a)</sup> Excludes employees of the legislative and judicial branches, the Department of the Auditor General, the Treasury Department, the State System of Higher Education and independent agencies, boards and commissions.  
Source: Office of Administration, *Governor’s Annual Work Force Reports*.

## COMMONWEALTH FINANCIAL STRUCTURE AND PROCEDURES

The Constitution and the laws of the Commonwealth require all payments from the State Treasury, with the exception of refunds of taxes, licenses, fees and other charges, to be made only by duly enacted appropriations. Amounts appropriated from a fund may not exceed its actual and estimated revenues for the fiscal year plus any unappropriated surplus available. Appropriations from the principal operating funds of the Commonwealth (the General Fund, the Motor License Fund and the State Lottery Fund) are generally made for one fiscal year and are returned to the unappropriated surplus of the fund (a lapse) if not spent or encumbered by the end of the fiscal year. The Commonwealth’s fiscal year begins July 1 and ends June 30. (Fiscal year 2007 refers to the fiscal year ended June 30, 2007.) See Appendix C for a further description of the fiscal administration of the Commonwealth.

### Description of Funds

The Commonwealth utilizes the fund method of accounting. For purposes of governmental accounting, a “fund” is defined as an independent fiscal and accounting entity with a self-balancing set of accounts. Each fund records the cash and/or other resources together with all related liabilities and equities that are segregated for the purpose of the fund. In the Commonwealth, funds are established by legislative enactment or in certain limited cases by administrative action. Over 150 funds have been established and currently exist for the purpose of recording the receipt and disbursement of moneys received by the Commonwealth. Annual budgets are adopted each fiscal year for the principal operating funds of the Commonwealth and several other special revenue funds. Expenditures and encumbrances against these funds may be made only pursuant to appropriation measures enacted by the General Assembly and approved by the Governor.

The General Fund, the Commonwealth's largest operating fund, receives all tax revenues, non-tax revenues and federal grants and entitlements that are not specified by law to be deposited elsewhere. The majority of the Commonwealth's operating and administrative expenses are payable from the General Fund. Debt service on all bond indebtedness of the Commonwealth, except that issued for highway purposes or for the benefit of other special revenue funds, is payable from the General Fund.

The Motor License Fund receives all tax and fee revenues relating to motor fuels and vehicles except the revenues from one-half cent per gallon of the liquid fuels tax, which are deposited in the Liquid Fuels Tax Fund for distribution to local municipalities. All revenues relating to motor fuels and vehicles are required by the Constitution to be used only for highway purposes. Most federal aid revenues designated for transportation programs and tax revenues relating to aviation fuels are also deposited in the Motor License Fund. Operating and administrative costs for the Department of Transportation and other Commonwealth departments conducting transportation related programs, including the highway patrol activities of the Pennsylvania State Police, are also paid from the Motor License Fund. Debt service on bonds issued by the Commonwealth for highway purposes is payable from the Motor License Fund.

Other special revenue funds have been established by law to receive specified revenues that are appropriated to departments, boards and/or commissions for payment of their operating and administrative costs. Such funds include the Game, Fish, Boat, Banking Department, Milk Marketing, State Farm Products Show, Environmental Stewardship, State Racing, and Tobacco Settlement Funds. Some of these special revenue funds are required to transfer excess revenues to the General Fund, and some receive funding, in addition to their specified revenues, through appropriations from the General Fund.

The Tobacco Settlement Fund is a special revenue fund established to receive tobacco litigation settlement payments paid to the Commonwealth. The Commonwealth is one of forty-six states that settled certain smoking-related litigation in a November 1998 master settlement agreement with participating tobacco product manufacturers (the "Tobacco MSA"). Under the Tobacco MSA, the Commonwealth is entitled to receive a portion of payments made pursuant to the Tobacco MSA by tobacco product manufacturers participating in the Tobacco MSA. Most revenues to the Tobacco Settlement Fund are subject to annual appropriation by the General Assembly and approval by the Governor.

The Tax Stabilization Reserve Fund and the Budget Stabilization Reserve Fund that replaced the Tax Stabilization Reserve Fund following its abolishment in 2002 are special revenue funds designated to receive a statutorily determined portion of the budgetary basis fiscal year-end surplus of the General Fund. The Budget Stabilization Reserve Fund was established in July 2002 after the Tax Stabilization Reserve Fund was abolished and its balance transferred to the General Fund for the 2002 fiscal year budget. The Budget Stabilization Reserve Fund is to be used for emergencies threatening the health, safety or welfare of citizens or during downturns in the economy that result in significant unanticipated revenue shortfalls not able to be addressed through the normal budget process. Assets of the fund may be used upon recommendation by the Governor and an approving vote by two-thirds of the members of each house of the General Assembly. For GAAP (as defined below) reporting purposes, the Budget Stabilization Reserve Fund (previously the Tax Stabilization Reserve Fund) has been reported as a fund balance reservation in the General Fund (governmental fund category) since fiscal year 1999. Prior to that fiscal year, the Tax Stabilization Reserve Fund was reported, on a GAAP basis, as a designation of the General Fund unreserved fund balance. See "Budget Stabilization Reserve Fund and Tax Stabilization Reserve Fund" below.

The Commonwealth maintains trust and agency funds that are used to administer funds received pursuant to a specific bequest or as an agent for other governmental units or individuals.

Enterprise funds are maintained for departments or programs operated like private enterprises. Two of the largest of such funds are the State Stores Fund and the State Lottery Fund. The State Stores Fund is used for the receipts and disbursements of the Commonwealth's liquor store system. Sale and distribution of all liquor within Pennsylvania is a government enterprise. The State Lottery Fund is also an Enterprise fund for the receipt of lottery ticket sales and lottery licenses and fees. Its revenues, after payment of prizes, are dedicated to paying the costs of programs benefiting the elderly and handicapped in Pennsylvania.



In addition, the Commonwealth maintains funds classified as working capital, bond, and sinking funds for specified purposes.

### **Accounting Practices**

Financial information for the principal operating funds of the Commonwealth is maintained on a budgetary basis of accounting. The Commonwealth also prepares annual financial statements in accordance with generally accepted accounting principles (“GAAP”). Annual financial statements prepared in accordance with GAAP are audited jointly by the Department of the Auditor General and an independent public accounting firm.

#### ***Budgetary Basis***

A budgetary basis of accounting is used for ensuring compliance with the enacted operating budget and is governed by applicable statutes of the Commonwealth and by administrative procedures. The Constitution provides that operating budget appropriations shall not exceed the actual and estimated revenues and unappropriated surplus available in the fiscal year for which funds are appropriated. Annual budgets are enacted for the General Fund and certain special revenue funds that together represent the majority of expenditures of the Commonwealth. The annual budget classifies fund revenues as Commonwealth revenues, augmentations, federal revenues, or restricted receipts and revenues. Commonwealth revenues are revenues from taxes and from non-tax sources such as licenses and fee charges, penalties, interest, investment income and other miscellaneous sources. Augmentations consist of departmental and institutional billings that supplement an appropriation of Commonwealth revenues, thereby increasing authorized spending. For example, patient billings for services at Commonwealth-owned institutions are augmentations that supplement Commonwealth revenues appropriated to each institution for operating costs. Federal revenues are those federal aid receipts that pay for or reimburse the Commonwealth for funds disbursed for federally assisted programs. Restricted receipts and revenues are funds that are restricted to a specific use or uses by state law, administrative decision, or the provider of the funds. Only Commonwealth revenues and expenditures from these revenues are included in the computation made to determine whether an enacted budget is constitutionally balanced. Augmenting revenues and federal revenues are considered to be self-balancing with expenditures from their respective revenue sources.

The Commonwealth’s budgetary basis financial reports for its governmental funds are based on a modified cash basis of accounting as opposed to the modified accrual basis prescribed by GAAP. Under the Commonwealth’s budgetary basis of accounting, tax receipts, non-tax revenues, augmentations and all other receipts are recorded at the time cash is received. An adjustment is made at fiscal year-end to include accrued revenue unrealized; that is, revenues earned but not collected. Revenues accrued include estimated receipts from (i) sales and use, personal income, realty transfer, inheritance, cigarette, liquor, liquid fuel, fuels, and oil company franchise taxes, and interest earnings, and (ii) federal government commitments to the Commonwealth. Expenditures are recorded at the time payment requisitions and invoices are submitted to the Treasury Department for payment. Appropriated amounts are reserved for payment of contracts for the delivery of goods or services to the Commonwealth through an encumbrance process. Unencumbered appropriated funds are automatically lapsed at fiscal year-end and are available for re-appropriation. Estimated encumbrances are established at fiscal year-end to pay certain direct expenditures for salaries, wages, travel, and utility costs payable against current year appropriations but disbursed in the subsequent fiscal year. Recording of the applicable expenditure liquidates the encumbered amount. Over-estimates of fiscal year-end encumbrances are lapsed in the subsequent fiscal year and under-estimates are charged to a subsequent fiscal year appropriation. Appropriation encumbrances are shown on the Commonwealth’s balance sheet as a reservation of fund balance.

Other reservations of fund balance include (i) the unexpended balance of continuing appropriations (that is, appropriations that do not lapse at fiscal year-end), and (ii) requested appropriation supplements and deficiency appropriations. Revenues dedicated for specific purposes and remaining unexpended at the fiscal year-end are likewise reserved.

#### ***GAAP Financial Reporting***

At fiscal year-end, budgetary basis fund financial information, both revenues and expenditures, is adjusted to reflect appropriate accruals for financial reporting in conformity with GAAP. The Commonwealth is not required to prepare GAAP financial statements and does not prepare them on an interim basis. GAAP fund financial reporting

requires a modified accrual basis of accounting for governmental funds, while proprietary and fiduciary funds are reported on the accrual basis of accounting.

Fund financial statements of the Commonwealth prepared under GAAP differ from those traditionally prepared on a budgetary basis for several reasons. Among other differences, the GAAP fund financial statements (i) generally recognize revenues when they become measurable and available rather than when cash is received, (ii) report expenditures when goods and services are received and a liability incurred rather than when cash is disbursed, (iii) include a combined balance sheet for the Commonwealth presented by GAAP fund type rather than by Commonwealth fund, and (iv) include activities of all funds in the reporting entity, including agencies and authorities usually considered as independent of the Commonwealth for budgetary purposes. Adjustments to budgetary basis revenues and expenditures required to conform to GAAP accounting generally require including (i) corporation, sales, and personal income tax accruals, (ii) tax refunds payable and tax credits, and (iii) expenditures incurred but not yet posted as expenditures or not covered by appropriations.

An independent public accounting firm and the Department of the Auditor General jointly audit the Commonwealth's annual GAAP basis financial statements. The audited Basic Financial Statements are a component of the Commonwealth's Comprehensive Annual Financial Report ("CAFR"). The CAFRs for recent fiscal years, including the fiscal year ended June 30, 2005, have been filed with each Nationally Recognized Municipal Information Repository (a "NRMSIR") currently recognized by the Securities and Exchange Commission and are available from any NRMSIR and at the Budget & Financial Reports section of the Office of the Budget's web site - [www.budget.state.pa.us](http://www.budget.state.pa.us) - and such CAFRs are incorporated herein by reference. In February 2004, the Commonwealth restated its GAAP basis financial statements for the fiscal year ended June 30, 2002, for reasons discussed in "COMMONWEALTH FINANCIAL PERFORMANCE – Restatement of Financial Statements." The Commonwealth has filed both the restated financials and restated CAFR with each NRMSIR and has posted them at the Office of the Budget's web site. **Beginning with the CAFR for the fiscal year ended June 30, 2002 and continuing in subsequent CAFRs, the Commonwealth has incorporated several new accounting and reporting standards that affect the comparability of financial information for those fiscal years to GAAP basis financial information reported for fiscal years prior to the adoption of the new standards. See "New Governmental Accounting and Reporting Standards" below.**

### ***New Governmental Accounting and Reporting Standards***

Beginning with its GAAP basis financial statements for the fiscal year ended June 30, 2002, the Commonwealth adopted several new accounting and reporting standards established by the Governmental Accounting Standards Board in its Statements 33, 34, 35, 36, 37 and 38 (collectively, the "New Standards"). Among other things, these New Standards require presentation of government-wide and fund financial statements that constitute basic financial statements and replace general-purpose financial statements reported under former standards. Government-wide financial statements are intended to portray the government "as a whole" while fund financial statements provide fund-specific information. Government-wide financial statements are intended to describe the total cost of providing governmental services and disclose whether the Commonwealth's financial condition improved or weakened during the fiscal year. Other features of the new government-wide financial statements are the reporting of infrastructure assets and related depreciation. Previously, the Commonwealth did not report infrastructure values or accumulated depreciation related to general fixed assets. As part of implementing the New Standards, effective July 1, 2001, the Commonwealth reclassified and/or restated numerous fund balance amounts previously reported at June 30, 2001 and reported governmental activities net assets at June 30, 2001. Note B to the financial statements in the June 30, 2002 CAFR provides a detailed explanation of the nature and amount of such restatements. The New Standards also require providing supplementary information, including a Management's Discussion and Analysis of the financial statements. Beginning with fiscal year 2002 the Commonwealth also changed how functional expenditure categories are defined. All of these changes may hamper the comparability of GAAP basis financial information for fiscal years ended June 30, 2002 and later to financial reports for years prior to the implementation of the New Standards.

## **Investment of Funds**

The Treasury Department is responsible for the deposit and investment of most funds belonging to the Commonwealth, including the proceeds of the Bonds and the funds held for the periodic payment of interest on and maturing principal of the Bonds. The Commonwealth's Fiscal Code contains statutory limitations on the investment of funds by the Treasury Department. The Board of Finance and Revenue, a six-person board of state officials chaired by the State Treasurer, is authorized to establish the aggregate amount of funds that may be invested in some of the various categories of permitted investments. The State Treasurer ultimately determines the asset allocation and selects the investments within the parameters of the law.

The Commonwealth's Fiscal Code permits investments in the following types of securities: (i) United States Treasury securities and United States Agency securities maturing within two years of issue; (ii) commercial paper issued by industrial, common carrier or finance companies rated "Prime One" or its equivalent; (iii) certificates of deposit of Pennsylvania-based commercial banks, savings banks or savings and loans; (iv) repurchase obligations secured with obligations described under (i); (v) banker's acceptances written by domestic commercial banks with a rating of "Aa" or better, or its equivalent; and (vi) other non-equity investments subject to a "prudent investor" test not to exceed ten percent of assets. The Treasury Department maintains additional investment restrictions contained in its Investment Policy Guidelines. A summary of the Investment Policy Guidelines and a report on investment activity and performance of funds invested by the Treasury Department are contained in a report periodically prepared and publicly distributed by the Treasury Department.

Additionally, in June 1999, legislation authorized the State Treasurer to invest Commonwealth moneys in equity securities under a prudent person standard. The common investment pool operated by the State Treasurer for the investment of operating funds of the Commonwealth maintains a portion of its investments in equity securities. The legislative authorization to invest in equity securities has been extended until December 2008.

## **Budget Stabilization Reserve Fund and Tax Stabilization Reserve Fund**

Legislation enacted with the adoption of the fiscal year 2003 budget abolished the Tax Stabilization Reserve Fund and transferred its balance of \$1.038 billion to the General Fund. That legislation also established a new reserve fund named the Budget Stabilization Reserve Fund and initially directed \$300 million of funding from the General Fund for deposit to the fund during fiscal year 2003. Subsequently, the General Assembly repealed the \$300 million transfer allowing that amount to remain in the General Fund to help offset anticipated revenue shortfalls to the fiscal year 2003 budget.

Balances in the Budget Stabilization Reserve Fund, the successor to the Tax Stabilization Reserve Fund, may be used to alleviate emergencies threatening the health, safety or welfare of the Commonwealth's citizens or to offset unanticipated revenue shortfalls due to economic downturns. Income to the fund is provided by the transfer of a legislatively determined portion of the General Fund budgetary basis unappropriated surplus at the close of a fiscal year, by investment income to the fund, and by specific appropriation from other available funds by the General Assembly. The Budget Stabilization Reserve Fund is intended to accumulate a balance equal to 6 percent of General Fund revenues. Beginning with fiscal year 2003, 25 percent of any fiscal year-end surplus is to be deposited into the Budget Stabilization Reserve Fund. When the Budget Stabilization Reserve Fund balance reaches or exceeds a level equal to 6 percent of General Fund revenues, the proportion of the General Fund's fiscal year-end balance to be transferred to the Budget Stabilization Reserve Fund is to be lowered from 25 percent to 10 percent. The General Assembly may appropriate additional amounts to this fund at any time. During fiscal year 2003, the General Assembly repealed a fiscal year 2003 \$300 million transfer from the General Fund to the Budget Stabilization Reserve Fund to retain that amount in the General Fund. This action, in addition to other budget actions taken during fiscal year 2003, contributed to the achievement of a General Fund unappropriated surplus balance of \$279.1 million on June 30, 2003. As required by law, 25 percent of that amount was transferred to the Budget Stabilization Reserve Fund, or \$69.8 million. Following completion of the fiscal year 2004 budget, a General Fund unappropriated surplus balance of \$266.9 million was achieved with 25 percent or \$66.7 million transferred to the Budget Stabilization Reserve Fund. In addition, the Commonwealth made an additional transfer to the Budget Stabilization Reserve Fund of \$123.3 million, which resulted in a total fiscal year 2004 contribution of \$190 million. At the end of the 2005 fiscal year, the Commonwealth's unappropriated surplus balance was \$429.2 million and a one-time reduction in the transfer rate from 25 percent to 15

percent resulted in a statutorily required transfer of nearly \$64.4 million to the Budget Stabilization Reserve Fund. For fiscal year 2006, \$171.4 million has been transferred to the Fund, which represents the required statutory transfer of 25 percent of the \$685.4 million unappropriated surplus balance. At present, the Commonwealth maintains a balance of approximately \$518.2 million in the Budget Stabilization Reserve Fund. Further, as of October 2006, the Commonwealth maintains balances in various funds and accounts, including the Budget Stabilization Reserve Fund, totaling approximately 6.0 percent of the Commonwealth's annual operating costs. See data contained in Table 8 for additional information. These additional funds may become available through either executive or legislative action to address unforeseen budgetary stresses that could occur. Balances in the Budget Stabilization Reserve Fund are to be used only when emergencies involving the health, safety or welfare of the residents of the Commonwealth or downturns in the economy resulting in significant unanticipated revenue shortfalls cannot be dealt with through the normal budget process. Funds in the Budget Stabilization Reserve Fund may be appropriated only upon the recommendation of the Governor and the approval of a separate appropriation bill by a vote of two-thirds of the members of both houses of the General Assembly. However, Act 66 of 2006, provided the Secretary of the Budget with the option to transfer up to \$290 million from the Budget Stabilization Reserve Fund to the operating budget to cover certain state appropriations related to health care costs within the Department of Public Welfare. Such a transfer could be authorized by the Secretary of the Budget if sufficient funds to cover said health care costs were not sufficiently appropriated as part of the fiscal year 2007 budget. The Budget Secretary has not authorized a transfer from the Budget Stabilization Reserve Fund under the provisions of Act 66 of 2006 nor is he compelled to do so. Any funds appropriated from the Budget Stabilization Reserve Fund that are unspent are returned to the Budget Stabilization Reserve Fund.

## **COMMONWEALTH FINANCIAL PERFORMANCE**

### **Recent Developments**

On July 2, 2006, the Commonwealth's fiscal year 2007 budget was enacted by the General Assembly and was signed into law by the Governor. The fiscal year 2007 budget includes a projected rise in Commonwealth revenues, prior to reserves for tax refunds, of nearly 3.7 percent over fiscal year 2006 receipts. The rate of growth in revenues is based upon a projection that the national and state economies will continue to grow at a modest rate. The enacted fiscal year 2007 budget provides for an increase in appropriations of 5.8 percent over fiscal year 2006 enacted budget and supplemental appropriations. The difference between the enacted appropriations and available revenues is funded through the utilization of the remaining unappropriated surplus from fiscal year 2006. See "Fiscal Year 2007 Budget."

### **Introduction**

The most recent audited financial statements for a fiscal year are available in the CAFR issued by the Commonwealth for the fiscal period ended June 30, 2005 ("fiscal year 2005"), which was filed with each NRMSIR in February 2006. Beginning with the CAFR for fiscal year 2002, the Commonwealth incorporates New Standards that affect the comparability of financial information for that fiscal year to GAAP basis financial information reported for fiscal years prior to the adoption of the New Standards. See "COMMONWEALTH FINANCIAL STRUCTURE AND PROCEDURES - New Governmental Accounting And Reporting Standards." Information contained in the fund financial statements for fiscal years 2002 through 2005 continue to report what was formerly reported for governmental funds in the General Purpose Financial Statements in CAFRs for prior fiscal years, although fund reclassifications and changed definitions for categories of expenditures for fiscal year 2002 and beyond will hamper comparability to data for prior fiscal years.

Copies of CAFRs recently issued by the Commonwealth are available from (i) any NRMSIR listed in the section "CONTINUING DISCLOSURE", (ii) the Secretary of the Budget, Mr. Michael Masch, Attn: Mr. Mike Higgins, 6th Floor, Strawberry Square Bell Tower, Harrisburg, Pennsylvania 17101 (Telephone (717) 787-5312), and (iii) the Budget & Financial Reports section of the Office of the Budget's web site at [www.budget.state.pa.us](http://www.budget.state.pa.us), which CAFRs are incorporated herein by reference. The basic financial statements for fiscal year 2005 are incorporated herein by the above reference as to their availability by other than in this Official Statement. This means that (i) the incorporated information is considered part of this Official Statement, and (ii) such information should be reviewed by prospective purchasers of the Bonds as a part of their review of this entire Official Statement.

**Government-Wide Financial Data (GAAP Basis)**

Government-wide financial statements report financial position and results of activity for the Commonwealth as a whole. Government-wide statements do not report information fund-by-fund; rather, they reveal information for all governmental activities and all business-type activities in separate columns. In government-wide statements, for both governmental and business-type activities, the economic resources measurement focus and accrual basis of accounting are used, with revenues and expenses recognized when they occur, rather than when cash is received or paid. This results in assets including an estimate of the total amount of receivables due at fiscal year-end that are expected to be collected in the future. Capital assets are reported with acquisition or construction costs being reported when the assets are placed in service less accumulated depreciation. Reported liabilities include all liabilities, regardless of when payment is due, including bond principal, employee disability claims liability, and employee compensated absence liabilities.

Table 5, on the following page, presents condensed financial statement information derived from the Commonwealth's government-wide June 30, 2005 Statement of Net Assets and includes amounts for the "primary government" only.

**Table 5**  
**Condensed Statement of Net Assets**  
**Primary Government**  
**Fiscal Year Ended June 30, 2005**  
(In Billions)

	<b>Governmental Activities</b>	<b>Business-Type Activities</b>	<b>Total</b>
<b>Assets:</b>			
Cash and investments.....	\$ 10.0	\$ 5.5	\$ 15.5
Capital assets (net).....	21.9	-	21.9
All other assets.....	6.1	1.2	7.3
<b>Total Assets.....</b>	<b>\$ 38.0</b>	<b>\$ 6.7</b>	<b>\$ 44.7</b>
<b>Liabilities:</b>			
Accounts payable.....	\$ 3.8	\$ 0.4	\$ 4.2
All other current liabilities.....	4.2	1.4	5.6
<b>Total Current Liabilities.....</b>	<b>8.0</b>	<b>1.8</b>	<b>9.8</b>
Bonds payable.....	6.6	-	6.6
All other long-term liabilities.....	2.6	2.3	4.9
<b>Total long-term liabilities.....</b>	<b>9.2</b>	<b>2.3</b>	<b>11.5</b>
<b>Total liabilities.....</b>	<b>\$ 17.2</b>	<b>\$ 4.1</b>	<b>\$ 21.3</b>
<b>Net assets:</b>			
Invested in capital assets, net of related debt.....	\$ 18.2	-	\$ 18.2
Restricted.....	3.3	\$ 2.6	5.9
Unrestricted.....	(0.7)	-	(0.7)
<b>Total Net Assets.....</b>	<b>\$ 20.8</b>	<b>\$ 2.6</b>	<b>\$ 23.4</b>

Source: Comprehensive Annual Financial Report, fiscal year ended June 30, 2005.

During the fiscal year ended June 30, 2005, the overall financial position (net assets) of the Commonwealth, including both governmental and business-type activities, increased by \$1.6 billion or 7.3 percent of total beginning net assets of \$21.8 billion. For governmental activities, the net increase in net assets was \$1.1 billion or 5.6 percent of beginning net assets of \$19.7 billion. Total investments, not counting the State Employees' Retirement Fund and other fiduciary funds, were over \$14.2 billion and total cash balances were over \$1.3 billion. These amounts represent considerable liquidity for the current and future fiscal years. The increase in net assets for governmental activities compares favorably relative to the prior year change, where revenues, transfers and special items exceeded expenses by

\$1.1 billion. These increases represent a year-over-year improvement in the Commonwealth's overall financial position during each of the fiscal years ended June 30, 2005 and 2004. The \$0.5 billion increase in total net assets for business-type activities follows a \$0.4 billion decrease during the prior fiscal year. This \$0.9 billion improvement is primarily attributable to a \$0.8 billion decrease in unemployment compensation benefit payments coupled with a \$0.3 billion increase in unemployment compensation assessments. During these fiscal years, unemployment compensation activities net assets increased by \$0.3 and decreased by \$0.4 billion, respectively. Statutory contribution increases occurred during each of the fiscal years ended June 30, 2005 and 2004. Such increases are intended to eliminate net asset decreases in the unemployment compensation program. During the fiscal year ended June 30, 2005, total business-type activities revenues exceeded total expenses by \$0.8 billion; and in the prior fiscal year total revenues were equal to expenses. Including net transfers to other funds of \$0.3 billion (\$0.4 billion in the prior year), business-type activities net assets increased by over \$0.5 billion (\$0.4 billion in the prior year). The primary reason for this increase was the \$0.3 billion improvement in Unemployment Compensation Fund net assets. Fiscal year 2005 Unemployment Compensation Fund revenues decreased by over \$0.1 billion and expenses decreased by \$0.8 billion compared to the fiscal year ended June 30, 2004.

***Financial Data for Governmental Fund Types (GAAP Basis)***

Governmental fund financial statements provide fund-specific information about the General Fund, the Motor License Fund, and the Tobacco Settlement Fund (initially reported for fiscal year 2002) and for other Commonwealth funds categorized as governmental funds and reported as such in the General Purpose Financial Statements of prior fiscal years. Where government-wide financial statements cover the entirety of the Commonwealth, fund financial statements provide a more detailed view of the major individual funds established by the Commonwealth. Fund financial statements differ from government-wide statements in the use by the latter of the current financial resources measurement focus and the modified accrual basis of accounting.

The governmental funds balance sheet reports total fund balances for all governmental funds. Assets of the Commonwealth's governmental funds (the General Fund, the Motor License Fund and the Tobacco Settlement Fund are major governmental funds) as of June 30, 2005 were \$15,984.09 million. Liabilities for the same date totaled \$9,002.10 million, leaving a fund balance of \$6,981.99 million, an increase of \$188.11 million from the fund balance at June 30, 2004. On a fund specific basis, the fund balance for the General Fund decreased by \$137.4 million, the fund balance for the Motor License Fund increased by \$196.9 million, the fund balance for the Tobacco Settlement Fund increased by \$56.7 million and the fund balance for aggregated non-major funds increased by \$71.9 million. See "General Fund – Fiscal Year 2005 Financial Results."

To help understand the relationship between the Commonwealth's GAAP fund balance (fund perspective) for governmental funds and the Commonwealth's governmental net assets (government-wide perspective) under the new presentation of financial information, the following reconciliation is presented:

**Table 6**  
**Reconciliation of the Balance Sheet**  
**Governmental Funds (Fund Perspective) to**  
**the Statement of Net Assets - Governmental Activities**  
**June 30, 2005**  
**(In Thousands)**

<b>Fund Balances - Governmental Funds</b>	
General Fund.....	\$ 2,869.1
Motor License Fund.....	1,276.5
Tobacco Settlement Fund.....	949.7
Nonmajor Funds.....	1,886.7
<b>Total Fund Balance - Governmental Funds.....</b>	<b>\$ 6,982.0</b>
Plus: Capital Assets, including infrastructure.....	32,606.5
Less: Accumulated depreciation.....	(10,775.1)
Plus: Deferred revenue.....	1,758.5
Plus: Additional accrued receivables.....	189.2
Plus: Net assets of internal service funds.....	75.4
Plus: Inventories.....	79.6
Less: Long-term liabilities.....	(10,116.9)
<b>Total Net Assets - Governmental Activities.....</b>	<b>\$ 20,799.2</b>

More detailed information with respect to the General Fund and the Motor License Fund, major operating funds that are categorized as governmental funds, is presented in Table 7 (General Fund) and in Table 9 (Motor License Fund).

The financial tables that follow containing GAAP basis financial data are unaudited but are derived from the Commonwealth's audited financial statements. The discussion of financial performance on a budgetary basis for prior fiscal years is based on an analysis of budget numbers and not on numbers prepared in accordance with GAAP. Likewise, the discussion of the financial estimates for fiscal year 2006 and the enacted budget for fiscal year 2007 reflects a budgetary basis analysis rather than a GAAP basis analysis.

## **General Fund**

### ***Financial Results for Recent Fiscal Years (GAAP Basis)***

During the five-year period from fiscal year 2001 through fiscal year 2005, total revenues and other sources increased by an average of 6.5 percent annually. Tax revenues during this same period increased by an annual average of 4.3 percent with a portion of the average annual growth rate attributable to various tax rate and base changes enacted over the same period. During the past several fiscal years, fees and license income and other financing sources such as transfers from other funds have continued to become a larger portion of income to the General Fund. Expenditures and other uses during the fiscal years 2001 through 2005 rose at an average annual rate of 6.9 percent. Comparison of expenditures by individual category in fiscal years 2002 through 2005 to prior fiscal years is not reliable due to a change to the definitions for these expenditure categories in fiscal year 2002.

The fund balance at June 30, 2005 totaled \$2,869.1 million, a decrease of \$137.4 million from the balance at June 30, 2004. The fiscal year 2005 year-end unreserved-undesignated portion of the fund balance was \$927.2 million, \$706.1 million below the amount recorded for fiscal year 2004 at years end.

Table 7 on the next page presents a summary of revenues and expenditures (GAAP basis for the General Fund, including the Budget Stabilization Reserve Fund that replaced the Tax Stabilization Reserve Fund) for the fiscal years 2001 through 2005.

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**Table 7**  
**Results of Operations—General Fund**  
**GAAP Basis—Unaudited**  
(In Thousands)

	Fiscal Year Ended June 30				
	2001	2002(a)	2003	2004	2005
<b>Fund Balance — Beginning of Period .....</b>	\$ 4,263,641	\$ 4,484,995	\$ 3,022,842	\$ 2,357,713	\$ 3,006,514
Restatements.....	-	159,919	-	-	-
<b>Fund Balance — Beginning of Period, as Restated.....</b>	<b>\$ 4,263,641</b>	<b>\$ 4,644,914</b>	<b>\$ 3,022,842</b>	<b>\$ 2,357,713</b>	<b>\$ 3,006,514</b>
<b>Revenues:</b>					
Taxes.....	\$ 19,297,659	\$ 18,649,928	\$ 19,553,998	\$ 21,190,494	\$ 22,841,136
Licenses and fees.....	202,591	201,388	250,264	275,898	300,450
Intergovernmental.....	10,588,526	11,652,199	12,943,624	14,790,701	15,102,454
Other revenues.....	2,779,739	2,539,271	2,313,183	2,423,649	4,053,837
<b>Other Financing Sources:</b>					
Operating transfers in.....	75,491	213,419	425,875	133,670	62,912
Transfer from component unit.....	-	256,206	-	-	-
Other additions.....	2,789	4,428	3,851	1,535	640
<b>TOTAL REVENUES AND OTHER SOURCES.....</b>	<b>\$ 32,946,795</b>	<b>\$ 33,516,839</b>	<b>\$ 35,490,795</b>	<b>\$ 38,815,947</b>	<b>\$ 42,361,429</b>
<b>Expenditures: (b)</b>					
Direction and supportive services.....	\$ 1,613,383	\$ 910,399	\$ 854,434	\$ 1,412,250	\$ 2,047,999
Protection of persons and property.....	3,026,625	3,104,079	2,941,339	2,958,160	3,013,875
Health and human services.....	16,645,180	18,221,987	19,549,141	20,816,721	23,361,454
Public education.....	8,667,618	8,813,198	10,174,386	10,520,428	11,382,118
Recreation and cultural enrichment.....	-	326,361	324,186	225,367	292,981
Conservation of natural resources.....	155,468	-	-	-	-
Economic development.....	522,073	824,830	984,334	963,926	987,325
Transportation.....	401,621	315,591	407,328	351,911	449,228
Capital outlay.....	117,354	50,818	17,698	142,651	27,305
<b>Other Uses:</b>					
Operating transfers out.....	1,460,431	1,528,451	903,078	775,732	936,549
Transfers to component units.....	-	1,043,197	-	-	-
<b>TOTAL EXPENDITURES AND OTHER USES</b>	<b>\$ 32,609,753</b>	<b>\$ 35,138,911</b>	<b>\$ 36,155,924</b>	<b>\$ 38,167,146</b>	<b>\$ 42,498,834</b>
<b>REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURE AND OTHER USES.....</b>	<b>337,042</b>	<b>(1,622,072)</b>	<b>(665,129)</b>	<b>648,801</b>	<b>(137,405)</b>
<b>Residual Equity Transfer In (Out) .....</b>	<b>(115,688)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Fund Balance — End of Period .....</b>	<b>\$ 4,484,995</b>	<b>\$ 3,022,842</b>	<b>\$ 2,357,713</b>	<b>\$ 3,006,514</b>	<b>\$ 2,869,109</b>
<b>Components of Fund Balance</b>					
Reserved for encumbrances.....	\$ 426,956	\$ 479,314	\$ 341,881	\$ 259,178	\$ 617,861
Reserved for advances and other.....	1,454,146	315,822	431,552	622,292	809,911
Unreserved — designated.....	1,079,047	623,884	269,775	491,718	514,174
Unreserved — undesignated.....	1,524,846	1,603,822	1,314,505	1,633,326	927,163
<b>TOTAL FUND BALANCE.....</b>	<b>\$ 4,484,995</b>	<b>\$ 3,022,842</b>	<b>\$ 2,357,713</b>	<b>\$ 3,006,514</b>	<b>\$ 2,869,109</b>

(a) Restated. For the fiscal year ended June 30, 2002 and subsequent fiscal years, the Commonwealth has adopted several new accounting and reporting standards described earlier in “COMMONWEALTH FINANCIAL STRUCTURE AND PROCEDURES – New Governmental Accounting and Reporting Standards.” The new standards require numerous changes to how fund financial statements are presented. Certain funds have been reclassified and fund balances restated. See Note B to the Comprehensive Annual Financial Report for the fiscal year ended June 30, 2002 for a more detailed explanation. These changes may limit the comparability of that year’s data and subsequent data to data for prior fiscal years.

(b) Beginning with the fiscal year ended June 30, 2002, the number and the definition of the functional categories of expenditures have been revised. These changes limit the comparability of fiscal years’ 2002, 2003, 2004 and 2005 data to data shown for prior fiscal years.

Source: Compiled from Office of the Budget, Comprehensive Annual Financial Report for fiscal years ended June 30, 2005, 2004, 2003, 2002, and 2001.



### ***Fiscal Year 2004 Financial Results***

*GAAP Basis.* At June 30, 2004, the General Fund reported a fund balance of \$3,006.5 million, an increase of \$648.8 million from the reported \$2,357.7 million fund balance at June 30, 2003. On a net basis, total assets increased by \$1,939 million to \$10,464 million. Liabilities increased by \$1,290 million to \$7,457 million largely because of a \$764 million increase in accounts payable.

General Fund tax revenues increased by 8.4 percent due to economic growth and specific statutory increases in certain tax bases and rates enacted in December 2003. Intergovernmental revenues increased by 14.3 percent, due primarily to increases in Federally-funded programs, particularly medical and other assistance, where expenditures increased over the prior year. Total General Fund revenues increased by 10.3 percent during the fiscal year. The overall increase in the fund balance, \$648.8 million, during the fiscal year was an improvement of \$1,314 million over the prior fiscal year decrease in fund balance of \$665 million. On an overall basis, during periods of declining or slow economic growth, it is common for the fund balance of the General Fund to decline and, conversely, to increase during periods of economic growth. During periods of economic growth, General Fund revenues increase while certain significant expenditures, such as medical assistance, also increase, but at a slower rate. Total General Fund expenditures increased by 6.0 percent during the fiscal year ended June 30, 2004, on a GAAP-reported basis, largely because of the increase in expenditures for medical and other assistance (reported as part of health and human services). Expenditures for direction and supportive services increased due to significantly higher employer costs for both active and retired employee healthcare benefits. Year-over-year expenditures for the health and human services function increased by 6.5 percent; all other expenditures, on a combined basis, increased by 5.5 percent, largely as a result of higher amounts appropriated throughout most of the General Fund.

*Budgetary Basis.* A rebounding national economy that exceeded preliminary estimates for growth resulted in actual fiscal year 2004 Commonwealth General Fund revenues exceeding the budget estimate by 2.9 percent, or \$636.7 million. Total fiscal year 2004 revenues net of reserves for tax refunds and including intergovernmental transfers and additional resources totaled \$23,159.7 million. Total expenditures net of appropriation lapses and including intergovernmental transfers and expenditures from additional resources was \$23,089.2 million. As result of Commonwealth financial operations during the fiscal year, the preliminary unappropriated surplus balance, prior to the statutorily required 25 percent transfer to the Budget Stabilization Reserve Fund, was scheduled to increase \$57.5 million to \$266.8 million from the fiscal year 2003 ending balance. Following the statutorily required 25 percent transfer to the Budget Stabilization Reserve Fund (\$66.7 million), a supplemental transfer of \$123.3 million was also made to the Budget Stabilization Reserve Fund. As result, the fiscal year 2004 final unappropriated surplus balance was \$76.7 million as of June 30, 2004.

Revenues available to the Commonwealth, including intergovernmental transfers and additional resources, increased 6.2 percent from fiscal year 2003 levels. Fiscal year 2004 revenues totaled \$23,159.7 million, an increase of \$1,351.2 million over fiscal year 2003 revenues. Commonwealth taxes and revenues, prior to reserves for refunds, increased by \$1,513.6 million to \$22,828.1 million in fiscal year 2004, a 7.1 percent increase from fiscal year 2003 actual receipts. This increase in tax revenues was primarily due to increases for certain Commonwealth taxes enacted with the fiscal year 2004 budget. Tax revenues to the Commonwealth for fiscal year 2004 exceeded the budget estimate, as re-certified in December 2003, by \$636.7 million or 2.9 percent. Nearly all Commonwealth major tax and revenue categories experienced revenue collections above the budget estimate. The personal income tax was \$117.8 million or 1.5 percent over the estimate for fiscal year 2004; the non-withholding portion of the personal income tax was 8.4 percent or \$124.5 million over the estimate. Corporate net income tax collections were \$201.6 million (13.7 percent) over estimate and the Capital Stock and Franchise tax collections were \$50 million (5.4 percent) more than projected. Sales and use tax receipts exceeded the budgeted amount by \$28 million or 0.4 percent. The insurance premiums tax and the inheritance tax each exceed their estimates by \$58.9 million (17.7 percent) and \$43.3 million (6.2 percent) respectively. Non-tax revenue collections were \$158.9 million (25.5 percent) greater than projected, principally due to increased earnings on investments and the enhancement of the Commonwealth's escheat program. The rate of growth in earnings on investments was, in large part, the result of actions by the Commonwealth Treasurer to terminate a formerly separate pool of available General Fund cash balances that have been invested in equity securities. By

combining all General Fund cash balances into one common investment pool, the General Fund achieved approximately \$50 million in previously unrealized capital gains during fiscal year 2004. Further, revisions to the escheat program resulted in approximately \$190 million in additional revenues. As part of the fiscal year 2004 budget certain tax, fee and other revenue enhancement items totaling \$794 million were enacted. Major components of the \$794 million increase were: (i) an increase in the personal income tax rate from 2.8 percent to 3.07 percent, which is estimated to have provided \$301.7 million in fiscal year 2004; (ii) an extension of the gross receipts tax to cellular and interstate telecommunications, which is estimated to have provided \$222.4 million; (iii) revisions to the law regarding the escheating of property to the Commonwealth, which is estimated to have provided \$190 million; (iv) a continued partial deferral of the scheduled reduction in the capital stock and franchise tax, which is estimated to have provided \$60.7 million; (v) an increase of 10 cents per pack to the cigarette tax, which is estimated to have provided \$25.4 million; and (vi) various other minor revisions, including some tax cuts, which combined to total a net increase in Commonwealth revenues of \$794 million in fiscal year 2004.

Reserves for tax refunds in fiscal year 2004 were \$1,014.7 million, an increase of 9.2 percent over fiscal year 2003 reserves. Recent tax rate and tax base changes have contributed to the growth rate in refunds in fiscal year 2004. Actual tax refunds have stabilized after several recent years of increases. At the end of fiscal year 2004, approximately \$91.7 million of reserves were available for making tax refunds in the following fiscal year.

Expenditures for the fiscal year, including supplemental appropriations, intergovernmental transfers and additional resources, and net of appropriation lapses, totaled \$23,089.2 million, representing an increase of \$1,417.3 million or 6.5 percent from the fiscal year 2003 level. A total of \$182.9 million in appropriations were lapsed in fiscal year 2004. The fiscal year 2004 budget continued to utilize an enhanced level of intergovernmental transfers for a portion of medical assistance costs, albeit at a reduced rate from fiscal year 2003. Intergovernmental transfers replaced \$738.7 million of General Fund medical assistance costs in fiscal year 2004, compared to \$844.6 million in fiscal year 2003. Expenditures normally funded from Commonwealth revenues that were instead funded from additional resources in fiscal year 2004 totaled \$607.6 million. These expenditures included \$457.6 million in available federal fiscal relief funds, which were used to offset certain medical assistance and other health care costs as well as \$150 million in available capital debt fund reserves, which were used to offset General Fund debt service costs in fiscal year 2004.

As part of his fiscal year 2004 budget proposal, the Governor proposed two major program expansions that were enacted by the General Assembly. In education, the Governor proposed to shift a substantial portion of local public school costs from local property taxes levied by school districts to an increased subsidy payment to school districts by the Commonwealth. The program as enacted would increase, over time, the Commonwealth's subsidy of local public school costs to 50 percent of total costs in the aggregate. Funds for education at the local level totaling nearly \$1.0 billion are expected to be funded from taxes realized from the legalization of slot machines at racetracks in the state. The increased level of education funding from the Commonwealth would be used to reduce local property taxes by an equal amount. The Governor also proposed an economic stimulus plan for the Commonwealth to provide additional funding to be combined with private investments to fund economic development projects within the state. Investments are to be directed to blighted rural, urban and suburban sites to be re-developed to spur the location of new job-creating businesses. The funding for the economic stimulus program is to come from \$2,025 million of debt issued over more than four fiscal years. The proposed debt is composed of (i) \$890 million of capital budget debt in addition to that anticipated to support the current capital budget program, and (ii) \$1,135 million of debt of the newly created Commonwealth Financing Authority (the "CFA") to be repaid from annual budget appropriations.

Major portions of the Governor's economic stimulus proposal were enacted with the passage of Acts 10, 12, 22, 23 and 67 of 2004. Act 22 created the CFA, an independent authority with the power to issue debt of the Authority for the purposes of funding certain activities of the economic stimulus program. Legislation enacted to date has established, through the CFA, several new grant and loan programs as well as new loan guarantee programs to be funded with debt of the CFA. The Business in Our Sites program is expected to be capitalized with \$300 million in debt of the CFA so that it may offer flexible loans and grants to local municipalities for acquisition and site preparation for economic development opportunities. The Building Pennsylvania program is expected to receive \$150 million in CFA bond proceeds to provide funding for the development of real estate assets for purposes of economic stimulation. These funds will be loaned to private sector real estate funds on a matching basis to encourage economic development through real estate development. A new Pennsylvania Venture Guarantee Program is being created to be funded with

up to \$250 million in CFA bond proceeds in order to provide guarantees to venture capital firms investing in Pennsylvania. The Pennsylvania Capital Investment Program will provide up to \$60 million in capital, derived from CFA bond proceeds, to Pennsylvania venture capital firms for investment in underserved areas of the Commonwealth. The First Industries Fund is expected to be capitalized with \$150 million from CFA debt, to provide financial incentives and assistance to tourism-related and agricultural projects. A Second Stage Loan program is expected to be capitalized with \$50 million in bond proceeds to provide guarantees for bank loans to second stage manufacturers and technology companies for working capital needs. The Core Industries Program will provide \$75 million in revolving loan funds, funded by bonds of the CFA, for enhanced machinery and equipment financing. The Tax Increment Financing Guarantee Program, which will be funded through debt of the CFA, will provide \$100 million in loan guarantee assistance for small and mid-sized Commonwealth communities to encourage this method of financing economic development projects.

It is anticipated that General Fund appropriations will be required to support the CFA's annual debt service cost on its debt. Provisions of Act 22 of 2004 place limitations on the incurring of debt to fund portions of the economic stimulus program. Such limitations include provisions that no more than \$250 million in debt may be issued within a fiscal year to support certain activities within the economic stimulus program. Further, Act 22 of 2004 requires the Secretary of the Budget to certify that sufficient excess General Fund revenues exist or will likely exist to support the annual issuance of up to \$250 million in economic stimulus debt. The General Assembly also approved Act 67 of 2004 which enacted the remaining component of the Governor's economic stimulus proposal, an increase of \$640 million in certain capital budget debt authorization for local economic redevelopment projects.

In February 2004, the General Assembly approved Act 10 of 2004, which authorized a ballot referendum pertaining to the Governor's proposed water and sewer infrastructure program. On April 27, 2004, the voters of the Commonwealth approved the referendum proposal authorizing the Commonwealth to incur an additional \$250 million in general obligation debt for the funding of certain local water and sewer capital infrastructure projects directly related to economic development projects funded via the Governor's economic stimulus program. The General Assembly has approved legislation to authorize the issuance of debt approved by the referendum.

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**Table 8**  
**Sources, Uses and Changes in Unappropriated Balance**  
**General Fund and Other Funding Sources — Unaudited Budgetary Basis**  
**Commonwealth Revenues Only**  
(In Millions)

	<u>Actual</u> <u>Fiscal Year 2005</u>	<u>Actual</u> <u>Fiscal Year 2006</u>	<u>Budget</u> <u>Fiscal Year 2007</u>
<b>Sources:</b>			
Cash revenues .....	\$ 24,308.5	\$ 25,854.1	\$ 26,799.5
Tax refunds .....	(1,000.0)	(1,035.0)	(1,195.0)
Additional resources available .....	399.2	145.9	257.7
Intergovernmental transfer transactions <sup>(a)</sup> .....	<u>697.9</u>	<u>856.8</u>	<u>884.7</u>
TOTAL SOURCES .....	<u>\$ 24,405.6</u>	<u>\$ 25,821.8</u>	<u>\$ 26,746.9</u>
<b>Uses:</b>			
General fund appropriations .....	\$ 23,104.9	\$ 24,680.6	\$ 26,113.6
Expenditures from additional resources .....	399.2	145.9	257.7
Lapses and other reductions <sup>(b)</sup> .....	(148.1)	(181.8)	.....
Intergovernmental transfer transactions <sup>(a)</sup> .....	<u>697.9</u>	<u>856.8</u>	<u>884.7</u>
TOTAL USES .....	<u>\$ 24,053.9</u>	<u>\$ 25,501.5</u>	<u>\$ 27,256.0</u>
OPERATING BALANCE .....	<u>\$ 351.7</u>	<u>\$ 320.3</u>	<u>\$ (509.1)</u>
BEGINNING UNAPPROPRIATED BALANCE .....	76.7	364.8	514.0
ADJUSTMENT TO UNAPPROPRIATED BALANCE <sup>(c)</sup> .....	0.8	.....	.....
TRANSFER (TO)/FROM BUDGET STABILIZATION RESERVE FUND .....	<u>(64.4)</u>	<u>(171.4)</u>	<u>(1.2)</u>
ENDING UNAPPROPRIATED BALANCE .....	<u>\$ 364.8</u>	<u>\$ 514.0</u>	<u>\$ 3.6</u>

Totals may not add due to rounding.

(a) Only includes funds replacing Commonwealth funds. Fiscal year 2005 included \$157.8 million, fiscal year 2006 included \$213.3 million and fiscal year 2007 includes \$153.5 million from a nursing home tax used to augment appropriated funds for long-term care. Additionally, fiscal year 2005 included \$174.9 million, fiscal year 2006 included \$194.5 million and fiscal year 2007 includes \$191.9 million from a tax imposed on managed care organizations.

(b) Includes prior year appropriation lapses from fiscal year 2004 of \$97.2 million, \$50.9 million from fiscal year 2005 and \$165.9 million from fiscal year 2006.

(c) The fiscal year 2005 adjustments generally reflect the appropriation of prior year funds.

### ***Fiscal Year 2005 Financial Results***

*GAAP Basis.* At June 30, 2005, the General Fund reported a fund balance of \$2,869.1 million, a decrease of \$137.4 million from the reported \$3,006.5 million fund balance at June 30, 2004. On a net basis, total assets decreased by \$601 million to \$9,863 million. Liabilities decreased by \$463 million to \$6,994 million largely because of a smaller securities lending program (\$369 million) and a lower accounts payable (\$156 million).

General Fund tax revenues increased by 8 percent due to overall economic growth, including nearly identical percentage increase in personal income tax revenue during the fiscal year ended June 30, 2005. Intergovernmental revenues increased by only \$311 million, almost solely due to increases in federally-funded medical and other assistance, where expenditures increased significantly over the prior year. Charges for sales and services increased by nearly \$2 billion, more than doubling prior year revenues of \$1,751 million because of specific program funding changes, including nursing home assessments associated with an increase in health and human services expenditures. Total General Fund revenues increased by 9 percent during the fiscal year. The overall decrease in fund balance, \$137.4 million, during the fiscal year was \$787 million less than the prior fiscal year increase in fund balance of \$649 million. Total General Fund expenditures increased by 11 percent during the fiscal year ended June 30, 2005, on a GAAP-reported basis, largely because of a \$2.5 billion increase in expenditures for medical and other assistance (reported as part of health and human services). This increase was caused by significant increases in utilization (participation) and per-unit health care cost increases. Expenditures for direction and support services increased due to significantly higher reported employer costs for active and retired employee healthcare benefits. Higher public

education appropriations resulted in an \$861 million expenditure increase. Actual, final General Fund expenditures (budgetary basis) increased by 9 percent over the prior fiscal year, while revenues (budgetary basis) increased by 10 percent.

*Budgetary Basis.* Total fiscal year 2005 revenues, net of reserves for tax refunds and including intergovernmental transfers and additional resources, totaled \$24,405.6 million. Total expenditures net of appropriation lapses and including intergovernmental transfers and expenditures from additional resources were \$24,053.9 million. As result of Commonwealth financial operations during the fiscal year, the preliminary unappropriated surplus balance, prior to the statutorily required 25 percent transfer to the Budget Stabilization Reserve Fund, was \$429.2 million, an increase of \$162.5 million from the fiscal year 2004 preliminary ending balance. Following the statutorily required 25 percent transfer to the Budget Stabilization Reserve Fund (\$64.4 million) the fiscal year 2005 final unappropriated surplus balance was \$364.8 million as of June 30, 2005.

The fiscal year 2005 budget was based initially on an estimated 4.5 percent increase for Commonwealth General Fund revenues prior to accounting for any changes in tax and revenue provisions enacted in the second half of fiscal year 2004. After adjustments for various tax rate and tax base changes enacted for the fiscal year 2004 budget, total Commonwealth General Fund revenues were projected to increase 3.8 percent over fiscal year 2004 actual receipts and total \$23,866.5 million prior to reserves for tax refunds. Total fiscal year 2005 Commonwealth revenues net of reserves for tax refunds, exceeded \$24,308.5 million, a 6.5 percent increase over fiscal year 2004 receipts. The tax revenue component of Commonwealth receipts, including the effects of the tax rate and tax base changes enacted in fiscal year 2004, rose \$1,666.4 million or 7.6 percent over fiscal year 2004 actual receipts. An estimated two-thirds of the increase in tax revenues is associated with the various tax rate and tax base changes. Major components of the tax revisions were: (i) an increase in the personal income tax from 2.8 percent to 3.07 percent; (ii) a restructuring of taxation of telecommunications to include the imposition of the gross receipts tax on cellular and interstate telecommunication as well as certain sales and use tax exemptions for particular telecommunications activities; (iii) an increase to the cigarette tax from \$1.00 per pack to \$1.35 per pack, a portion of which was transferred to the new Health Care Provider Retention Account to be used to provide financial assistance for malpractice premiums for certain physicians practicing in particular high-risk medical specializations under the medical malpractice abatement program. This program was enacted for calendar years 2003 and 2004, and the General Assembly approved an extension for an additional year in 2005; (iv) a modification of the scheduled phase-out of the capital stock and franchise tax for tax years 2003 and 2004; and (v) various other tax rate and tax base revisions, including some tax cuts. Total revenues to the Commonwealth exceeded the budget estimate by \$442.0 million or 1.9 percent. Personal income tax receipts grew by \$1,013 million or 13.1 percent over fiscal year 2004 revenues. Revisions to the personal income tax rate in December 2003 contributed to the large year-over-year increase in these receipts. During fiscal year 2005, corporate tax receipts grew \$285.1 million or 10.7 percent, which generally reflected improvements in the overall state and national economy. Sales and use tax revenues to the Commonwealth grew \$271.4 million or 3.5 percent over fiscal year 2004 receipts. Receipts of Commonwealth non-tax revenues continued to exceed the estimate as total revenue from this source exceeded \$596.0 million. Earnings from investments and revisions to the Commonwealth's escheats program continued to provide revenues well in excess of the estimate for fiscal year 2005. Various revisions to the Commonwealth's escheat program were enacted as part of the fiscal year 2003 and 2004 budgets. These revisions to the escheat program have produced substantial non-recurring revenues during each of the two most recent fiscal years. Additionally, significant non-recurring capital gains earnings on the investment of available General Fund cash balances (See "General Fund Fiscal Year 2004 Financial Results") and increased contributions from the Commonwealth's liquor store profits contributed to enhanced non-tax revenues during the prior two fiscal years. Reserves for tax refunds in fiscal year 2005 were \$1,000.0 million, a decrease of \$14.7 million or 1.4 percent from fiscal year 2004 levels.

Fiscal year 2005 state-level expenditures, including supplemental appropriations and net of appropriation lapses, totaled \$22,956.8 million, an increase of 5.6 percent from fiscal year 2004 appropriations. A total of \$148.1 million in appropriations were lapsed in fiscal year 2005 and the fiscal year 2005 budget continued to utilize an enhanced level of intergovernmental transfers for a portion of medical assistance costs, albeit at a reduced rate from fiscal year 2004. Intergovernmental transfers replaced \$697.9 million of General Fund medical assistance costs in fiscal year 2005, compared to \$738.7 million in fiscal year 2004. In addition, approximately \$399 million in additional funds, primarily \$377.6 million of remaining federal fiscal relief, was appropriated in fiscal year 2005 to fund expenditures

normally funded from Commonwealth revenues. The ending unappropriated balance was \$364.8 million for fiscal year 2005.

### ***Fiscal Year 2006 Financial Results***

The following financial information is based on the Commonwealth's budgetary basis financial data. GAAP basis information is not yet available.

*Budgetary Basis.* During fiscal year 2006, revenues to the Commonwealth exceeded the certified estimate by \$864.6 million or nearly 3.5 percent. Final Commonwealth General Fund revenues for the fiscal year totaled \$25,854.1 million. Total fiscal year 2006 revenues, net of reserves for tax refunds and including intergovernmental transfers and additional resources, totaled \$25,821.8 million. Total expenditures, net of appropriation lapses and including intergovernmental transfers and expenditures from additional sources, was \$25,501.5 million. As result of Commonwealth financial operations during the fiscal year, the preliminary unappropriated surplus balance, prior to the statutorily required 25 percent transfer to the Budget Stabilization Reserve Fund, increased to \$685.1 million, including the beginning balance from the prior year of operations. Accordingly, 25 percent of this preliminary balance or \$171.4 million was transferred to the Budget Stabilization Reserve Fund. The final fiscal year 2006 unappropriated surplus balance was \$514.0 million as of June 30, 2006.

Revenues available to the Commonwealth, including intergovernmental transfers and additional sources, increased 5.8 percent. Fiscal year 2006 revenues (all sources) totaled \$25,821.8 million, an increase of \$1,416.2 million over fiscal year 2005. Intergovernmental transfer proceeds increased \$158.9 million or 22 percent, while funding from additional sources decreased \$253.3 million or 63 percent, primarily due to the expiration of the previously available one-time federal fiscal relief that had been made available to the various states. General Fund revenues grew \$1,563 million or 6.3 percent during fiscal year 2006 when measured on a year-over-year basis. Corporate tax receipts grew \$425.8 million over estimate, an 8.9 percent surplus to the year-to-date estimate. Personal income taxes were \$342.6 million over the estimate, a surplus of 3.7 percent versus the year-to-date estimate. Sales and use taxes were essentially at estimate as actual receipts were \$65.2 million above estimate, a difference of 0.8 percent from the fiscal year estimate. Realty transfer tax revenues also exceeded the estimate by \$61.4 million or 12.5 percent based in part on continuation of a strong housing market within the Commonwealth. Non-tax revenues of the Commonwealth were below estimate for fiscal year 2006 by \$61.4 million or 11.3 percent, due primarily to lower than projected earnings from the Commonwealth's escheats program. Reserves for tax refunds in fiscal year 2006 were \$1,035 million, an increase of 3.5 percent from the fiscal year 2005 reserves. At the end of fiscal year 2006, approximately \$103 million of reserves were available for making tax refunds in the following fiscal year.

In July 2005, the General Assembly approved and the Governor signed into law Act 45 of 2005, which authorized the issuance of up to \$625 million in debt of the Commonwealth to support programs commonly referred to as "Growing Greener II." The enactment of Act 45 implements the Governor's major environmental initiative in the fiscal year 2006 budget. The Growing Greener II program will provide bond funding for the maintenance and protection of the environment, open space and farmland preservation, watershed protection, abandoned mine reclamation, acid mine drainage remediation and other environmental initiatives. Additionally, Act 45 of 2005 authorizes the Governor to direct up to \$60 million in existing Growing Greener fees, that are otherwise directed into the Commonwealth's Environmental Stewardship Fund, to support General Fund debt service for the authorized Growing Greener II bond issuances.

Fiscal year 2006 appropriations from Commonwealth revenues, including supplemental appropriations and net of appropriation lapses, totaled \$24,664.6, an increase of 7.4 percent from fiscal year 2005 expenditures. A total of \$181.8 million in appropriations were lapsed in fiscal year 2006, and the fiscal year 2006 budget continued to utilize an enhanced level of intergovernmental transfers for a portion of medical assistance costs. Intergovernmental transfers replaced \$856.8 million of General Fund medical assistance costs in fiscal year 2006, compared to \$697.9 million in fiscal year 2005. In addition, approximately \$145.9 million in additional funds were appropriated in fiscal year 2006 to fund expenditures normally funded from Commonwealth revenues, a decrease from \$399 million in fiscal year 2005. The ending unappropriated balance was \$514.0 million for fiscal year 2006. A more detailed description of fiscal year 2006 expenditures among major program areas is provided in the section titled "COMMONWEALTH REVENUES AND EXPENDITURES."

### ***Fiscal Year 2007 Budget***

The adopted fiscal year 2007 budget provides appropriations totaling \$26,113.6 million of Commonwealth funds against estimated revenues, net of tax refunds and proposed tax reductions, of \$25,604.5 million. The \$509.1 million difference between estimated revenues and budgeted appropriations is funded by a draw down of the anticipated \$514 million beginning balance. Additionally, the enacted fiscal year 2007 budget allocates additional state funds to replace significant amounts of formerly available intergovernmental transfer transaction-derived federal funds.

The fiscal year 2007 revenue estimate for the Commonwealth is based upon an economic forecast of 3.0 percent growth in gross domestic product from the start of the third quarter of 2006 to the end of the second quarter of 2007. Trends in the Commonwealth's economy are expected to maintain their close association with national economic trends. Personal income growth in Pennsylvania is projected to remain slightly below that of the United States, while the Pennsylvania unemployment rate is anticipated to be close to the national rate. The tax revenue component of Commonwealth General Fund receipts is expected to increase by \$804.7 million or approximately 3.2 percent prior to reserves for refunds. Fiscal year 2007 Commonwealth revenues from the personal income tax are forecasted to increase by 4.6 percent, while receipts from the sales and use tax are estimated to rise 3.3 percent over fiscal year 2006 receipts. Corporate receipts are expected to grow in fiscal year 2007, at a rate of 6.4 percent and revenues from non-tax sources such as liquor store profits and earnings on investments forecast to increase by 29.0 percent. A majority of the projected increase in non-tax revenues is attributable to additional profit transfers from the state liquor stores.

The Commonwealth's fiscal year 2007 enacted budget includes significant increases in funding for local school districts and higher education within the Commonwealth as the Basic Education appropriation is increased \$267 million or 5.9 percent, the largest increase since fiscal year 1992. Additionally, the Commonwealth's contribution to the Public School Employees Retirement System is increased \$114 million in fiscal year 2007, and the Pennsylvania Accountability Block Grant to local school districts is increased by \$50 million to \$250 million annually. The enacted budget also includes a new children's health insurance program called "Cover All Kids" which is intended to gradually expand available health insurance to all Pennsylvania children not currently covered by insurance. The Commonwealth's prescription drug coverage program is expanded to cover an additional 120,000 seniors within the next 18 months by building upon the federal Medicare Part D program. The enacted fiscal year 2007 budget reflects initiatives to increase the efficiency of government operations within the Commonwealth and includes estimates to save over \$1 billion annually in fiscal year 2007. The enacted budget for fiscal year 2007 also includes \$884.7 million in funding for various medical assistance expenditures through intergovernmental transfer proceeds, certain nursing home assessments and a tax on managed care organizations. This amount is an increase of 3.3 percent from the \$856.8 million in such proceeds utilized during fiscal year 2006. Under the intergovernmental transfer transactions, certain county governments contribute funds to the Commonwealth to help pay Medicaid expenses. The Commonwealth receives the contributions as augmentations to appropriations of Commonwealth revenues for the medical assistance program. These augmentations have the effect of supplementing the amount of Commonwealth revenues available for the medical assistance program and are available to match federal Medicaid funds. Federal authority for Pennsylvania to use the county contributions to pool transactions to match additional federal funds is currently scheduled to expire in 2010. The year ending unappropriated balance is currently estimated to be \$3.6 million for fiscal year 2007.

As part of his fiscal year 2007 budget proposal, the Governor proposed a major program revision to the Commonwealth's Health Investment Plan, a series of health-related programs funded entirely from Tobacco MSA revenues. Currently, 100 percent of Tobacco MSA payments received are utilized for health care related expenditures and revenues received are statutorily distributed based upon enacted funding formula. The Commonwealth's health research component currently receives 19 percent of annual Tobacco MSA funds and these funds are annually expended on health-related research projects undertaken by Pennsylvania-based researchers. The Governor's fiscal year 2007 budget proposed to create the Jonas Salk Legacy Fund, which would utilize half of the 19 percent (9.5 percent) of Tobacco MSA payments, currently dedicated to health research activities, to accelerate funding for bioscience research in Pennsylvania. Under this proposal, 9.5 percent of Tobacco MSA payments would be securitized through the issuance of approximately \$500 million in bonds, the proceeds of which would be used to accelerate the construction of bioscience facilities, including laboratories, incubators and research parks. The proposed debt would be issued over a two-year period following approval by the General Assembly and programs funded with this debt from the Jonas Salk Legacy Fund would require a dollar-for-dollar private match, thereby increasing total investment in biosciences research

and facility construction to over \$1 billion. The proposed debt would be secured and paid solely from a pledge of 9.5 percent of the revenue from the Tobacco MSA. The General Assembly and the Governor continue to deliberate the proposal.

The achievement of the budgeted results may be adversely affected by a number of trends or events, including developments in the national and state economy.

### **Motor License Fund**

The Constitution requires all proceeds of motor fuels taxes, vehicle registration fees, license taxes, operators' license fees and other excise taxes imposed on products used in motor transportation to be used exclusively for construction, reconstruction, maintenance and repair of and safety on highways and bridges and for debt service on obligations incurred for these purposes. The Motor License Fund is the fund through which most such revenues are accounted for and expended. Portions of certain taxes whose receipts are deposited into the Motor License Fund are legislatively restricted to specific transportation programs. These receipts are accounted for in restricted accounts in the Motor License Fund and are not included in the budgetary basis presentations or discussions on the Motor License Fund. The Motor License Fund budgetary basis includes only unrestricted revenue available for annual appropriation for highway and bridge purposes. The GAAP basis presentations include restricted account revenues and expenditures.

#### ***Financial Results for Recent Fiscal Periods (GAAP Basis)***

The fund balance at June 30, 2005, was \$1,276.5 million, a nearly \$197 million increase from the June 30, 2004 fund balance, which represents an 18 percent increase. Over the five fiscal years of 2001 through 2005, revenues and other sources have averaged an annual 1.5 percent increase. Expenditures and other uses during the period from fiscal years 2001 through 2005 have averaged a 0.9 percent annual increase. Revenues grew \$11 million from fiscal 2004 to fiscal 2005. During fiscal year 2005, the fund reported total tax revenues of \$1,845 million and license and fee revenues of \$890 million, which represented growth of 5.9 percent and 2.7 percent respectively from fiscal year 2004 to fiscal year 2005. Reported federal revenues, received principally from the Federal Highway Administration, totaled \$1,213 million, a decrease of 8.3 percent. Other revenues to the fund, principally earnings on investments, totaled \$172 million, a decrease of 2.8 percent from the prior fiscal year. Expenditures from the fund were \$3,923 million during fiscal year 2005, an increase of \$1.3 million over fiscal year 2004 expenditure levels. The decrease in capital outlay during the 2005 fiscal year was offset by a corresponding increase in reported transportation expenditures. Table 9, on the following page, sets forth a condensed summary of revenues and expenditures (presented on a GAAP basis) for the Motor License Fund for the fiscal years 2001 through 2005.

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**Table 9**  
**Results of Operations—Motor License Fund**  
**GAAP Basis—Unaudited**  
(In Thousands)

	Fiscal Year Ended June 30				
	2001	2002 <sup>(a)</sup>	2003	2004	2005
<b>Fund Balance — Beginning of Period .....</b>	\$ 684,681	\$ 751,961	\$ 712,427	\$ 893,133	\$ 1,079,617
<b>Revenues:</b>					
Taxes.....	\$ 1,647,122	\$ 1,694,421	\$ 1,705,082	\$ 1,742,332	\$ 1,844,670
Licenses and fees.....	806,726	838,525	842,466	866,552	889,984
Intergovernmental.....	1,305,345	1,402,468	1,379,786	1,323,005	1,213,487
Other revenues.....	123,480	94,273	124,866	176,910	171,839
<b>Other Financing Sources:</b>					
Operating transfers in.....	-	3,937	-	-	-
Other additions.....	3,818	1,339	805	-	562
<b>TOTAL REVENUES AND OTHER SOURCES.....</b>	<b>\$ 3,886,491</b>	<b>\$ 4,034,963</b>	<b>\$ 4,053,005</b>	<b>\$ 4,108,799</b>	<b>\$ 4,120,542</b>
<b>Expenditures: (b)</b>					
Direction and supportive services.....	\$ 399,531	\$ 48,579	\$ 48,400	\$ 49,693	\$ 50,338
Protection of persons and property.....	-	492,504	514,100	496,105	509,999
Public education.....	-	1,075	1,068	1,023	1,058
Recreation and cultural enrichment.....	-	1,927	3,504	4,199	3,437
Transportation.....	3,234,879	3,369,240	3,205,830	1,641,755	1,826,539
Capital outlay.....	46,712	46,416	39,154	1,668,261	1,472,434
<b>Other Uses:</b>					
Operating transfers out.....	110,089	86,756	60,243	61,279	59,829
Transfers to component units.....	-	28,000	-	-	-
<b>TOTAL EXPENDITURES AND OTHER USES</b>	<b>\$ 3,791,211</b>	<b>\$ 4,074,497</b>	<b>\$ 3,872,299</b>	<b>\$ 3,922,315</b>	<b>\$ 3,923,634</b>
<b>REVENUES AND OTHER SOURCES OVER (UNDER) EXPENDITURE AND OTHER USES.....</b>	<b>95,280</b>	<b>(39,534)</b>	<b>180,706</b>	<b>186,484</b>	<b>196,908</b>
<b>Residual Equity Transfers In (Out).....</b>	<b>(28,000)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Fund Balance — End of Period .....</b>	<b>\$ 751,961</b>	<b>\$ 712,427</b>	<b>\$ 893,133</b>	<b>\$ 1,079,617</b>	<b>\$ 1,276,525</b>
<b>Components of Fund Balance</b>					
Reserved for encumbrances.....	\$ 382,462	\$ 389,942	\$ 456,015	\$ 591,598	\$ 601,809
Reserved for advances and other.....	-	-	-	220,662	110,000
Unreserved - designated - highways.....	182,670	175,249	215,946	209,647	218,885
Unreserved - undesignated.....	186,829	147,236	221,172	57,710	345,831
<b>TOTAL FUND BALANCE.....</b>	<b>\$ 751,961</b>	<b>\$ 712,427</b>	<b>\$ 893,133</b>	<b>\$ 1,079,617</b>	<b>\$ 1,276,525</b>

(a) For the fiscal year ended June 30, 2002 and subsequent fiscal years, the Commonwealth has adopted several new accounting and reporting standards described earlier in “COMMONWEALTH FINANCIAL STRUCTURE AND PROCEDURES – New Governmental Accounting and Reporting Standards.” The new standards require numerous changes to how fund financial statements are presented. Certain funds have been reclassified and fund balances restated. See Note B to the Comprehensive Annual Financial Report for the fiscal year ended June 30, 2002 for a more detailed explanation. These changes limit the comparability of that year’s data and subsequent data to data for prior fiscal years.

(b) Beginning with the fiscal year ended June 30, 2002, the functional categories of expenditures have been revised. Additionally, beginning with the fiscal year ended June 30, 2004, a portion of the functional categories within expenditures (transportation and capital outlay) have been further revised. These changes limit the comparability of fiscal years’ 2002, 2003, 2004 and 2005 data to data for prior fiscal years.

Source: Compiled from Office of the Budget, Comprehensive Annual Financial Report for fiscal years ended June 30, 2005, 2004, 2003, 2002 and 2001.

The following budgetary basis information is derived from the Commonwealth’s unaudited budgetary basis financial statements.

***Fiscal Year 2004 Financial Results***

*Budgetary Basis.* Commonwealth revenues to the Motor License Fund totaled \$2,085.7 million, an increase of 4.3 percent over actual fiscal year 2003 revenues. Liquid fuels taxes grew by less than 1 percent, while license and fee revenues grew by 1.7 percent. Other revenue receipts, namely earnings on investments, grew by \$64.9 million or 101

percent from prior year receipts. The rate of growth in earning on investments was, in large part, the result of actions by the State Treasurer to terminate a formerly separate pool of available Motor License Fund cash balances that have been invested in equity securities. By combining all Motor License Fund cash balances into one common investment pool, the Motor License Fund achieved approximately \$20 million in previously unrealized capital gains. Expenditures, net of current year lapses, totaled \$2,022.6 million. This amount represents a decrease of 1.2 percent from expenditures in fiscal year 2003. Revenues, including prior year lapses, in excess of expenditures for fiscal year 2004 contributed to the Motor License Fund ending the fiscal year with an unappropriated surplus of \$113.6 million, an increase of \$83.2 million or 274 percent from fiscal year 2003.

#### ***Fiscal Year 2005 Financial Results***

The Motor License Fund ended the fiscal year with an unappropriated surplus of \$212.4 million, a net increase of \$98.8 million or 87 percent from fiscal year 2004. Motor License Fund revenues totaled \$2,156.9 million, an increase of 3.4 percent over actual fiscal year 2004 receipts. Revenues from other revenue receipts, primarily earnings on investments, grew 86.7 percent during fiscal year 2004, while receipts from license and fees increased by 4.0 percent over fiscal year 2004 receipts. Revenues to the Motor License Fund from liquid fuels taxes increased by 4.2 percent during fiscal year 2005. Expenditures of Commonwealth Motor License Fund revenues totaled \$2,071.2 million for fiscal year 2005, an increase of 2.4 percent from actual fiscal year 2004 expenditures net of lapses.

#### ***Fiscal Year 2006 Financial Results***

During fiscal year 2006, revenues excluding prior year lapses, of the Motor License Fund were \$2,265.9 million, an increase of 5.1 percent over actual fiscal year 2005 receipts. Liquid fuels tax receipts increased by 5.7 percent while license and fee revenues grew minimally (0.1% growth). Other revenue receipts, including earnings on investments, increased by 34.9%. Appropriations and executive authorizations from Commonwealth funds for fiscal year 2006 totaled \$2,340.6 million, an increase of 13 percent. The Motor License Fund ended the fiscal year with an unappropriated surplus of \$283.7 million, a net increase of \$71.3 million.

#### ***Fiscal Year 2007 Budget***

The enacted fiscal year 2007 budget for the Motor License Fund estimates revenues of \$2,322.7 million, an increase of 2.5 percent over actual fiscal year 2006 receipts. The enacted fiscal year 2007 Motor License Fund budget provides \$2,562.1 million of appropriations and executive authorizations from Commonwealth funds for fiscal year 2007. The budgeted appropriations and authorizations represents an increase of 9.5 percent above the amount expended during fiscal year 2006. The enacted budget anticipates a draw down of approximately \$239.3 million from the fiscal year 2007 beginning balance.

The achievement of the budgeted results may be adversely affected by a number of trends or events, including developments in the national and state economy or adverse developments in the price and availability of motor vehicle fuels.

#### **State Lottery Fund**

The Commonwealth operates a statewide lottery program that consists of various lottery games using computer sales terminals located throughout the state, and instant games using preprinted tickets. The net proceeds of all lottery game sales, less sales commissions and directly paid prizes, are deposited into the State Lottery Fund.

State Lottery Fund receipts support programs to financially assist elderly and handicapped individuals, primarily through property tax and rent rebate assistance and a pharmaceutical assistance program to recipients who meet specified income limits, and the provision of free mass transit rides during off-peak hours. Certain administrative costs and the payment to the General Fund of the personal income tax due on lottery prizes, which taxes and costs were previously paid from the State Lottery Fund, are now being paid by the General Fund, beginning in fiscal year 2000.

#### ***Financial Results for Recent Fiscal Periods (GAAP Basis)***

State Lottery Fund cash and investments increased by \$88 million or 19 percent during the fiscal year ended June 30, 2005, due to an increase in gross ticket sales. Total revenue increased \$289 million or 12 percent, primarily

due to an increase in instant ticket sales during the fiscal year. Expenditures and other uses from the State Lottery Fund increased \$245 million or 12 percent during the fiscal year, partly due to increased field paid prizes from instant ticket sales, advertising and special services. The fiscal year 2005 statutory transfer from the State Lottery Fund for the payment of benefits to the elderly that the fund subsidizes amounted to \$300 million, a decrease of \$70 million over fiscal year 2004. Table 10 sets forth a condensed summary of revenues and expenditures (presented on a GAAP basis) for the State Lottery Fund for fiscal years 2001 through 2005.

**Table 10**  
**Results of Operations—State Lottery Fund**  
**GAAP Basis—Unaudited**  
(In Thousands)

	Fiscal Year Ended June 30				
	2001	2002(a)	2003	2004	2005
<b>Fund Balance/Net Assets -</b>					
<b>Beginning of Period</b> .....	\$ 242,987	\$ 201,215	\$ 180,921	\$ 142,372	\$ 158,426
Restatements .....	-	173	-	-	-
<b>Fund Balance/Net Assets -</b>					
<b>Beginning of Period, as Restated</b> .....	\$ 242,987	\$ 201,388	\$ 180,921	\$ 142,372	\$ 158,426
<b>Revenues:</b>					
Lottery revenues.....	1,788,333	1,932,692	2,100,096	2,350,892	2,645,713
Intergovernmental.....	67,758	-	-	-	-
Investment income.....	21,645	23,042	15,139	13,127	17,282
Other revenues.....	7,478	65,474	68,522	73,681	68,412
<b>TOTAL REVENUES AND OTHER SOURCES</b> .....	<u>\$ 1,885,214</u>	<u>\$ 2,021,208</u>	<u>\$ 2,183,757</u>	<u>\$ 2,437,700</u>	<u>\$ 2,731,407</u>
<b>Expenditures:</b>					
Operating expenses (b).....	\$ 1,636,986	\$ 1,682,675	\$ 1,827,306	\$ 2,051,646	\$ 2,298,417
<b>Other Uses:</b>					
Operating transfers out.....	290,000	359,000	395,000	370,000	300,000
<b>TOTAL EXPENDITURES AND OTHER USES</b>	<u>\$ 1,926,986</u>	<u>\$ 2,041,675</u>	<u>\$ 2,222,306</u>	<u>\$ 2,421,646</u>	<u>\$ 2,598,417</u>
<b>REVENUES AND OTHER SOURCES OVER</b>					
<b>(UNDER) EXPENDITURE AND OTHER USES</b> .....	<u>(41,772)</u>	<u>(20,467)</u>	<u>(38,549)</u>	<u>16,054</u>	<u>132,990</u>
<b>Fund Balance/Net Assets - End of Period</b> .....	<u>\$ 201,215</u>	<u>\$ 180,921</u>	<u>\$ 142,372</u>	<u>\$ 158,426</u>	<u>\$ 291,416</u>
<b>Components of Fund Balance/Net Assets</b>					
Reserved for encumbrances.....	\$ 5	-	-	-	-
Reserved for long-term investments.....	-	-	-	-	-
Reserved for other.....	13	-	-	-	-
Unreserved - designated - other.....	264	-	-	-	-
Unreserved - undesignated (deficit).....	200,933	\$ 180,921	\$ 142,372	\$ 158,426	\$ 291,416
<b>TOTAL FUND BALANCE/NET ASSETS</b> .....	<u>\$ 201,215</u>	<u>\$ 180,921</u>	<u>\$ 142,372</u>	<u>\$ 158,426</u>	<u>\$ 291,416</u>

(a) For the fiscal year ended June 30, 2002 and subsequent fiscal years, the Commonwealth has adopted several new accounting and reporting standards described earlier in "COMMONWEALTH FINANCIAL STRUCTURE AND PROCEDURES – New Governmental Accounting and Reporting Standards." The new standards require numerous changes to how fund financial statements are presented. The State Lottery Fund has been reclassified from the governmental fund category to the proprietary fund category. The change in fund category also produced a change in basis of accounting and required a restatement of beginning fund balance/net assets for the fund at June 30, 2001. See Note B to the Comprehensive Annual Financial Report for the fiscal year ended June 30, 2002 for a more detailed explanation. These changes limit comparability of fiscal year 2002, 2003, 2004 and 2005 data to data reported for prior fiscal years.

(b) The reclassification of the State Lottery Fund to the proprietary fund category caused a change in reporting of all expenditures as operating expenses.

Source: Computed from Office of the Budget, Comprehensive Annual Financial Report for fiscal years ended June 30, 2005, 2004, 2003, 2002 and 2001.

The following budgetary basis information is derived from the Commonwealth's unaudited budgetary basis financial statements.

### ***Fiscal Year 2004 Financial Results***

*Budgetary Basis.* Lottery ticket sales rose 9.7 percent from fiscal year 2003 and provided net revenues of \$1,170.5 million. Revenues from various lottery sources, including the state's participation in the multi-state Powerball game, were 1.6 percent below the budget estimate. Expenditures net of current year lapses totaled \$1,139 million. Revenues, including prior year lapses, in excess of expenditures for fiscal year 2004 contributed to an unappropriated fund balance and reserve of \$299.8 million (including \$100 million of reserves), an increase of 20 percent from fiscal year 2003.

### ***Fiscal Year 2005 Financial Results***

Revenues from tickets sales of the Lottery and other miscellaneous revenue sources rose 3.5 percent during fiscal year 2005, totaling \$1,211.9 million. Expenditures net of lapses, totaled \$1,139 million, an amount equal to the expenditure levels experienced in fiscal year 2004. Revenues, including prior year lapses, in excess of expenditures for fiscal year 2005 contributed to an unappropriated fund balance and reserve of \$381.0 million (including \$100 million of reserves), an increase of 27 percent from fiscal year 2004.

### ***Fiscal Year 2006 Financial Results***

During fiscal year 2006, ticket sales less field prizes and commissions were \$1,459.5 million, a 20.4 percent increase in revenues from lottery sources, including instant ticket sales and the state's participation in the multi-state Powerball game. Expenditures, net of projected lapses totaled \$1,437.7.1 million, were 26.2 percent above fiscal year 2005 expenditures. The fiscal year-end unappropriated balance and reserve totaled \$439.0 million (including \$100 million of reserves), an increase of 15.2 percent.

### ***Fiscal Year 2007 Budget***

The enacted fiscal year 2007 budget anticipates a 3.7 percent increase in revenues from lottery sources, including instant ticket sales and the state's participation in the multi-state Powerball game. Appropriations totaling \$1,421.3 million are budgeted. The expansion of the federal Medicare program to cover prescription drugs is expected to save the Commonwealth's Lottery Fund approximately \$185 million annually. The Commonwealth's prescription drug coverage program is also proposed to expand to cover an additional 120,000 seniors within the next 18 months by building upon the federal Medicare Part D program. Additionally, the enacted fiscal year 2007 budget includes a transfer of approximately \$210 million in long-term care costs from the Commonwealth's General Fund to the State Lottery Fund. The anticipated fiscal year-end balance and reserve is projected to total \$531.9 million, (including \$100 million of reserves), an increase of 21.2 percent.

Trend projections for fiscal years beyond fiscal year 2007 show estimated program and administrative costs above estimated net revenues as the forecasted rate of increase in program expenses, namely the pharmaceutical assistance program, is expected to outpace revenues. The estimated expenditures in excess of estimated revenues will be funded from a further draw-down of available reserves and balances in the State Lottery Fund. Based upon current projections, higher revenues and/or lower expenditures will be required for the State Lottery Fund to balance operations within a fiscal year.

The achievement of the budgeted results may be adversely affected by a number of factors, including failure of the marketing and game strategies to achieve the projected rise in revenues and increased competition from other forms of gaming that may be available to Pennsylvania lottery players.

## **COMMONWEALTH REVENUES AND EXPENDITURES**

### **Recent Receipts and Forecasts**

Table 11, on the following, page presents the Commonwealth revenue receipts, including net revenues accrued but not deposited, on a budgetary basis, for the major operating funds of the Commonwealth as actually received for fiscal years 2001 through 2006 and as budgeted in the enacted budget for the fiscal year 2007.

**Table 11**  
**Commonwealth Revenues** <sup>(a)</sup>  
**General Fund, Motor License Fund and State Lottery Fund - Unaudited**  
**Fiscal Year 2001 – Fiscal Year 2006 and Fiscal Year 2007 Budget**  
(In Millions)

	Fiscal Year Ended June 30						
	2001	2002	2003	2004	2005	2006	Budget 2007
<b>General Fund</b>							
Tax Revenues:							
Sales and use .....	\$ 7,203.8	\$ 7,292.5	\$ 7,519.6	\$ 7,728.5	\$ 8,000.0	\$ 8,334.2	\$ 8,605.7
Personal income .....	7,491.5	7,138.7	7,105.9	7,733.8	8,746.8	9,524.1	9,960.0
Corporate (b).....	2,666.4	2,331.9	2,292.9	2,661.7	2,947.3	3,382.8	3,336.9
Public utility (c).....	705.8	739.4	897.6	1,062.7	1,167.1	1,191.2	1,233.9
Inheritance .....	799.8	779.6	693.8	747.6	716.1	745.2	778.2
Financial and insurance (d) .....	481.3	516.9	545.0	608.3	619.6	595.0	601.6
Cigarette .....	269.3	266.8	826.7	856.4	784.4	792.1	778.0
Realty transfer .....	268.8	290.5	362.6	400.6	472.5	552.5	611.7
Alcoholic beverages (e) .....	187.6	197.4	219.9	221.4	237.4	249.2	254.9
Other .....	16.6	19.9	33.2	25.0	21.3	3.7	13.9
<b>TOTAL TAX REVENUES .....</b>	<b>\$ 20,090.9</b>	<b>\$ 19,573.6</b>	<b>\$ 20,497.2</b>	<b>\$ 22,046.0</b>	<b>\$ 23,712.5</b>	<b>\$ 25,370.0</b>	<b>\$ 26,174.8</b>
Non-Tax Revenues:							
Liquor store profits .....	\$ 50.0	\$ 120.0	\$ 155.0	\$ 50.0	\$ 54.9	\$ 80.0	\$ 150.0
Licenses, fees and miscellaneous.....	387.7	333.4	627.4	696.9	509.1	368.6	444.3
Fines, penalties and interest .....	33.1	32.6	34.9	35.1	32.0	35.5	30.4
<b>TOTAL NON-TAX REVENUES .....</b>	<b>\$ 470.8</b>	<b>\$ 486.0</b>	<b>\$ 817.3</b>	<b>\$ 782.0</b>	<b>\$ 596.0</b>	<b>\$ 484.1</b>	<b>\$ 624.7</b>
<b>TOTAL GENERAL FUND .....</b>	<b>\$ 20,561.7</b>	<b>\$ 20,059.6</b>	<b>\$ 21,314.5</b>	<b>\$ 22,828.0</b>	<b>\$ 24,308.5</b>	<b>\$ 25,854.1</b>	<b>\$ 26,799.5</b>
<b>Motor License Fund</b>							
Tax Revenues:							
Liquid fuels .....	\$ 567.8	\$ 578.5	\$ 579.4	\$ 587.1	\$ 588.4	\$ 581.8	\$ 597.3
Fuels use .....	146.2	148.4	148.8	155.0	157.4	162.4	164.3
Oil company franchise .....	324.5	337.3	343.1	342.4	381.3	445.2	476.0
Motorbus & alt fuels.....	31.7	26.4	34.2	28.6	32.7	36.6	37.4
<b>TOTAL TAX REVENUES .....</b>	<b>\$ 1,070.2</b>	<b>\$ 1,090.6</b>	<b>\$ 1,105.5</b>	<b>\$ 1,113.1</b>	<b>\$ 1,159.8</b>	<b>\$ 1,226.0</b>	<b>\$ 1,275.0</b>
Non-Tax Revenues:							
Licenses and fees .....	\$ 795.4	\$ 814.4	\$ 828.8	\$ 843.2	\$ 876.9	\$ 877.8	\$ 874.1
Other and miscellaneous.....	86.3	50.2	64.5	129.4	120.1	162.0	173.6
<b>TOTAL NON-TAX REVENUES .....</b>	<b>\$ 881.7</b>	<b>\$ 864.6</b>	<b>\$ 893.3</b>	<b>\$ 972.6</b>	<b>\$ 997.0</b>	<b>\$ 1,039.8</b>	<b>\$ 1,047.7</b>
<b>TOTAL MOTOR LICENSE FUND .....</b>	<b>\$ 1,951.9</b>	<b>\$ 1,955.2</b>	<b>\$ 1,998.8</b>	<b>\$ 2,085.7</b>	<b>\$ 2,156.8</b>	<b>\$ 2,265.8</b>	<b>\$ 2,322.7</b>
<b>State Lottery Fund</b>							
Non-Tax Revenues:							
Lottery revenues .....	\$ 916.1	\$ 989.6	\$ 1,057.0	\$ 1,152.2	\$ 1,194.0	\$ 1,430.1	\$ 1,493.9
Other and miscellaneous .....	11.7	12.9	9.8	18.3	17.9	29.5	20.3
<b>TOTAL NON-TAX REVENUES .....</b>	<b>\$ 927.8</b>	<b>\$ 1,002.5</b>	<b>\$ 1,066.8</b>	<b>\$ 1,170.5</b>	<b>\$ 1,211.9</b>	<b>\$ 1,459.6</b>	<b>\$ 1,514.2</b>
<b>TOTAL STATE LOTTERY FUND .....</b>	<b>\$ 927.8</b>	<b>\$ 1,002.5</b>	<b>\$ 1,066.8</b>	<b>\$ 1,170.5</b>	<b>\$ 1,211.9</b>	<b>\$ 1,459.6</b>	<b>\$ 1,514.2</b>

Source: Office of the Budget. Totals may not add due to rounding

- (a) Budgetary basis including taxes and interest accrued but not deposited by the Commonwealth by June 30 of each fiscal year.
- (b) Includes the corporate net income and the capital stock and franchise taxes.
- (c) Includes the utility gross receipts and utility property taxes.
- (d) Includes the financial institution and insurance premium taxes.
- (e) Includes the liquor and malt beverage taxes.

Table 12, on the following page, presents a comparison of the actual revenues on a budgetary basis to the official revenue estimate used for budget enactment for the General Fund and the Motor License Fund for fiscal years 2002 through 2006.

**Table 12**  
**Commonwealth Revenues — Official Estimate vs. Actual<sup>(a)</sup>**  
**General Fund and Motor License Fund – Unaudited**  
**Fiscal Year 2002 — Fiscal Year 2006**  
(In Millions)

<u>Fiscal Year Ended June 30</u>	<u>General Fund</u>			<u>Motor License Fund</u>		
	<u>Official Estimate<sup>(b)</sup></u>	<u>Actual</u>	<u>Variance</u>	<u>Official Estimate<sup>(b)</sup></u>	<u>Actual</u>	<u>Variance</u>
2002 .....	21,328.3	20,059.6	-1,268.7	1,955.8	1,955.2	-0.6
2003 .....	21,812.1	21,314.5	-497.6	2,029.3	1,998.8	-30.5
2004 .....	22,191.3	22,828.0	636.7	2,026.3	2,085.7	59.3
2005 .....	23,866.5	24,308.5	442.0	2,101.9	2,156.9	55.0
2006 .....	24,989.9	25,854.3	864.4	2,229.2	2,265.9	36.7

Source: Office of the Budget.

<sup>(a)</sup> Budgetary basis including taxes and interest accrued but not deposited by the Commonwealth by June 30 of each fiscal year.

<sup>(b)</sup> As certified for budget enactment.

### Tax Revenues

Tax revenues constitute approximately 98 percent of Commonwealth revenues in the General Fund. The major tax sources for the General Fund of the Commonwealth are the personal income tax, the sales tax, the corporate net income tax, and the capital stock and franchise tax. Together these four taxes produce over 81 percent of General Fund tax revenues.

The major tax sources for the Motor License Fund are the liquid fuels taxes and the oil company franchise tax. Together these taxes produce nearly 54 percent of Motor License Fund revenues. Portions of certain taxes whose receipts are deposited into the Motor License Fund are legislatively restricted to specific transportation programs. These receipts are accounted for in restricted accounts in the Motor License Fund and are not included in the discussions of the tax revenues of the Motor License Fund.

The major tax sources for the General Fund and the Motor License Fund are described briefly below. The tax receipt amounts in the descriptions are on a budgetary basis.

*Personal Income Tax.* This tax accounted for \$9,524.1 million or 36.8 percent of fiscal year 2006 General Fund Commonwealth revenues. The tax is levied at a flat rate on the taxable income of all residents and resident trusts and estates and taxable income attributable to Pennsylvania non-resident estates and trusts. The current tax rate of 3.07 percent became effective on January 1, 2004. Credit against the tax is allowed for gross or net income taxes paid to other states by Pennsylvania residents.

Withholding is required by employers from all persons liable for the tax with the size of collections determining the frequency for remittance to the Commonwealth. A declaration and partial payment of the estimated tax is required for those individuals with taxable incomes over \$8,000 per year, other than wages subject to withholding.

Individuals and families meeting qualifying income limits do not pay personal income tax on all or a portion of their taxable income with the exemptions depending on their total income. A qualifying family of four owes no personal income tax on taxable income up to \$32,000 annually.

*Sales Tax.* This tax accounted for \$8,334.2 million or 32.2 percent of fiscal year 2006 General Fund Commonwealth revenues. The tax is levied at a rate of 6 percent on the sale, use, storage, rental or consumption of tangible personal property, cigarettes, and certain services, and upon the occupancy of hotel rooms. Substantial exemptions from the tax include clothing, food purchased in grocery stores or supermarkets, medical supplies, drugs, residential use of certain utilities, motor fuels, and machinery, equipment and items used in manufacturing, processing, farming or dairying, and utility service. The tax base was expanded in fiscal year 1992 to include a number of services not previously taxed. Beginning in fiscal year 1998, 1.22 percent of collections, up to an annual limit of \$75 million, are

transferred to a special fund for mass transit assistance. Beginning in fiscal year 2004, an additional 0.417 percent of receipts are transferred for transit assistance purposes.

Vendors collecting \$600 or more of sales tax in the previous year's third quarter are required to remit collections monthly within 20 days of the last day of the collection month.

*Corporate Net Income Tax.* The Commonwealth received \$2,301.9 million, or 8.9 percent of fiscal year 2006 General Fund Commonwealth revenues, from this tax. The tax is paid by all domestic and foreign corporations for the privilege of doing business, carrying on activities, or employing capital or property in Pennsylvania and is levied on federal net taxable income with Pennsylvania modifications. Building and loan associations, banks, savings institutions, trust companies, insurance and surety companies, Pennsylvania S corporations and non-profit corporations are exempt from the tax. When less than the entire business of any corporation is transacted within the Commonwealth, the taxable income in Pennsylvania is determined by an apportionment formula.

The current tax rate of 9.99 percent became effective for fiscal years beginning on or after January 1, 1995. The previous tax rate of 11.99 percent had been in effect since January 1, 1994.

The corporate net income tax is to be paid in four equal installments throughout the corporation's tax year based on estimated taxes due for the entire tax year. Any remaining portion of taxes due is to be paid with the corporation's annual report due three-and-one-half months following the end of the corporation's tax year.

*Utility Gross Receipts Tax.* This tax accounted for \$1,150.9 million, or 4.5 percent of fiscal year 2006 General Fund Commonwealth revenues. The tax is levied on the gross receipts from business transacted within Pennsylvania by specified public utilities owned, operated or leased by corporations, associations or individuals. Public utilities owned or operated by a municipality or a municipal authority furnishing public utility services within the limits of the municipality are exempt from paying tax on the receipts arising from business done within the municipality. Beginning January 1, 2004, interstate and cellular telecommunications services are subject to the gross receipts tax. The tax rate is 50 mills, which became effective in July 1991, having been raised from its prior tax rate of 44 mills for all utilities except electric utilities, which are taxed at the rate of 44 mills. The tax rate for electric utilities is adjusted annually under provisions of a formula enacted with the deregulation of electric generation in Pennsylvania. Beginning with fiscal year 1999, 0.18 percent of receipts are transferred to a special fund for mass transit purposes. Revenue from 0.2 mills of the tax is deposited in the Alternative Fuels Incentive Grant Fund.

All firms, except public utilities owned or operated by a municipality or a municipal authority and motor transportation companies, are required to file estimated revenue reports annually, together with the tentative payment of the current year's tax calculated by applying the current tax rate to 90 percent of the tax base for the preceding year. Effective for tax years after January 1, 2000, natural gas companies became exempt from the tax. The tax report and tentative payment are required to be made by March 15. The remaining tax is due and payable by the succeeding March 15.

*Capital Stock and Franchise Taxes.* These taxes generated \$1,080.9 million for the Commonwealth in fiscal year 2006, or 4.2 percent of General Fund Commonwealth revenues. They are levied on the capital stock value of domestic and foreign corporations doing business or having property or capital employed in Pennsylvania on that portion of capital stock value apportionable to Pennsylvania under a statutory formula.

Capital stock and franchise tax tentative payments are payable quarterly based on 90 percent of the tax liability of the year preceding the immediate prior year. Under current law, the General Fund tax rate for tax years that began in 2006 is 4.89 mills, having been reduced from 5.99 mills effective January 1, 2006. This tax is scheduled to be phased out by annual rate reductions through 2010 under legislation enacted in 2002 and amended in 2003 and 2006.

*Cigarette Tax.* Collections of this tax totaled \$792.1 million in fiscal year 2006, or 3.1 percent of General Fund Commonwealth revenues. The tax is imposed and assessed on the sale or possession of cigarettes within the Commonwealth. It is levied on the consumer but is collected by the sale of stamps and meter units to dealers who affix them to each package. The current rate is \$1.35 per package of 20 cigarettes, which was increased by 31 cents in 2002 and further increased by 35 cents effective in 2004. The 6 percent sales tax is also imposed on the retail sale of cigarettes. A portion of the collections from the tax are transferred to a special fund for children's health insurance and

to a special fund for preserving farmland. Additionally, an amount approximately equal to 25 cents per pack is transferred to the Healthcare Provider Retention Account.

*Inheritance and Estate Taxes.* Collections of these taxes were \$745.2 million in fiscal year 2006, or 2.9 percent of General Fund Commonwealth revenues. The inheritance tax is levied on the value of property transferred to heirs of a deceased person. Prior to July 1, 2000, the tax rate was 6 percent of the value, if passing to lineal heirs, and 15 percent if passing to collateral heirs. Effective July 1, 2000, the tax rate on transfers to parents, grandparents and lineal descendants was lowered to 4.5 percent and a new tax rate of 12 percent on transfers to siblings was established. The estate tax is a “pick-up” tax in the amount of the maximum federal tax credit less State death taxes paid. Counties collect the inheritance and estate tax, which is due within nine months following the death of the person whose property is being transferred.

*Insurance Premiums Tax.* This tax is levied at the rate of 2 percent of the gross premiums (subject to retaliatory provisions) on all business of domestic and foreign insurance companies transacted within the Commonwealth during each calendar year. Revenues from the two percent tax on foreign fire and casualty companies accrues to special revenue funds while the remaining taxes accrue to the General Fund. The tax on foreign companies is based on the amount of business transacted in Pennsylvania. Marine insurance companies, both domestic and foreign, pay a 5 percent tax on underwriting profits attributable to Pennsylvania in lieu of the gross premium tax.

A 90 percent tentative payment is required for insurance companies, except foreign fire and casualty companies, calculated on the tax base of the preceding tax year. As an alternative, the taxpayer may elect to make a tentative payment in an amount not less than 90 percent of the tax as finally reported. Payments must be submitted by March 15 of each year, while the remaining amount due must be paid by April 15 of the following year.

*Realty Transfer Tax.* This tax is levied at the rate of 1 percent of the value of the real property transferred, as represented by deed, instrument or other writing. The tax is collected by the recorders of deeds in the counties and transmitted to the Commonwealth when collected. From July 1994 through December 2001, fifteen percent of the revenues from this tax was transferred to the Keystone Recreation, Park and Conservation Fund, and the remaining portion was deposited in the General Fund. For the period from January 2002 through June 2002, the transfer amount was reduced to 10 percent; from July 2002 to June 2003, the transfer was reduced to seven and one-half percent. Effective July 2003, the transfer is fifteen percent. The fiscal year 2007 enacted budget includes a one-year suspension of the fifteen percent transfer to the Keystone Recreation, Park and Conservation Fund.

*Liquor Tax.* This tax is levied at the rate of 18 percent of the net purchase price on all liquor sold by the Pennsylvania Liquor Control Board. Revenues from this tax accrue to the General Fund. The 6 percent sales tax is also imposed on all liquor sold by the Pennsylvania Liquor Control Board and is included in the sales tax receipts.

*Financial Institution Taxes.* The bank shares tax is levied at the rate of 1.25 percent of the value of shares of state and national banks and title insurance companies. Each institution computes the tax base by averaging the share value, adjusted to exclude the value of United States obligations, for each quarter of the previous calendar year. A payment of the tax for the current tax year is due by March 15 of that year. Revenues of this tax are deposited into the General Fund.

The mutual thrift institutions tax is levied on the taxable net income of such institutions at the rate of 11.5 percent. Revenues of this tax accrue to the General Fund. Annually, the mutual thrift institutions are required to transmit tentative reports together with a tentative payment of the current year’s tax computed by applying the current tax rate to 90 percent of the tax base for the second preceding tax year. The taxpayer may elect to make a tentative payment at an amount not less than 90 percent of the tax as finally reported. Tentative reports and prepayments are due by March 15 of the current calendar year, with the remaining amount payable by April 15 of the next year.

*Public Utility Realty Tax.* The tax is levied on the state taxable value of utility real property belonging to a firm or other entity (i) furnishing utility service and (ii) regulated by the Pennsylvania Public Utility Commission or similar regulatory body. State taxable value is the current market value derived from assessed values for county real estate tax purposes. Certain items are specifically exempt from the tax. The tax rate for the General Fund portion of the tax is set annually by the Secretary of Revenue. The tax rate is to be set at a rate intended to produce revenues sufficient



to reimburse local taxing authorities for foregone property tax revenues. Revenues from an additional 7.6 mill tax are deposited into a special revenue fund.

The tax is subject to a tentative payment of the then current year's tax liability. The tentative reports and tax payments are due in May. The remaining tax payments must be paid in September.

*Malt Beverage Tax.* This tax is levied on all malt or brewed beverages sold in Pennsylvania. The tax rate is  $\frac{2}{3}$  cent per half-pint, 1 cent per pint and \$2.48 per barrel. The various manufacturers pay the tax monthly to the Department of Revenue. Revenues from this tax are deposited into the General Fund.

*Liquid Fuels Tax.* This tax accounted for \$581.8 million, or 25.7 percent of Motor License Fund Commonwealth revenues in fiscal year 2006. It is an excise tax imposed upon all liquid fuels used or sold within the Commonwealth. The tax is imposed upon and collected by the fuel distributor. After discounts, all monies collected are deposited in the Motor License Fund, except that an amount equal to one-half cent per gallon is deposited in the Liquid Fuels Tax Fund. Fuels sold and delivered to the U.S. government, the Commonwealth and any of its political subdivisions, public authorities, non-profit schools, volunteer fire companies, ambulance services, rescue squads, and fuels sold and delivered in interstate commerce are exempt from payment of the tax. In addition to these exemptions, reimbursement is made for fuels used for certain agricultural purposes. The present rate of the liquid fuels tax is 12 cents per gallon.

*Oil Company Franchise Tax.* This tax accounted for \$445.2 million, or 19.6 percent of fiscal year 2006 Motor License Fund Commonwealth revenues. The tax is levied on the privilege of selling petroleum products subject to liquid fuels taxes (primarily gasoline) for transportation purposes at the rate of 153.5 mills upon each dollar of such revenues. The tax rate was increased by 38.5 mills in May 1997 to its current rate. By law, portions of the tax are dedicated to certain highway purposes, including transfers to local governments for roads and highways. Exemptions from the tax are the same as those provided from the liquid fuels tax.

*Fuels Tax.* This tax accounted for \$162.4 million, or 7.2 percent of fiscal year 2006 Motor License Fund Commonwealth revenues. It is an excise tax imposed on fuels (primarily diesel fuel) used or sold within the Commonwealth. The tax is imposed upon and collected by the distributor. After discounts, all monies collected are deposited in the Motor License Fund, except an amount equal to one-half cent per gallon placed in the Liquid Fuels Tax Fund for distribution to local governments. The present tax rate is 12 cents per gallon for fuel used in the Commonwealth.

Fuels exempt from this tax are those delivered in interstate commerce, those used by and sold to the Commonwealth and any of its political subdivisions, those sold and delivered to the U.S. government, those (less than 50 gallons) brought into the Commonwealth in the fuel tanks of motor vehicles, those used by public authorities, volunteer fire companies, ambulance services, rescue squads and non-profit schools, and those used for certain agricultural purposes.

*Motor Carriers Road Tax.* This tax is levied on motor carrier vehicles having a gross weight in excess of 26,000 pounds. All monies collected are deposited in the Motor License Fund. The current rate is 12 cents per gallon, plus an additional factor based on the oil company franchise tax for fuel used within the Commonwealth. In May 1997, the tax rate was reduced by 6 cents to its current level. The revenue lost from the tax reduction is being covered by an additional 55 mills tax rate for the oil company franchise tax. Both the repealed and the new tax portions are dedicated to bridge improvement.

## **Non-Tax Revenues**

*Licenses and Fees.* License and fee receipts in the General Fund for fiscal year 2006 totaled \$115.8 million, representing 0.4 percent of Commonwealth revenues to the General Fund. A general increase in various General Fund fees was enacted in December 2003 and effective beginning in January 2004. Revenues from motor vehicle licenses and fees in fiscal 2004 were \$877.89 million, representing 38.7 percent of total fiscal year 2006 Motor License Fund Commonwealth revenues. A general increase in various fees and licenses was enacted in April 1997 and effective beginning with the 1998 fiscal year.

*Miscellaneous Revenue.* Revenues from non-tax sources not categorized elsewhere are credited to miscellaneous revenues. Interest earnings on securities and deposits are included in this source. Miscellaneous revenues receipts in the General Fund for fiscal year 2006 totaled \$252.8 million or 0.9% of the Commonwealth revenues to the General Fund. Receipts from miscellaneous motor vehicle revenues in fiscal 2006 were \$162.0 million, representing 7.1 percent of total fiscal year 2006 Motor License Fund Commonwealth revenues.

*State Stores Fund Transfers.* This is an amount determined by the Liquor Control Board to be available for transfer to the General Fund. The amount transferred for fiscal year 2006 was \$80.0 million. In Pennsylvania, the distribution and sale of liquor is a state enterprise.

*Fines, Penalties and Interest.* This revenue source includes all fines, penalties and interest collected in the enforcement of tax regulations. The amount deposited to the General Fund for fiscal year 2006 was \$35.5 million. The largest portion is from corporation tax penalties.

*Tobacco Settlement Payments.* The Commonwealth's portion of payments made by cigarette manufacturers participating in the Tobacco MSA are deposited in the Tobacco Settlement Fund to be used for certain health-related programs. See "COMMONWEALTH FINANCIAL STRUCTURE AND PROCEDURES – Description of Funds."

### **Federal Revenues**

Receipts by the Commonwealth in its General Fund, Motor License Fund, Tobacco and State Lottery Fund from the federal government during fiscal year 2006 totaled \$17.5 billion. Approximately \$11.4 billion, or 65.4 percent of total federal revenue to the Commonwealth for fiscal year 2006, was attributable to public health and welfare programs, the largest of which are for the Medical Assistance and Temporary Assistance to Needy Families programs.

For fiscal year 2007, funds expected to be received from the federal government in the General Fund, the Motor License Fund, the Tobacco Fund and the State Lottery Fund are estimated to be \$17.5 billion.

### **Major Commonwealth Expenditures**

The Commonwealth's major operating funds—the General Fund, the Motor License Fund and the State Lottery Fund—provide financial resources to operate programs and fund grants. Trends in expenditures from those funds for various program areas are discussed below based on budgetary basis financial statements for fiscal year 2006 and the enacted budget for fiscal year 2007.

#### ***Education***

In fiscal year 2006, expenditures from Commonwealth revenues for education purposes were over \$10.1 billion. The enacted budget for fiscal year 2007 includes over \$10.8 billion in education funding, an increase of 7.6 percent over fiscal year 2006.

*Elementary and Secondary Education.* The financing of public elementary and secondary education in Pennsylvania is shared by the Commonwealth and local school districts. There are 501 local school districts in the state. With certain exceptions, each is governed by a locally elected school board responsible for the administration of the public schools in the school district with the authority to levy taxes within the limits prescribed by the Public School Code of 1949, as amended. Funds supplied by the Commonwealth supplement the funds raised locally. Local school districts receive various subsidy payments for basic instruction, vocational education, debt service, pupil transportation, employee retirement programs including Social Security, and various special education programs from the Commonwealth. The largest such subsidy is the Basic Education Funding subsidy. The enacted budget for fiscal year 2007 increases Basic Education Funding by over \$267 million, or 5.9 percent, to over \$4.78 billion. The increase includes a base supplement based on school district enrollment and relative wealth, a small district assistance component, an enrollment growth supplement and a supplement based upon school district personal income and relative wealth and a supplement based upon enrollment and relative local taxing effort. For fiscal year 2007, every school district is guaranteed a 3.5 percent increase over its fiscal year 2006 total allocation.

Certain specialized education programs are operated and administered in Pennsylvania by 29 intermediate units established by the component local school districts. These intermediate units are funded from annual General Fund appropriations and contributions from member school districts. Programs operated by intermediate units generally are

special education programs for the gifted, for individuals with mental and physical disabilities, and for support of nonpublic schools through the provision of auxiliary services and the lending of instructional materials such as textbooks to children attending nonpublic schools in Pennsylvania.

Total Commonwealth expenditures for basic education programs in fiscal year 2006 were over \$8.1 billion, representing 80.1 percent of all Commonwealth expenditures for education in fiscal year 2006. The enacted budget for fiscal year 2007 includes over \$8.7 billion for basic education programs.

**Table 13**  
**Fall Enrollment in Pennsylvania Public and**  
**Non-Public Elementary Schools and Secondary Schools**  
**School Years 2002-2006**  
(In Thousands)

	School Year Ended June				
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Elementary Schools					
Public .....	960	942	933	935	931
Nonpublic .....	236	229	220	210	203
Secondary Schools					
Public .....	862	875	888	893	900
Nonpublic .....	85	84	83	81	78
Total					
Public .....	1,822	1,817	1,821	1,828	1,831
Nonpublic .....	<u>321</u>	<u>313</u>	<u>303</u>	<u>291</u>	<u>281</u>
Total .....	2,143	2,130	2,124	2,119	2,112

Source: Pennsylvania Department of Education.

*Philadelphia School District.* The Secretary of Education of the Commonwealth, under the provisions of the Commonwealth’s Public School Code (the “School Code”), declared the Philadelphia School District as distressed effective December 22, 2001. During the period of distress covered by that declaration, all powers and duties of the Philadelphia School District Board of Education granted under the School Code or any other law are suspended and all such powers and duties are vested in a school reform commission. Currently, the school reform commission statutorily consists of five members, four appointed by the Governor and one appointed by the Mayor of the City of Philadelphia. The school reform commission’s objectives are to improve the levels of academic achievement and achieve financial stability within the school district. Termination of the declaration of distress by the Secretary of Education of the Commonwealth may be made only upon the recommendation of a majority of the members of the school reform commission. Upon termination of the declaration of distress, the Philadelphia School District Board of Education will resume the exercise of its powers. The fiscal year 2006 budget included a \$25 million appropriation for the Philadelphia School District. Funding for the Philadelphia School District was formerly shown under its own appropriation. That funding is now included as part of the Basic Education Funding appropriation in the fiscal year 2007 enacted budget.

*Higher Education.* Higher education in Pennsylvania is provided through 271 degree-granting institutions, which include the fourteen universities of the State System of Higher Education (“SSHE”), four State-related universities, community colleges, independent colleges/universities and specialized degree-granting institutions. SSHE, created in 1982 from the fourteen state-owned colleges, is administered by a Board of Governors whose members are appointed by the Governor and confirmed by the Senate. Over \$1.90 billion was expended by the Commonwealth in the 2006 fiscal year for these institutions and for student financial assistance. The enacted budget for fiscal year 2007 includes over \$2.016 billion for higher education.

**Table 14**  
**Full-Time Equivalent Enrollment at State-Supported**  
**Institutions of Higher Education**  
**School Years 2002-2006**  
(In Thousands)

	School Year Ended June				
	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
State System of Higher Education .	94	96	95	99	101
State-Related Universities .....	137	140	141	141	141
Community Colleges .....	75	81	87	88	93
State-Aided Institutions .....	<u>39</u>	<u>40</u>	<u>42</u>	<u>43</u>	<u>45</u>
Total .....	345	357	365	371	380

Source: Governor's Executive Budget, various years.

***Public Health and Human Services***

The Commonwealth provides temporary support for its residents who are seeking to achieve and sustain independence. It also provides care, treatment and rehabilitation to persons with mental and physical disabilities and supports programs to prevent or reduce social, mental and physical disease and disabilities. In addition, it plans for and coordinates all the health resources within Pennsylvania. Services are provided directly through administration of programs and services, and indirectly through programs of standard setting, regulation, supervision, licensing, grants, subsidies and purchases of services.

Fiscal year 2006 public health and human services expenditures were \$23.6 billion and are projected to be \$24.4 billion for fiscal year 2007. Of the fiscal year 2006 expenditures, \$9.2 billion was funded from the General Fund, while \$9.5 billion will be provided from the General Fund for fiscal year 2007. Federal funds are expected to increase by \$298.8 million, and augmentations are expected to increase by \$246.7 million for fiscal year 2007. The fiscal year 2007 budget also includes \$355.5 million of receipts from the Tobacco Settlement Fund that will be expended for health care. Federal funds matching the additional state Tobacco MSA funds are included in the increase noted above. In addition, under the terms of the 1998 settlement that created the Tobacco Settlement Fund, payments by the tobacco companies may, in certain circumstances be reduced, reflecting decline in cigarette sales, and such payments also may be limited, delayed or terminated as a result of bankruptcy or insolvency of tobacco companies or legal challenges to the settlement. For fiscal year 2007, receipts from the Tobacco MSA have been reduced by \$42.8 million as certain tobacco companies decided to withhold or to place into escrow over \$1 billion in payments from their April 2006 payments to the various states and localities under provisions of the Tobacco MSA. The Commonwealth's share of withheld Tobacco MSA funds totals \$42.8 million and the Commonwealth has filed suit to recover the funding withheld by tobacco companies. Public health and human service programs are the largest single component of combined state and federal spending in the Commonwealth's operating budget. The overall budget decrease reflects proposed cost containment and cash flow strategies that will eliminate or delay some medical assistance payments offsetting the impact of caseload increases as well as higher costs to provide support for former welfare clients obtaining work, federal mandates, litigation and continued support of county operated programs for child welfare, mental health and mental retardation.

Programs providing temporary financial assistance and medical assistance comprise the largest portion of public health and human services expenditures. General Fund expenditures for these assistance programs by the Commonwealth amounted to \$5.4 billion in fiscal year 2006, while \$5.7 billion is budgeted from the General Fund for fiscal year 2007. The fiscal year 2006 budget included the use of \$80.0 million in additional intergovernmental transfer funds to offset General Fund requirements. A nursing home assessment fee provided a General Fund offset of \$212.8 million in fiscal year 2006 and is expected to provide \$153.5 million offset in fiscal year 2007. In addition, a managed care organization assessment provided a General Fund offset of \$194.5 million in fiscal year 2006 and is expected to provide a \$191.9 million offset in fiscal year 2007. Approximately 39 percent of the total cost of assistance to the economically needy is supported by Commonwealth funds appropriated from the General Fund. The balance is

provided from reimbursements by the federal government and through various program collection activities conducted by the Commonwealth.

Medical assistance continues to be a rapidly growing component of public health and human services expenditures. Despite implementation of Commonwealth initiatives to restrain costs, the program continues to grow due to an expanding caseload, technology improvements and general medical inflation. Expenditures for medical assistance increased during the period from fiscal years 1996 through 2006 by an average annual rate of 10.7 percent. Fiscal year 2006 expenditures from Commonwealth funds were \$4.9 billion and the enacted budget for fiscal year 2007 provides \$5.1 billion for medical assistance, an increase of 5.0 percent over the previous fiscal year. The increase reflects normal inflationary increases and is deflated by proposed cost containment initiatives and cash flow strategies anticipated to reduce General Fund expenditures by \$383.4 million in fiscal year 2007. The Commonwealth has experienced the rise in medical and pharmaceutical costs that has been occurring nationwide. This increase is particularly evident in the rates requested by managed care providers and in services for children. Income maintenance cash assistance payments to families in transition to independence were \$1,002.6 million for fiscal year 2006, of which \$434.9 million is from the General Fund. The enacted budget for fiscal year 2007 includes a total of \$1,082.0 million, with \$488.8 million provided from the General Fund. Cash assistance is time-limited and requires participation in work activities to maintain eligibility. To support a client's finding and retaining employment, small grants are available to clients to overcome employment obstacles such as child care, transportation, vision and hearing difficulties, and other such barriers. In fiscal year 2007 and the future, increased costs are expected to be incurred in training and support for the most hard to place clients in order to meet the 50 percent work participation requirements included in the Temporary Assistance to Needy Families Reauthorization. These increased costs will include some state-only payments for clients who are working the required amount but still require assistance to complete training.

### ***Transportation***

The Commonwealth is responsible for the construction, restoration and maintenance of the highways and bridges in the 40,000 mile state highway system, including certain city streets that are a part of the state highway system. Assistance for the maintenance and construction of local roads and bridges is provided to municipalities through grants of financial aid. Highway maintenance costs, construction costs and assistance grants are paid from the Motor License Fund. The General Fund, the State Lottery Fund and other special funds, including the Public Transportation Assistance Fund, the Liquid Fuels Tax Fund, the Highway Beautification Fund and the Motor Vehicle Transaction Recovery Fund provide the remainder of funding for transportation programs.

In addition to its unrestricted state funds, the Motor License Fund includes five restricted revenue accounts funded by specific state revenues legislatively dedicated to specific purposes. Some of the restricted purposes funded from these accounts also receive funding by annual appropriations of unrestricted Motor License Fund revenues. Programs receiving funds from a restricted account include highway bridges, highway construction and maintenance, grants to municipalities for highways and bridges, and airport development.

In addition to its support of the highway system, the Commonwealth provides subsidies for mass transit systems including passenger rail and bus service. The Commonwealth assists local mass transit systems through grants and payment for free rides by senior citizens during non-peak hours. In addition, transit operators receive payments for providing senior citizen transportation service on a shared-ride basis generally in areas where fixed route service is not available. A total of \$457.8 million in Commonwealth revenues was expended from the General Fund and the State Lottery Fund for such purposes in fiscal year 2006, and \$463.7 million is available for fiscal year 2007. Beginning with fiscal year 1998, 1.22 percent of sales and use tax collections in the General Fund, up to an annual limit of \$75 million, is transferred to a separate account and used to pay mass transportation operating grants to local mass transit systems.

In 1991, the Public Transportation Assistance Fund was created with dedicated sources of funding for mass transit systems. Funds totaling \$174.4 million were expended from this fund in fiscal year 2006 and \$175.6 million is available for fiscal year 2007.

Liquid fuels tax and license and fee revenues provide resources for expenditures for highway construction and maintenance. Motor License Fund restricted revenues budgeted for highway construction purposes totaled \$594.2 million in fiscal year 2006. In fiscal year 2007, \$625.8 million is available. Combined Motor License Fund and

restricted revenues expended for highway maintenance in fiscal year 2006 totaled \$1,445.2 million. A total of \$1,558.5 million is budgeted for fiscal year 2007. Support of highway and bridge expenditures by local governments through grants paid from Motor License Fund and restricted revenues were \$325.5 million in fiscal year 2006. A total of \$333.9 million is available for fiscal year 2007. The Commonwealth's current aviation program funds the development of public airport facilities through grants providing for airport development, runway rehabilitation, and real estate tax rebates for public use airports. Taxes levied on aviation and jet fuel provide revenues for a restricted account for aviation programs in the Motor License Fund. In fiscal year 2006, \$8.3 million was expended from the aviation restricted account for such purposes. A total of \$8.3 million is available for fiscal year 2007. The Commonwealth is not responsible for the toll roads and bridges in Pennsylvania. These are under the jurisdiction of various authorities and commissions. See "GOVERNMENT AUTHORITIES AND OTHER ORGANIZATIONS."

## OUTSTANDING INDEBTEDNESS OF THE COMMONWEALTH

### General

The Constitution permits the Commonwealth to incur the following types of debt: (i) debt to suppress insurrection or rehabilitate areas affected by disaster, (ii) electorate-approved debt, (iii) debt for capital projects subject to an aggregate debt limit of 1.75 times the annual average tax revenues of the preceding five fiscal years, and (iv) tax anticipation notes payable in the fiscal year of issuance. All debt except tax anticipation notes must be amortized in substantial and regular amounts. See Appendix E for the text of selected constitutional provisions relating to the finances of the Commonwealth.

Debt service on Commonwealth general obligation debt is paid from appropriations out of the General Fund except for debt issued for highway purposes, which is paid from Motor License Fund appropriations.

**Table 15**  
**General Obligation Debt Outstanding<sup>(a)</sup>**  
**Fiscal Years 1997-2006**  
(In Millions)

<u>June 30</u>	<u>General Obligation Debt Outstanding</u>
1997.....	\$4,795.1
1998.....	4,724.5
1999.....	4,921.5
2000.....	5,014.9
2001.....	5,416.2
2002.....	6,059.3
2003.....	6,767.2
2004.....	6,892.6
2005.....	6,747.4
2006.....	7,287.0

<sup>(a)</sup> Net of sinking fund balances for all debt.

Net outstanding general obligation debt totaled \$7,287.0 million at June 30, 2006, a net increase of \$539.6 million from June 30, 2005. Over the 10-year period ended June 30, 2006, total net outstanding general obligation debt increased at an annual rate of 3.7 percent. Within the most recent 5-year period, outstanding general obligation debt has increased at an annual rate of 6.1 percent.

General obligation debt for non-highway purposes of \$7,149.9 million was outstanding on June 30, 2006. Outstanding debt for these purposes increased by a net \$567.4 million since June 30, 2005. For the period ended June 30, 2006, the 10-year and 5-year average annual compound growth rate for total outstanding debt for non-highway purposes has been 5.4 percent and 7.1 percent respectively. In its current debt financing plan, Commonwealth infrastructure investment projects include improvement and rehabilitation of existing capital facilities and construction of new facilities, such as public buildings, prisons and parks, transit facilities, economic development and community facilities, and environmental remediation projects.

Outstanding general obligation debt for highway purposes was \$137.2 million on June 30, 2006, a decrease of \$27.7 million from June 30, 2005. Highway outstanding debt has declined over the most recent 10-year and 5-year periods ended June 30, 2006, by the annual average rates of 16.7 percent and 17.0 percent respectively. The decline in outstanding highway debt is due to the policy begun in 1980 of funding highway capital projects with current revenues except for very limited exceptions. No debt issuance for highway capital projects is currently planned.

Table 16 shows selected debt ratios for the Commonwealth for fiscal year 1996 and for fiscal years 2002 through 2006. Table 16 contains corrections to certain prior fiscal year data as well as a revision in the methodology to account for debt service payments to include funding from all sources rather than debt service as paid from appropriations (resulting in some information in Table 16 being different from that appearing in previous official statements of the Commonwealth).

**Table 16**  
**Selected Debt Ratios**  
**Fiscal Years 1996 and 2002 to 2006**

	Fiscal Year Ended June 30					
	1996	2002	2003	2004	2005	2006
<b>Net Outstanding Debt (Millions)</b>						
General Obligation Debt(a).....	\$ 5,056	\$ 6,059	\$ 6,767	\$ 6,893	\$ 6,747	\$ 7,287
Lease Payment Obligations(b).....	942	687	648	114	108	476
Total.....	<u>\$ 5,998</u>	<u>\$ 6,746</u>	<u>\$ 7,415</u>	<u>\$ 7,007</u>	<u>\$ 6,855</u>	<u>\$ 7,763</u>
% Increase (Decrease) over prior year.....	-9.0%	11.2%	9.9%	-5.5%	-2.2%	13.2%
Population (Thousands) .....	12,038	12,324	12,365	12,394	12,430	12,430
Per Capita Debt.....	\$ 498	\$ 547	\$ 600	\$ 565	\$ 551	\$ 625
Personal Income (Millions).....	\$ 297,493	\$ 382,251	\$ 392,791	\$ 412,890	\$ 433,752	\$ 433,752
Debt as a % of Personal Income.....	2.0%	1.8%	1.9%	1.7%	1.6%	1.8%
<b>Debt Service (Millions)(c)</b>						
Highway Bonds(d).....	\$ 183	\$ 84	\$ 62	\$ 50	\$ 33	\$ 36
All Other Bonds(e).....	530	676	701	718	766	800
Lease Payments.....	113	70	73	12	12	125
Total.....	<u>\$ 826</u>	<u>\$ 830</u>	<u>\$ 836</u>	<u>\$ 780</u>	<u>\$ 811</u>	<u>\$ 961</u>
Increase (Decrease) Over Prior Year	-4.2%	(0.1%)	0.7%	(6.7%)	4.0%	18.5%
<b>Cash Revenues (Million)<sup>(f)</sup></b>						
Motor License Fund.....	\$ 1,566	\$ 1,955	\$ 1,999	\$ 2,086	\$ 2,157	\$ 2,266
General Fund.....	16,339	20,059	21,315	22,828	24,309	25,854
Total.....	<u>\$ 17,905</u>	<u>\$ 22,014</u>	<u>\$ 23,314</u>	<u>\$ 24,914</u>	<u>\$ 26,465</u>	<u>\$ 28,120</u>
% Increase (Decrease) over prior year.....	0.7%	(2.2%)	5.9%	6.9%	6.2%	6.3%
Highway Bond Debt Service as a % of Motor Fund Revenues.....	11.7%	4.3%	3.1%	2.4%	1.5%	1.6%
All Other Bond Debt Service and Lease % of General Fund Revenues.....	3.9%	3.7%	3.6%	3.2%	3.2%	3.6%
Total Debt Service and Lease Payments as a % License and General Fund Revenues.....	4.6%	3.8%	3.6%	3.1%	3.1%	3.4%

(a) Net of all sinking fund balances. Includes bond anticipation notes.

(b) Includes unduplicated data of issues contained in Table 20.

(c) As paid from appropriations, available funds and/or sinking fund balances.

(d) Highway Bonds, interest portion of Advance Construction Bonds, Highway Public Improvement Bonds, State Highway and Bridge Authority Bonds, General Authority Rentals, and Highway Bridge Improvement Bonds.

(e) Fiscal year 2002 decline due to use of available balance in lieu of appropriations.

(f) Commonwealth revenues only.

## General Obligation Debt Outstanding

As of June 30, 2006, the Commonwealth had the following amount of general obligation debt outstanding:

**Table 17**  
**General Obligation Debt Outstanding as of June 30, 2006**  
(In Thousands)

	Debt Outstanding <sup>(b)</sup>	Less: Refunding Escrow <sup>(c)</sup>	Less: Sinking Fund <sup>(d)</sup>	Net Debt Outstanding
<b>Capital Projects Debt:</b>				
Capital Facilities Bonds.....	\$ 5,361,580	\$ (1,500,075)	\$ (7,748)	\$ 3,853,757
Highway Bonds.....	-	-	-	-
Refunding Bonds .....	2,633,862	-	-	2,633,862
<b>Total Capital Projects Debt Outstanding.....</b>	<b>\$ 7,995,442</b>	<b>\$ (1,500,075)</b>	<b>\$ (7,748)</b>	<b>\$ 6,487,619</b>
<b>Electorate Approved Debt:</b>				
PA Economic Revitalization Bonds.....	\$ 2,880	-	-	\$ 2,880
Land & Water Development Bonds.....	1,440	-	(189)	1,251
Nursing Home Loan Development Bonds.....	-	-	-	-
Volunteer Companies' Loan Bonds.....	6,740	(5,325)	-	1,415
Vietnam Veterans Compensation Bonds.....	-	-	-	-
Water Facilities Restoration-1981 Referendum.....	13,210	(2,475)	-	10,735
Pennvest—1988 Referendum Bonds.....	53,775	(7,600)	-	46,175
Pennvest—1992 Referendum Bonds.....	26,700	(5,550)	-	21,150
Agricultural Conservation Easement Bonds.....	16,185	(6,050)	-	10,135
Local Criminal Justice Bonds.....	10,670	(4,200)	-	6,470
Keystone Recreation, Parks & Conservation Bonds.....	8,400	(6,750)	-	1,650
Growing Greener Bonds.....	183,000	-	-	183,000
Water Supply and Wastewater Treatment Bonds.....	50,000	-	-	50,000
<b>Total Electorate Approved Debt Outstanding.....</b>	<b>\$ 373,000</b>	<b>\$ (37,950)</b>	<b>\$ (189)</b>	<b>\$ 334,861</b>
<b>Other Bonded Debt:</b>				
Disaster Relief Bonds.....	\$ 17,095	(9,025)	(2)	\$ 8,068
Refunding Bonds.....	456,483	-	-	456,483
<b>Total Other Bonded Debt Outstanding.....</b>	<b>\$ 473,578</b>	<b>\$ (9,025)</b>	<b>(2)</b>	<b>\$ 464,551</b>
<b>Total General Obligation Debt Outstanding.....</b>	<b>\$ 8,842,020</b>	<b>\$ (1,547,050)</b>	<b>\$ (7,939)</b>	<b>\$ 7,287,031</b>

<sup>(a)</sup> Accreted value of capital appreciation bonds included.

<sup>(b)</sup> Principal amount of bonds refunded to be paid from State Treasurer escrow account

<sup>(c)</sup> Balance in sinking fund

**[INTENTIONALLY LEFT BLANK]**



Debt service payable during each fiscal year on outstanding general obligation debt, net of refunding escrow amounts, as of June 30, 2006, for the years shown is as follows:

**Table 18**  
**Bond Debt Service**  
(In Thousands)

<u>Fiscal Year Ending June 30</u>	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
2007 .....	\$521,774	\$361,874	\$883,648
2008 .....	540,397	336,911	877,308
2009 .....	541,620	309,283	850,903
2010 .....	537,245	277,681	814,926
2011 .....	544,005	249,337	793,342
2012 .....	541,065	221,296	762,361
2013 .....	516,695	193,722	710,417
2014 .....	465,885	167,510	633,395
2015 .....	404,520	143,968	548,488
2016 .....	365,225	124,664	489,889
2017 .....	334,385	107,426	441,811
2018 .....	324,875	90,895	415,770
2019 .....	312,725	74,227	386,952
2020 .....	279,540	59,496	339,036
2021 .....	259,035	47,959	306,994
2022 .....	239,120	35,533	274,653
2023 .....	183,945	24,913	208,858
2024 .....	156,125	16,131	172,256
2025 .....	99,650	9,179	108,829
2026 .....	88,065	4,697	92,762
2027 .....	28,085	702	28,787
<b>Grand Total</b> .....	<b>\$ 7,283,980</b>	<b>\$ 2,857,406</b>	<b>\$ 10,141,386</b>

Totals may not add due to rounding.

### Nature of Commonwealth Debt

*Capital Projects Debt.* The Commonwealth may incur debt to fund capital projects for community colleges, highways, public improvements, transportation assistance, flood control, and redevelopment assistance. Before a project may be funded, it must be itemized in a capital budget bill adopted by the General Assembly. An annual capital budget bill states the maximum amount of debt for capital projects that may be incurred during the current fiscal year for projects authorized in the current or previous years' capital budget bills. Capital projects debt is subject to a constitutional limit on debt.

Once capital projects debt has been authorized by the necessary legislation, issuance authority rests with two of the Issuing Officials (the Governor, the State Treasurer and the Auditor General), one of whom must be the Governor.

*Electorate-Approved Debt.* The issuance of electorate-approved debt is subject to the enactment of legislation that places on the ballot the question of whether debt shall be incurred. The legislation authorizing the referendum must state the purposes for which the debt is to be authorized and, as a matter of practice, includes a maximum amount of funds to be borrowed. Upon electorate approval and enactment of legislation implementing the proposed debt-funded program, bonds may be issued. All such authorizing legislation to date has given issuance authority to two of the Issuing Officials, one of whom must be the Governor.

*Other Bonded Debt.* Debt issued to rehabilitate areas affected by disasters is authorized by specific legislation. Authorizing legislation has given issuance authority to two of the Issuing Officials, one of whom must be the Governor.

*Tax Anticipation Notes.* Due to the timing of major tax payment dates, the Commonwealth's General Fund cash receipts are generally concentrated in the last four months of the fiscal year, from March through June. Disbursements are distributed more evenly throughout the fiscal year. As a result, operating cash shortages can occur

during certain months of the fiscal year. When necessary, the Commonwealth engages in short-term borrowing to fund expenses within the fiscal year through the sale of tax anticipation notes. The authority to issue such notes rests with the Issuing Officials.

The Commonwealth may issue tax anticipation notes only for the account of the General Fund or the Motor License Fund or both such funds. The principal amount issued, when added to that outstanding, may not exceed in the aggregate 20 percent of the revenues estimated to accrue to the appropriate fund or both funds in the fiscal year.

Tax anticipation notes must mature within the fiscal year in which they were issued. The Commonwealth is not permitted to fund deficits between fiscal years with any form of debt. Any year-end deficit balances must be funded within the succeeding fiscal year's budget.

Currently, the Commonwealth has no tax anticipation notes outstanding. The fiscal year 2007 budget does not anticipate issuing tax anticipation notes.

In the last eight fiscal years, the Commonwealth has not issued any tax anticipation notes.

*Bond Anticipation Notes.* Pending the issuance of bonds, the Commonwealth may issue bond anticipation notes subject to the applicable statutory and constitutional limitations generally imposed on bonds. The term of such borrowings may not exceed three years. Issuing authority rests with the Issuing Officials. No bond anticipation notes are outstanding.

### Projected Issuance of Long-Term Debt

Table 19 shows projected future issuance of new-money long-term bonds or bond anticipation notes through fiscal year 2011 as currently estimated based on current authorizations. Included in Table 19 are bonds expected to be issued under two bond referendums proposed by the Governor and enacted by the General Assembly in 2004 and 2005 (See "Fiscal Year 2004 Financial Results" and "Fiscal Year 2005 Financial Results"). Not included however, are bonds authorized under the economic stimulus program of the Commonwealth Financing Authority. Actual issuance of bonds will be affected by a number of economic and other factors and may vary significantly from this projection.

**Table 19**  
**Projected Bond Issuance and Principal Retirements**  
**Fiscal Years 2007-2011<sup>(a)</sup>**  
(In Millions)

	<b>Fiscal Year Ending June 30</b>				
	<b><u>2007</u></b>	<b><u>2008</u></b>	<b><u>2009</u></b>	<b><u>2010</u></b>	<b><u>2011</u></b>
Capital Facilities <sup>(b)</sup>					
Buildings and Structures.....	\$ 445	\$ 735	\$ 690	\$ 620	\$ 530
Furniture and Equipment.....	5	35	11	1	0
Transportation Assistance .....	150	150	150	150	150
Redevelopment Assistance.....	230	310	295	250	195
Flood Control .....	10	3	4	5	6
Special Purpose:					
Pennvest — 1988 & 1992 Referenda .....	85	85	0	0	0
Local Criminal Justice.....	0	0	0	0	0
Disaster Relief.....	0	0	0	0	0
Water Facilities Loan—1981 Referendum.....	0	0	0	0	0
Water and Wastewater Referendum <sup>(a)</sup> .....	95	55	50	0	0
Growing Greener II Referendum <sup>(a)</sup> .....	<u>105</u>	<u>105</u>	<u>105</u>	<u>205</u>	<u>0</u>
Total Projected Issuance.....	<u>\$ 1,125</u>	<u>\$ 1,478</u>	<u>\$ 1,305</u>	<u>\$ 1,231</u>	<u>\$ 881</u>
Principal Retirement <sup>(c)</sup> .....	<u>\$ 610.9</u>	<u>\$ 748.0</u>	<u>\$ 855.5</u>	<u>\$ 953.7</u>	<u>\$1,035.4</u>

Totals may not add due to rounding.

<sup>(a)</sup> As proposed in fiscal year 2007 budget.

<sup>(b)</sup> Includes issuance for new projects and for projects previously authorized.

<sup>(c)</sup> On bonded debt outstanding and pro forma for projected.

## OTHER STATE-RELATED OBLIGATIONS

### Moral Obligations

Moral obligation financing is a financing arrangement in which designated officials of the Commonwealth, its departments or agencies agree, when necessary, to request the General Assembly to appropriate funds as may be required to make up any deficiency in a debt service reserve fund established to assure payment of obligations issued under such an arrangement. The General Assembly is not required to approve such appropriation requests.

*Pennsylvania Housing Finance Agency ("PHFA").* The PHFA is a state-created agency that provides financing for housing for lower and moderate income families in the Commonwealth. The bonds, but not the notes, of the PHFA are partially secured by a capital reserve fund required to be maintained by the PHFA in an amount equal to the maximum annual debt service on its outstanding bonds in any succeeding calendar year. If there is a potential deficiency in the capital reserve fund or if funds are necessary to avoid default on interest, principal or sinking fund payments on bonds or notes of PHFA, the statute creating PHFA provides a mechanism for obtaining additional funds. That mechanism directs the Governor, upon notification from PHFA, to place in the budget of the Commonwealth for the next succeeding year an amount sufficient to make up any such deficiency or to avoid any such default. The budget as finally adopted by the General Assembly may or may not include the amount so placed therein by the Governor. PHFA is not permitted to borrow additional funds so long as any deficiency exists in the capital reserve fund. No deficiency exists currently.

According to PHFA, as of June 30, 2006, PHFA had \$3,426.8 million of revenue bonds outstanding.

### Lease Financing

The Commonwealth, through several of its departments and agencies, leases various real property and equipment. Some leases and their respective lease payments are, with the Commonwealth's approval, pledged as security for debt obligations issued by certain public authorities or other entities within the state. All lease payments payable by Commonwealth departments and agencies are subject to and dependent upon an annual spending authorization approved through the Commonwealth's annual budget process. The Commonwealth is not required by law to appropriate or otherwise provide moneys from which the lease payments are to be paid. The obligations to be paid from such lease payments are not bonded debt of the Commonwealth.

Table 20 contains summary information on obligations of significant amounts secured by lease payments from leases with Commonwealth departments and agencies payable from the General Fund or other budgeted special funds.

**Table 20**  
**Obligations Secured By Commonwealth**  
**Lease Payments**  
(In Thousands)

<u>Lessor</u>	<u>Purpose</u>	<u>Maximum Annual Lease Payment</u>	<u>Principal Amount Outstanding as of 6/30/2006</u>	<u>Final Maturity</u>
Harristown Development Corporation	Office Space	\$ 6,306	\$ 55,305	May 1, 2016
Philadelphia Regional Port Authority	Port Facilities	4,965	45,900 <sup>(a)</sup>	Sept. 1, 2020

<sup>(a)</sup> The outstanding balance of the Authority's Series 1993 Bonds was refunded by the issuance of its \$53.9 million principal amount of Series 2003 Bonds in August 2003.

The Harristown Development Corporation leases office space to the Commonwealth in the city of Harrisburg. Certificates of participation in the principal amount of \$71,135,000 were issued in October 2001, representing

undivided rights in the lease payments by the Commonwealth to the Harristown Development Corporation for nearly one million square feet of office space occupied by Commonwealth departments and agencies since 1978.

The Commonwealth has also leased port facilities of the Philadelphia Regional Port Authority (“PRPA”) to encourage trade through the Port of Philadelphia. Lease revenue bonds of PRPA in the amount of \$53.9 million were issued by that authority in August 2003 to refund all outstanding PRPA Series 1993 Bonds. These bonds are payable from lease payments made by the Commonwealth from an annual appropriation authorizing payments to PRPA.

These lease obligations and agreements to lease various other facilities and equipment entered into by the Commonwealth are included in Note K to the Fund Financial Statements for the fiscal year ended June 30, 2005.

### **Commonwealth Financing Authority**

The Commonwealth Financing Authority (the “CFA”), a major component of the Governor’s Economic Stimulus Proposals for the Commonwealth, was established in April 2004 with the enactment of legislation establishing the CFA as an independent authority and an instrumentality of the Commonwealth. The CFA is authorized to issue its limited obligation revenue bonds and other types of limited obligation revenue financing for the purposes of promoting the health, safety, employment, business opportunities, economic activity and general welfare of the Commonwealth and its citizens through loans, grants, guarantees, leases, lines and letters of credit and other financing arrangements to benefit both for-profit and non-profit entities. The CFA’s bonds and financings are to be secured by revenues and accounts of the CFA, including funds appropriated to CFA from general revenues of the Commonwealth for repayment of CFA obligations. The obligations of the CFA will not be a debt or liability of the Commonwealth but it is expected that the CFA may issue debt that may be payable from appropriations of the Commonwealth.

In November 2005, the CFA issued its first bonds and since that time, the CFA has completed additional bond issues. As of June 30, 2006, the CFA had \$375.0 million in outstanding bond debt. The Commonwealth’s fiscal year 2007 enacted budget appropriates \$36.939 million in state funds to the CFA for payment of all or a portion of CFA debt service during fiscal year 2007. In addition, approximately \$3 million in state funds remain available from the Commonwealth’s fiscal year 2006 enacted budget to fund CFA debt service in fiscal year 2007. Additional appropriations from Commonwealth General Funds for future debt service beyond those mentioned in this section are expected to be requested by the Department of Community and Economic Development for inclusion in future Governor’s Executive Budget requests to the General Assembly.

### **Pensions and Retirement Systems**

#### *General Information*

The Commonwealth maintains contributory benefit pension plans covering all state employees, public school employees and employees of certain state-related organizations. State employees and employees of certain state-related organizations are members of the State Employees’ Retirement System (“SERS”). Public school employees are members of the Public School Employees’ Retirement System (“PSERS”). With certain exceptions, membership in the applicable retirement system is mandatory for covered employees.

SERS and PSERS are established by state law as independent administrative boards of the Commonwealth, each directed by a governing board, which exercises control and management of its system, including the investment of its assets. The board of the SERS consists of eleven members, six appointed by the Governor, two members each from the Senate and House of Representatives and the State Treasurer. The PSERS board has fifteen members, including the Commonwealth’s Secretary of Education, the State Treasurer, the executive secretary of the Pennsylvania School Boards Association, two members appointed by the Governor, six elected members (five from among PSERS members and one from among school board members in Pennsylvania) and two members each from the Senate and the House of Representatives.

The retirement plans of SERS and PSERS are contributory defined benefit plans for which the benefit payments to members and contribution rates by employees are specified in state law. Changes in benefit and contribution provisions for each retirement plan must be made by legislation. Under statutory provisions established in 1981, all legislative bills and amendments proposing to change a public employee pension or retirement plan are to be

accompanied with an actuarial note prepared by an enrolled pension actuary providing an estimate of the cost and actuarial effect of the proposed change.

The Commonwealth's retirement programs are jointly contributory between the employer and employee. The contribution rate for new PSERS members who enroll in the pension plan on or after January 1, 2002 is 7.5 percent of compensation. The contribution rates for current PSERS members range from 5 percent to 7.5 percent of compensation depending upon their date of employment and elections made by the member. The SERS' average employee contribution rate is 6.25%. Interest on each employee's accumulated contributions is credited annually at a 4 percent rate mandated by state statute. Accumulated contributions plus interest credited is refundable to covered employees upon termination of their employment.

Act 40 of 2003 amended the PSERS' actuarial cost method. Under Act 40, the outstanding balance of the unfunded accrued liability as of June 30, 2001 and the decrease in the unfunded accrued liability due to the actuarial asset method change provided by Act 38 continue to be amortized over a 10-year period, with level dollar funding, beginning July 1, 2002. The increases in the unfunded accrued liability due to the July 1, 2002 and July 1, 2003 cost-of-living adjustments provided by Act 38 continue to be amortized over a 10-year period, with level dollar funding, starting on July 1, 2003 and July 1, 2004, respectively. All other changes in the unfunded accrued liability at June 30, 2001, June 30, 2002, and June 30, 2003, are amortized over a 30-year period, with level dollar funding, starting on July 1, 2002, July 1, 2003, and July 1, 2004, respectively. Future benefit improvements for active members and retirees will be amortized over a 10-year period with level dollar funding. Future gains and losses will be amortized over a 30-year period with level dollar funding. Act 40 also provides a 4.00% floor on the employer contribution rate for PSERS.

With respect to SERS, Act 40 of 2003 set the amortization period for the accrued liabilities at 10 and 30 year schedules with level payments. Additionally, Act 40 revised minimum contributions for SERS to 2%, 3%, and 4% effective July 1, 2004, 2005, and 2006, respectively; the minimum contribution provision for SERS expires on July 1, 2007. Supplemental annuity contributions are funded over 10 years with level dollar payments. SERS employer rates vary by class/category of service. For fiscal year 2005, the SERS composite employer rate was 2.02 percent and for fiscal year 2006 it is 3.02 percent.

For PSERS, the employer's contribution is shared by the Commonwealth and the school districts. For school entities, the Commonwealth remits its employer contribution portion to those school entities, which then remit the entire employer contributions (both school entity and Commonwealth portions) to PSERS. The Commonwealth's contribution is appropriated annually from the General Fund to the Department of Education. The PSERS employer rate for fiscal year 2006 is 4.69 percent and for fiscal year 2007 is 6.46 percent

Commonwealth contributions to both pension systems are projected to grow significantly in fiscal year 2007 based on current assumptions. Commonwealth contributions to SERS and PSERS were \$152.8 million and \$254.50 million respectively in fiscal year 2006. The fiscal year 2007 enacted budget includes Commonwealth contributions for both SERS and PSERS of \$205.5 million and \$368.8 million respectively, a 41 percent increase in the year-over-year contribution to each system. Additionally, based on the most recent valuations of the two systems, after several years of projected moderate increases, Commonwealth contributions to both systems are projected to increase significantly in fiscal year 2013. Current projections forecast Commonwealth contributions to SERS and PSERS of \$259.4 million and \$369.0 million in fiscal year 2012 and these contributions to SERS and PSERS are forecast to rise to \$1,273.3 million and \$1,220.5 million respectively in fiscal year 2013. The projected contribution increases are the result of significant benefit improvements enacted in 2001, a cost of living adjustment enacted in 2002 and the actuarial method changes enacted in 2002 and 2003. The Commonwealth is currently actively evaluating ways to prepare for and moderate the projected fiscal year 2013 contribution increases.

Contributions to the pension plans by the employer (including normal costs and payments to amortize prior service costs and medical premium assistance payments), employee contributions, interest earnings on the plans and benefit payments are shown in the tables on the following page, which have been prepared by the staffs of SERS and PSERS.

**Table 21**  
**Public School Employees' Retirement Fund**  
(In Millions)

<u>Year Ended</u> <u>June 30</u>	<u>Employer</u> <u>Contributions</u>	<u>Employee</u> <u>Contributions</u>	<u>Net Investment</u> <u>Income</u>	<u>Total Deductions From</u> <u>Plan Net Assets<sup>(a)</sup></u>	<u>Net</u> <u>Assets<sup>(b)</sup></u>
2001 .....	\$186	\$722	\$(3,844)	\$2,332	\$48,153
2002 .....	109	806	(2,523)	2,948	43,597
2003 .....	116	897	1,022	3,144	42,488
2004 .....	407	944	8,245	3,547	48,537
2005 .....	458	955	6,081	3,920	52,111

<sup>(a)</sup> Includes the PSERS administrative expenses.

<sup>(b)</sup> PSERS adopted GASB Statement Nos. 25 and 26 retroactively to fiscal 1994. GASB Statement No. 25 requires the presentation of Plan Net Assets, which combines the cumulative residual effects of all System assets and current liabilities. System long-term actuarial liabilities are not presented on the System's basic financial statements, but instead are presented upon a supplementary schedule of funding progress. The presentations above include the effects of financial activity related to the administration of the PSERS healthcare insurance premium assistance program and Health Options Program. As required with the adoption of GASB Statement No. 26, separate financial presentation for these programs are made on PSERS financial statements. PSERS also adopted GASB Statement No. 34 for the fiscal year beginning July 1, 2001 that requires the presentation of Management's Discussion and Analysis as required supplementary information preceding the financial statement.

**Table 22**  
**State Employees' Retirement Fund**  
(In Millions)

<u>Year Ended</u> <u>December 31</u>	<u>Employer</u> <u>Contributions</u>	<u>Employee</u> <u>Contributions</u>	<u>Net Investment</u> <u>Income<sup>(a)</sup></u>	<u>Total Deductions</u> <u>From Plan Net Assets<sup>(b)</sup></u>	<u>Plan Net</u> <u>Assets<sup>(c)</sup></u>
2001 .....	\$77	\$241	\$(2,226)	\$1,266	\$24,706
2002 .....	51	304	(2,731)	1,450	20,880
2003 .....	69	308	4,936	1,656	24,536
2004 .....	107	310	3,569	1,881	26,641
2005 .....	148	306	3,623	1,966	28,752

<sup>(a)</sup> Includes net appreciation (depreciation) in fair value of investments.

<sup>(b)</sup> Includes SERS administrative costs.

<sup>(c)</sup> Market value of investment assets. SERS adopted GASB Statement No. 25. GASB Statement No. 25 requires that investments be reported at their fair value. Also includes securities lending collateral pool pursuant to GASB Statement No. 28. In 2002, SERS adopted GASB Statement No. 34, which requires the presentation of Management Discussion and Analysis as required supplementary information preceding the financial statements.

Annual actuarial valuations are required by state law to determine the employer contribution rates necessary to accumulate sufficient assets and provide for payment of future benefits. The actuary's recommendations for employer contribution rates represent a funding plan for meeting current and future retirement obligations and are included in the enacted budget for the current fiscal year. The employer's contribution rate is computed to fully amortize the unfunded actuarial accrued liability of the respective plan as determined by its actuary. The unfunded accrued liability is a measure of the present value of benefits estimated to be due in the future for current employees given assumptions as to mortality, pay levels, retirement experience and employee turnover, less the present value of assets available to pay those benefits given assumptions of normal cost, supplemental annuity amortization, employer contribution levels and member contributions. The unfunded actuarial accrued liability for the most recent years with completed valuations based on the projected benefit method utilizing level percentage entry age and normal cost is shown in Table 23 on the following page. Both SERS and PSERS currently use an investment rate of return assumption of 8.5 percent.

**Table 23**  
**Unfunded Actuarial Accrued Liability**  
**2001-2005**  
**(In Millions)**

<u>Valuation Year Ended</u>	<u>SERS<sup>(a)</sup></u>	<u>PSERS<sup>(b)</sup></u>
2001.....	(3,846)	(6,913)
2002.....	(1,848)	(2,500)
2003.....	(1,286)	(1,543)
2004.....	1,099	5,028
2005.....	2,058	10,007

<sup>(a)</sup> The fiscal year for SERS ends on December 31 of each year.

<sup>(b)</sup> The fiscal year for PSERS ends on June 30 of each year. The net increase in the unfunded actuarial accrued liability from 2001 to 2005 is attributable to pension plan modification under Act 9 of 2001 and Act 38 of 2002 and actuarial rates of return below the actuarially assumed rate.

For financial reporting purposes, both SERS and PSERS have adopted the Governmental Accounting Standards Board's Statement No. 25. This Statement requires a specific method of accounting and financial reporting for defined benefit pension plans. Among other things, the Statement requires a comparison of employer contributions to "annual required contributions" (the "ARC"). Independently audited financial statements for both SERS and PSERS, as of December 31, 2005 and June 30, 2005, respectively, provide this comparison for each of the five fiscal years then ended.

*Other Post-Employment Benefits*

In addition to a defined benefit retirement plan for State employees and employees of certain state-related organizations, the Commonwealth also provides certain health care benefits for Commonwealth retirees and retired State Police enlisted members. These and similar benefits are commonly referred to as "other post-employment benefits" or "OPEB." The State Police retiree benefits are determined through collective bargaining, while the Commonwealth's other retiree health care benefits are determined by the Commonwealth.

The General Assembly, based upon the Governor's request, annually appropriates funds to meet its obligation to pay such benefits on a "pay-as-you-go" basis. The Commonwealth has not established any fund or irrevocable trust for the accumulation of assets with which to pay such benefits in future years. Such expenditures are currently funded by the Commonwealth's General Fund (approximately 48 percent), Federal, Other and Special Funds. In fiscal year 2005 costs for such benefits totaled approximately \$469 million, and in fiscal year 2006 approximately \$499 million. The enacted budget for fiscal year 2007 estimates costs for retiree health care at \$556 million from all funding sources, including the General Fund, while fiscal year 2008 costs are currently estimated to be \$625 million. The Commonwealth has established a restricted receipts account for the purpose of accumulating the funds from which OPEB costs are paid. This restricted receipts account accumulated an ending balance of \$144 million in fiscal year 2006, which is expected to grow to \$277 million by the end of fiscal year 2007.

On June 21, 2004, the Governmental Accounting Standards Board (GASB) released its Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* ("Statement No. 45"). Statement No. 45 establishes standards for the measurement, recognition and display in the financial reports of state and local governments of obligations to pay OPEBs when provided separately from a pension plan expense or expenditures and related liabilities. Under Statement No. 45, governments will be required to: (i) measure the costs of benefits, and recognize other post-employment benefits expenses, on the accrual basis of accounting in periods that approximate employees' years of service; (ii) provide information about the actuarial liabilities of promised benefits associated with past services and whether, or to what extent, those benefits have been funded; and (iii) provide information useful in assessing potential demands on the employer's future cash flows. Statement No. 45 reporting requirements are effective for the Commonwealth in fiscal year 2008, and therefore the Commonwealth's financial statements to date do not reflect these requirements.

To date, the Commonwealth has not received a completed actuarial valuation of its potential liability to pay retiree health care benefits.

Pursuant to a procurement process begun in February 2006, the Commonwealth has retained the Hay Group, a national employee benefits consulting firm, to provide actuarial services for the Commonwealth in preparation for GASB 45 implementation. The Hay Group has not yet developed a completed actuarial valuation of the Commonwealth's OPEB liability. Through October 2006, however, it has collected substantial demographic, utilization and cost data and provided to the Commonwealth various preliminary draft actuarial valuations addressing the requirements of Statement No. 45. In particular, it has provided the Commonwealth the following preliminary draft valuations:

1. Estimated unfunded actuarial accrued liability ("UAAL") as of July 1, 2007 -- \$13.778 billion.
2. Estimated potential annual required contribution ("ARC") -- \$1.125 billion. Note that this estimate should be reduced to reflect the amount of cash the Commonwealth currently contributes annually for such benefits. The currently estimated cash contribution ("pay-as-you-go") from all funds for such benefits for fiscal year 2008 is \$625 million, thereby resulting in an estimated net reportable OPEB liability of \$500 million as of June 30, 2008.

Assuming that the contributions from the General Fund for such benefits continue at 48 percent as described above, the projected impact of the estimated UAAL, ARC and net OPEB liability on the Commonwealth's General Fund would be approximately one half of the estimated valuations cited herein.

It is important to note the Commonwealth has not completed (1) its review of various actuarial assumptions and cost methods, including discount rates, utilized by the Hay Group or (2) its review and analysis appropriate to ensure that final calculations accurately reflect the Commonwealth's actual benefit plans, current costs and covered population. The Commonwealth has not requested that the Hay Group refine its estimates based on any proposed changes to the benefit plans. **Accordingly, all of the above numbers must be considered preliminary and are subject to material change.** The actuarial measures to be used for the financial statements beginning as of June 30, 2008, will reflect further revisions and refinements and will be determined using a December 31, 2005 valuation date.

The Commonwealth expects the Hay Group to complete its actuarial services by the end of December 2006. The Commonwealth may provide additional information on OPEBs when further analysis and refinement have been completed.

#### *Future Obligations*

The Commonwealth has already taken several steps to manage its OPEB obligations over time. These include, but are not limited to:

1. State Police new hires are required to enroll in Medicare upon age 65;
2. Employees retiring after July 1, 2005 are required to pay 1 percent of their final salary as a contribution towards the cost of coverage;
3. Service requirement eligibility has been lengthened from 15 years to 20 years starting after June 30, 2008;
4. The Commonwealth has applied for Medicare Part D retiree drug subsidy as of September 2005;
5. The Commonwealth has rebid health care and pharmacy coverages periodically to obtain lower costs;
6. Employees retiring after July 1, 2004 will have their post employment benefits changed automatically as the benefits for active employees are updated and changed;
7. State Police retirees are eligible to enroll in preferred provider organization (PPO) plans and State Police retirees will have three tier drug formularies.

Beyond these steps and others contemplated but not yet implemented or negotiated, the General Assembly has not, to date, adopted or considered any program for funding OPEB payments other than from annual appropriations on a "pay-as-you-go" basis. As indicated above, the Commonwealth has received draft valuations for both its UAAL and ARC estimates and its audited financial statements currently do not reflect any obligation to make such payments.



Based on existing collective bargaining agreements and related assumptions, the Commonwealth believes that the amount of such payments necessary to continue to fund OPEBs on a “pay-as-you-go” basis will increase modestly in future years. Conversely, based on the same collective bargaining agreements and related assumptions, the Commonwealth believes that the amount of contributions required to fund SERS and PSERS will increase substantially beginning in fiscal year 2013 as described above under “General Information.” As described above, the Commonwealth is actively evaluating additional ways to address these significant increases and expects to take into account OPEB obligations as it addresses these issues.

## GOVERNMENT AUTHORITIES AND OTHER ORGANIZATIONS

Certain state-created organizations have statutory authorization to issue debt for which state appropriations to pay debt service thereon are not required. The debt of these organizations is funded by assets of, or revenues derived from, the various projects financed and is not a statutory or moral obligation of the Commonwealth. However, some of these organizations are indirectly dependent upon Commonwealth operating appropriations. In addition, the Commonwealth may choose to take action to financially assist these organizations. These organizations, their purposes and their outstanding debt, as computed by each organization, are as follows:

*Delaware River Joint Toll Bridge Commission (“DRJTBC”).* The DRJTBC, a public corporation of the Commonwealth and New Jersey, owns and operates bridges across the Delaware River. Debt service on bonds is paid from tolls and other revenues of the Commission. The DRJTBC had \$186.9 million in bonds outstanding as of June 30, 2006.

*Delaware River Port Authority (“DRPA”).* The DRPA, a public corporation of the Commonwealth and New Jersey, operates several toll bridges over the Delaware River, and promotes the use of the Philadelphia-Camden port and promotes economic development in the port district. Debt service on bonds is paid from toll revenues and other revenues pledged by DRPA to repayment of bonds. The DRPA had \$1,216.9 million in revenue bond debt outstanding as of June 30, 2006.

*Pennsylvania Economic Development Financing Authority (“PEDFA”).* The PEDFA was created in 1987 to offer pooled bond and other bond issues for both taxable and tax-exempt bonds on behalf of local industrial and commercial development authorities for economic development projects. Bonds may be secured by loan repayments and all other revenues of the PEDFA. The PEDFA had \$1,418.5 million of debt outstanding as of June 30, 2006.

*Pennsylvania Energy Development Authority (“PEDA”).* The PEDA was created in 1982 to finance energy research projects, demonstration projects promoting the production or conservation of energy and the promotion, utilization and transportation of Pennsylvania energy resources. The authority’s funding is from appropriations and project revenues. Debt service on bonds is paid from project revenues and other revenues pledged by PEDA to repayment of bonds. The PEDA had \$61.5 million in bonds outstanding as of June 30, 2006.

*Pennsylvania Higher Education Assistance Agency (“PHEAA”).* The PHEAA makes or guarantees student loans to students or parents, or to lending institutions or post-secondary institutions. Debt service on the bonds is paid by loan interest and repayments and other agency revenues. The PHEAA had \$8,174.9 million in bonds outstanding as of June 30, 2006.

*Pennsylvania Higher Educational Facilities Authority (“PHEFA”).* The PHEFA is a public corporation of the Commonwealth established to finance college facilities. As of June 30, 2006, the PHEFA had \$5,221.1 million in revenue bonds and notes outstanding payable from the lease rentals or loan repayments of the projects financed. Some of the lessees or borrowers, although private institutions, receive grants and subsidies from the Commonwealth.

*Pennsylvania Industrial Development Authority (“PIDA”).* The PIDA is a public corporation of the Commonwealth established for the purpose of financing economic development. The PIDA had \$453.8 million in revenue bond debt outstanding on June 30, 2006, to which all of its revenues are pledged.

*Pennsylvania Infrastructure Investment Authority (“Pennvest”).* Pennvest was created in 1988 to provide low-interest rate loans and grants for the purpose of constructing new and improving existing water supply and sewage

disposal systems to protect the health and safety of the citizens of the Commonwealth and to promote economic development within the Commonwealth. Loans and grants are available to local governments and, in certain circumstances, to private companies. The Pennvest bonds are secured by principal repayments and interest payments on Pennvest loans. Pennvest had \$75.8 million of revenue bonds outstanding as of June 30, 2006.

*Pennsylvania Turnpike Commission (“PTC”).* The PTC operates the Pennsylvania Turnpike System (“System”). Its outstanding indebtedness, \$2,746.9 million as of June 30, 2006, is payable from the net revenues of the System, primarily toll revenues and rentals from leases and concessions or from certain taxes dedicated to the System.

*State Public School Building Authority (“SPSBA”).* The SPSBA finances public school projects and community colleges. Bonds issued by the SPSBA are supported by the lease rental payments or loan repayments made to the SPSBA by local school districts and the community colleges. A portion of the funds appropriated annually by the Commonwealth as aid to local school districts and community colleges may be used by them to pay a portion of such lease rental payments or loan repayments. The SPSBA had \$1,415.3 million of revenue bonds outstanding as of June 30, 2006.

### **CITY OF PHILADELPHIA - PICA**

The Pennsylvania Intergovernmental Cooperation Authority (“PICA”) was created by Commonwealth legislation in 1991 to assist the City of Philadelphia, the Commonwealth’s largest city, in remedying its fiscal emergencies. PICA is authorized to provide assistance through the issuance of funding debt and to make factual findings and recommendations to Philadelphia concerning its budgetary and fiscal affairs. This financial assistance has included grants used by the City for defeasance of certain City general obligation bonds, funding of capital projects and the liquidation of the cumulative general fund balance deficit of the City of Philadelphia as of June 30, 1992, of \$224.9 million. At this time, Philadelphia is operating under a five-year fiscal plan approved by PICA on July 5, 2006.

No further bonds may be issued by PICA for the purpose of either financing capital projects or a deficit, as the authority for such bond issuance expired December 31, 1994. PICA’s authority to issue debt for the purpose of financing a cash flow deficit expired on December 31, 1995. Its ability to refund existing outstanding debt is unrestricted. PICA had \$674.3 million in special tax revenue bonds outstanding as of June 30, 2006. Neither the taxing power nor the credit of the Commonwealth is pledged to pay debt service on PICA’s bonds.

### **LITIGATION**

The Commonwealth’s Office of Attorney General and Office of General Counsel have reviewed the status of pending litigation against the Commonwealth, its officers and employees, and have provided the following brief descriptions of certain cases affecting the Commonwealth.

In 1978, the General Assembly approved a limited waiver of sovereign immunity. Damages for any loss are limited to \$250,000 for each person and \$1,000,000 for each accident. The Supreme Court of Pennsylvania has held that this limitation is constitutional. Approximately 3,150 suits against the Commonwealth remain open. Tort claim payments for the departments and agencies, other than the Department of Transportation, are paid from departmental and agency operating and program appropriations. Tort claim payments for the Department of Transportation are paid from an appropriation from the Motor License Fund. The Motor License Fund tort claim appropriation for fiscal year 2006 is \$20.0 million.

#### *County of Allegheny v. Commonwealth of Pennsylvania*

In December 1987, the Supreme Court of Pennsylvania held in *County of Allegheny v. Commonwealth of Pennsylvania* that the statutory scheme for county funding of the judicial system is in conflict with the Pennsylvania Constitution. However, the Supreme Court of Pennsylvania stayed its judgment to afford the General Assembly an opportunity to enact appropriate funding legislation consistent with its opinion and ordered that the prior system of county funding shall remain in place until this is done.

The Court appointed retired Justice Frank J. Montemuro, Jr. as special master to devise and submit a plan for implementation. The *Interim Report of the Master* recommended a four-phase transition to state funding of a unified judicial system, during each of which specified court employees would transfer into the state payroll system. Phase I

recommended that the General Assembly provide for an administrative structure of local court administrators to be employed by the Administrative Office of Pennsylvania Courts, a state agency. Numbering approximately 165 people statewide, local court administrators are employees of the counties in which they work. On June 22, 1999, the Governor approved Act No. 1999-12, under which approximately 165 county-level court administrators became employees of the Commonwealth. Act 12 also triggered the release of appropriations that had been made for this purpose in 1998 and 1999.

The remainder of Justice Montemuro's recommendation for later phases remains pending before the Supreme Court of Pennsylvania.

*Unisys Corporation v. Commonwealth*

Unisys challenged the statutory three-factor apportionment formula used for the apportionment of capital stock value in the franchise tax on constitutional and statutory (fairness) grounds. Unisys's argument is that, because the valuation formula requires the use of consolidated net worth, instead of separate company net worth, and the inclusion of dividends paid by subsidiary corporations, the apportionment factors should also include the property, payroll and sales of the subsidiary corporations, not just those of the taxpayer.

The case was argued before the Commonwealth Court *en banc*, which issued its decision on March 8, 1999. The court sustained the statute from the constitutional challenge in favor of the Commonwealth. However, it ruled in favor of the taxpayer's fairness argument, which was based on 72 P.S. §7401(3) 2. (a)(18). There were two dissents.

The Commonwealth appealed this decision to the Pennsylvania Supreme Court and Unisys cross-appealed. The Court held oral argument in December 2000. On October 25, 2002, the Court issued a decision reversing the holding of the Commonwealth Court and upholding the Commonwealth's statutory apportionment formula. Unisys filed an application for re-argument, which was denied. Unisys filed a petition for certiorari to the U.S. Supreme Court, which was denied. The decision in this matter denied relief to the taxpayer because it failed to carry its burden of proof and did not resolve the underlying issue. Thus, the decision has very limited applicability to the numerous cases pending which raise the identical issue and which collectively involve undetermined but significant dollars.

*Northbrook Life Insurance Co. v. Commonwealth*

This case is the lead case in potential litigation with the entire insurance industry that does business in Pennsylvania. Currently, the Commonwealth Court has docketed in excess of 40 cases representing 20 or more insurance companies. Dozens of additional cases are being held pending this litigation at the administrative boards.

The cases challenge the Department of Revenue's application of portions of the Life and Health Guarantee Association Act of 1982 (the "Act"). The Act establishes a funding mechanism to fulfill defaulted obligations of insurance companies under life and health insurance policies and annuities contracts to insured Pennsylvania residents. In accordance with this funding mechanism, other insurance companies are assessed to provide the funds due to Pennsylvania residents insured by insurance companies which have become insolvent or are otherwise in default to their insureds.

Because the assessed insurance companies are paying the insurance obligations of other companies, a provision was placed in the Act which allows assessed insurance companies to claim a credit against their gross premiums tax liability based on such assessments.

The assessments on each company are broken into various categories, including life insurance assessments, health insurance assessments, and annuity assessments, based on the type and amount of business each company transacts in Pennsylvania.

Life and health insurance premiums have always been subject to the premiums tax and there is no dispute that companies may claim credit for life and health assessments. Annuity considerations, however, were taxed for approximately a three-year period, 1992-1995. Some annuity considerations were subject to tax; others were not. After several changes of direction, the Department of Revenue decided to allow credits for assessments paid on taxable annuity considerations. Credits were not allowed for assessments paid on non-taxable annuities. There is no provision

in the insurance law that restricts the credit to only the assessments paid on taxable annuities. Taxpayers want the credit for assessments paid on all annuities, both during the period that annuities were taxed and going forward.

The case was argued before the Commonwealth Court *en banc* on December 14, 2005. On January 26, 2006, the *en banc* Court issued a conflicted decision in which the majority ruled for both parties. Exceptions will be filed by both parties and it is likely this case will not be finally resolved until another round before the *en banc* Commonwealth Court and then appeal to the Pennsylvania Supreme Court. It is impossible to predict the outcome. If taxpayers prevail on all issues, estimated refunds would total about \$150 million.

#### *Duquesne Light Co. v. Commonwealth*

There are several appeals involving various years and challenges to the capital stock tax, corporate net income tax and gross receipts tax. The taxpayer plaintiff raises various issues including whether it is entitled to the manufacturing exemption for capital stock tax purposes for the generation of electricity, whether gains realized from the sale of several power plants in Ohio are subject to corporate net income tax, where sales receipts should be sourced for corporate net income tax and gross receipts tax purposes, whether the value of mandatory redeemable stock should be included in capital stock value for capital stock tax purposes, and whether receipts from competitive transition charges are subject to gross receipts tax, franchise tax and corporate net income tax.

While in the discovery phase of litigation, the parties continued efforts to negotiate a settlement. The parties have reached a tentative agreement to settle all issues for the tax years in court except for those issues involving the taxability of receipts from the competitive transition charges for gross receipts tax, franchise tax and corporate net income tax. A settlement memorandum is expected to be prepared within the next few weeks. The parties will then proceed to litigate the issue of whether receipts from the competitive transition charges (stranded costs) are subject to capital stock tax, corporate net income tax and gross receipts tax. There is more than \$100 million in disputed tax.

### **RATINGS**

Moody's Investors Service ("Moody's") has assigned its municipal bond rating of "Aa2" to the Bonds, Standard and Poor's Ratings Services, a division of the McGraw-Hill Companies ("S&P") has assigned its municipal bond rating of "AA" to the Bonds, and Fitch Ratings ("Fitch") has assigned its municipal bond rating of "AA" to the Bonds. The ratings reflect only the views of the rating agencies.

The ratings are based upon current information furnished by the Commonwealth or obtained from other sources considered reliable by the rating agencies, which do not perform any audit in connection with any rating and may, on occasion, rely on unaudited financial information. Reference is made to the rating agencies' manuals for complete descriptions of their respective rating procedures and other rating categories, and to S&P's, Moody's and Fitch's discussions of the Commonwealth expected to be released in connection with their ratings.

A security rating is not a recommendation to buy, sell or hold securities. There is no assurance that such ratings will continue for any given period of time or that they will not be revised downward or withdrawn entirely if, in the opinion of the rating agencies, circumstances warrant such revision or withdrawal. Any such downward revision or withdrawal could have an adverse effect on the marketability or market price of the Bonds. The Commonwealth has not undertaken any responsibility after issuance of the Bonds to assure the maintenance of the ratings, to oppose any revision or withdrawal of the ratings by S&P, Moody's or Fitch or to inform the holders of the Bonds of any such revision or withdrawal, except as set forth under "CONTINUING DISCLOSURE."

### **VERIFICATION OF MATHEMATICAL COMPUTATIONS**

BondResources Partners, LP has verified the arithmetical accuracy of certain computations included in the schedules provided by Public Financial Management on behalf of the Commonwealth relating to (i) computation of forecasted receipts of principal and interest on the Escrow Obligations and the forecasted payments of principal and interest to redeem the Refunded Bonds, and (ii) computation of the yields on the Bonds and the Escrow Obligations was verified by BondResources Partners, LP. Such computations were based solely on assumptions and information supplied by Public Financial Management on behalf of the Commonwealth. BondResources Partners, LP has restricted

its procedures to verifying the arithmetical accuracy of certain computations and has not made any study or evaluation of the assumptions and information on which the computations are based, and accordingly, has not expressed an opinion on the data used, the reasonableness of the assumptions, or the achievability of the forecasted outcome.

## **FEDERAL TAX LAWS**

Numerous provisions of the Internal Revenue Code of 1986, as amended (the "Code"), affect the issuers of state and local government bonds, such as the Commonwealth, and impair or restrict the ability of the Commonwealth to finance projects on a tax-exempt basis. Failure on the part of the Commonwealth to comply with any one or more of such provisions of the Code, or any regulations under the Code, could render interest on the Bonds includable in the gross income of the owners thereof for purposes of federal income tax retroactively to the date of issuance of the Bonds. Among these provisions are more restrictive rules relating to: (a) investment of funds treated as proceeds of the Bonds; (b) the advance refunding of tax-exempt bonds; and (c) the use of proceeds of the Bonds to benefit private activities. In addition, under the Code, the Commonwealth is required to file an information return with respect to the Bonds and, if applicable, to "rebate" to the federal government certain arbitrage profits on an ongoing basis throughout the term of the issue constituting the Bonds. Bond Counsel has not undertaken to determine (or to inform any person) whether any action taken (or not taken) or events occurring (or not occurring) after the date of issuance of the Bonds may affect the tax status of interest on the Bonds.

Other provisions of the Code affect the purchasers and holders of certain state and local government bonds, such as the Bonds. Prospective purchasers of the Bonds should be aware that: (i) Section 265 of the Code denies a deduction for interest on (a) indebtedness incurred or continued to purchase or carry certain state or local government bonds, such as the Bonds, or, (b) in the case of a financial institution, that portion of a financial institution's interest expense allocated to interest on certain state or local government bonds, such as the Bonds, unless the issuer of the state or local government bonds designates the bonds as "qualified tax-exempt obligations" for the purpose and effect contemplated by Section 265(b)(3)(B) of the Code (the Commonwealth has not designated the Bonds as "qualified tax-exempt obligations" under Section 265(b)(3) of the Code, as such phrase is defined in the Code); (ii) certain corporations must take into account interest on certain state or local government bonds, such as the Bonds, in determining adjusted current earnings for the purpose of computing the alternative minimum tax imposed on such corporations; (iii) with respect to insurance companies subject to the tax imposed by Section 831 of the Code, Section 832 (b)(5)(B)(1) reduces the deduction for loss reserves by 15% of the sum of certain items, including interest and amounts treated as such on certain state or local bonds such as the Bonds; (iv) interest on certain state or local government bonds, such as the Bonds, earned by certain foreign corporations doing business in the United States could be subject to a branch profits tax imposed by Section 884 of the Code, (v) if a Subchapter S corporation has passive investment income (which passive investment income will include interest on state and local government bonds such as the Bonds) exceeding 25% of such Subchapter S corporation's gross receipts and if such Subchapter S corporation has Subchapter "C" earnings and profits, then interest income derived from state and local government bonds, such as the Bonds, may be subject to federal income tax under Section 1375 of the Code; and (vi) Section 86 of the Code requires recipients of certain Social Security and certain Railroad Retirement benefits to take into account, in determining gross income, receipts or accruals of interest on certain state or local government bonds such as the Bonds.

THE ABOVE SUMMARY OF POSSIBLE TAX CONSEQUENCES IS NOT EXHAUSTIVE. ALL PURCHASERS OF THE BONDS SHOULD CONSULT THEIR TAX ADVISORS REGARDING THE POSSIBLE FEDERAL INCOME TAX CONSEQUENCES OF OWNERSHIP OF THE BONDS.

## **TAX MATTERS**

### **Federal Tax Exemption**

In the opinion of Stradley Ronon Stevens & Young, LLP, Bond Counsel, assuming the accuracy of the certifications of the Commonwealth and continuing compliance by the Commonwealth with the requirements of the Internal Revenue Code of 1986, as amended, and the regulations thereunder (the "Code"), interest on the Bonds is excludable from gross income for purposes of federal income tax under existing laws as enacted and construed on the date of initial delivery of the Bonds. Interest on the Bonds is not an item of tax preference for purposes of either

individual or corporate federal alternative minimum tax, but interest on Bonds held by a corporation (other than an S corporation, regulated investment company, real estate investment trust or real estate mortgage investment conduit) may be indirectly subject to federal alternative minimum tax because of its inclusion in the adjusted current earnings of the corporate holder. Interest on Bonds held by foreign corporations may be subject to the branch profits tax imposed by the Code. Other provisions of the Code will affect certain purchasers and holders of the Bonds. See “FEDERAL TAX LAWS” above.

Certain of the Bonds are offered at a discount (“original issue discount”) equal to the difference between public offering price and principal amount. For federal income tax purposes, original issue discount on a Bond accrues periodically over the term of the Bond as interest with the same tax exemption and alternative minimum tax status as regular interest. The accrual of original issue discount increases the holder’s tax basis in the Bond for determining taxable gain or loss from sale or from redemption prior to maturity. Purchasers of any Bond at an original issue discount should consult their tax advisors regarding the determination and treatment of original issue discount for federal income tax purposes, an explanation of the accrual rules and with respect to state and local tax consequences of owning such Bonds.

Certain of the Bonds are offered at a premium (“original issue premium”) over their principal amount. For federal income tax purposes, original issue premium is amortizable periodically over the term of a Bond through reductions in the holder’s tax basis for the Bond for determining taxable gain or loss from sale or from redemption prior to maturity. Amortizable premium is accounted for as reducing the tax-exempt interest on the Bond rather than creating a deductible expense or loss. Purchasers of any Bond at a premium, whether at the time of initial issuance or subsequent thereto, should consult their tax advisors with respect to the determination and treatment of premium for federal income tax purposes, an explanation of the amortization rules and with respect to state and local tax consequences of owning such Bonds.

Ownership of the Bonds may result in collateral federal income tax consequences to certain taxpayers, including, without limitation, financial institutions, property and casualty insurance companies, individual recipients of Social Security or Railroad Retirement benefits, certain S corporations and taxpayers who may be deemed to have incurred or continued indebtedness to purchase or carry the Bonds. Bond Counsel expresses no opinion as to these matters. Prospective purchasers of the Bonds should consult with their tax advisors as to applicability of any such collateral consequences.

The Code sets forth certain requirements, which must be met subsequent to the issuance and delivery of the Bonds for interest thereon to remain excludible from the gross income of the owners of the Bonds for federal income tax purposes. The Commonwealth has covenanted to comply with such requirements. Noncompliance with such requirements may cause the interest on the Bonds to be includible in the gross income of the owners of the Bonds for federal income tax purposes, retroactive to the date of issue of the Bonds. The opinion of Bond Counsel assumes compliance with such covenants and Bond Counsel has not undertaken to determine (or to inform any person) whether any actions taken (or not taken) or events occurring (or not occurring) after the date of issuance of the Bonds may affect the tax status of interest on the Bonds.

### **Pennsylvania Tax Exemption**

In the opinion of Bond Counsel, under the laws of the Commonwealth of Pennsylvania as enacted and construed on the date of original issuance of the Bonds, interest on the Bonds is exempt from Pennsylvania personal income tax and corporate net income tax, and the Bonds are exempt from personal property taxes in Pennsylvania.

THE ABOVE SUMMARY OF POSSIBLE TAX CONSEQUENCES IS NOT EXHAUSTIVE OR COMPLETE. ALL PURCHASERS OF THE BONDS SHOULD CONSULT THEIR TAX ADVISORS REGARDING THE POSSIBLE FEDERAL, STATE AND LOCAL TAX CONSEQUENCES OF OWNERSHIP OF THE BONDS. ANY STATEMENTS REGARDING TAX MATTERS HEREIN CANNOT BE RELIED UPON BY ANY PERSON TO AVOID TAX PENALTIES.

## **Regulations-Future Legislation**

Under the provisions of the Code, the Treasury Department is authorized and empowered to promulgate regulations implementing the intent of Congress under the Code which could affect the tax-exemption and/or tax consequences of holding tax-exempt obligations, such as the Bonds. In addition, legislation may be introduced and enacted in the future which could change the provisions of the Code relating to tax-exempt notes of a state or local government unit, such as the Commonwealth, or the taxability of interest in general.

No representation is made or can be made by the Commonwealth or any other party associated with the issuance of the Bonds as to whether or not any other legislation now or hereafter introduced and enacted will be applied retroactively so as to subject interest on the Bonds to federal income taxes or so as to otherwise affect the marketability or market value of the Bonds.

EACH PURCHASER OF THE BONDS SHOULD CONSULT HIS OR HER OWN TAX ADVISOR REGARDING ANY CHANGES IN THE STATUS OF PENDING OR PROPOSED FEDERAL TAX LEGISLATION.

## **UNDERWRITING**

After competitive bidding on December 5, 2006, the Bonds were awarded to a selling group represented by Merrill Lynch & Co. (the "Underwriters") for a purchase price of \$ 993,615,884.40 which is equivalent to the principal amount of the Bonds, less underwriters' discount of \$1,548,846.50 plus original issue premium, net of original issue discount, of \$44,494,730.90. The Underwriters have supplied the public offering yields of the Bonds shown on the front cover hereof. If all of the Bonds are resold to the public at such yields, the underwriters' discount will approximate 0.162922 percent of the aggregate principal amount of the Bonds. The Underwriters may change the public offering yields from time to time.

## **LEGALITY FOR INVESTMENT**

Under the Pennsylvania Probate, Estates and Fiduciaries Code, the Bonds are authorized investments for fiduciaries, as defined in that code, within the Commonwealth of Pennsylvania. The Bonds are legal investments for Pennsylvania savings banks, banks, bank and trust companies, and insurance companies and are acceptable as security for deposits of funds of the Commonwealth. The Bonds are eligible for purchase, dealing in, underwriting and unlimited holding by national banking associations pursuant to regulations promulgated by the Comptroller of the Currency set forth in the Code of Federal Regulations, Title 12—Banks and Banking, Sections 1.3(c) and 1.4.

## **FINANCIAL ADVISOR**

Public Financial Management, Philadelphia, Pennsylvania, is serving as independent Financial Advisor to the Commonwealth with respect to the Bonds (the "Financial Advisor"). The Financial Advisor's fees in connection with the issuance of the Bonds are expected to be paid from Bond proceeds.

## **LEGAL MATTERS**

All legal matters incident to the authorization and issuance of the Bonds are subject to the approval of the Attorney General of the Commonwealth of Pennsylvania, The Honorable Tom Corbett, and of Stradley Ronon Stevens & Young, LLP, Philadelphia, Pennsylvania, Bond Counsel. A copy of the opinion of Bond Counsel will accompany the Bonds delivered to DTC. Copies of the opinion of the Attorney General, together with additional copies of the opinion of Bond Counsel, will be available at the time of delivery of the Bonds. Proposed forms of these opinions are included as Appendices F and G respectively.

Hunton & Williams LLP, Richmond, Virginia, serves as a special disclosure counsel to the Commonwealth in connection with its general obligation bonds.

## ADDITIONAL INFORMATION

Periodic public reports relating to the financial condition of the Commonwealth are prepared by the Office of the Budget. These reports and additional information may be obtained upon request from the office of the Secretary of the Budget, Mr. Michael Masch, Attn.: Mr. Richard Dreher, 7th Floor, Bell Tower, 303 Walnut Street, Harrisburg, Pennsylvania 17101-1808 (Telephone (717) 783-3086). The annual Comprehensive Annual Financial Report (“CAFR”), a summary of the enacted fiscal year 2007 budget and certain other information are available in the Budget and Financial Reports section of the Office of the Budget’s web site on the World Wide Web, <http://www.budget.state.pa.us>.

## CONTINUING DISCLOSURE

The Commonwealth will execute a written agreement (the “Continuing Disclosure Agreement”) for the benefit of the beneficial owners of the Bonds in order to assist the Underwriters in meeting the requirements of Rule 15c2-12 (the “Rule”) promulgated by the Securities and Exchange Commission. The Continuing Disclosure Agreement will require the Commonwealth to:

- (i) File not later than 240 days following the end of each of the Commonwealth’s fiscal years, Annual Financial Statements and Annual Operating Data, as defined below, with each then-existing NRMSIR, or to DisclosureUSA or a similar central repository approved by the Securities and Exchange Commission (a “Central Repository”), and if one is established and then in operation, with any State Information Depository (“SID”) for the Commonwealth of Pennsylvania;
- (ii) File in a timely manner to each NRMSIR or a Central Repository (and any SID then existing) notice of certain specified events listed below; and
- (iii) File with either each NRMSIR, a Central Repository, or the Municipal Securities Rulemaking Board (and with any SID then existing) notice of any failure of the Commonwealth to file the information required by (i) above.

*Annual Financial Information.* It is expected that the financial statements to be filed annually as provided by (i) above will be audited financial statements. The Continuing Disclosure Agreement, however, permits the filing of unaudited financial statements if audited financial statements are not available by the 240-day deadline, with audited financial statements to be filed as soon as they are available. The Annual Operating Data will be operating data of the type contained in this Official Statement in the following tables:

- (i) Tables 5 through 12 under the heading “COMMONWEALTH FINANCIAL PERFORMANCE”;
- (ii) Tables 15 and 17 through 18 under the heading “OUTSTANDING INDEBTEDNESS OF THE COMMONWEALTH”; and
- (iii) Tables 20 through 23 under the heading “OTHER STATE-RELATED OBLIGATIONS.”

If any of the tables listed above reflect information that is no longer calculated and available or relevant because of changes in operations, the Commonwealth will provide notice of such change in the first annual filing of Annual Operating Data after such changes are undertaken. The format of the tables also may be altered.

*Event Disclosure.* The Continuing Disclosure Agreement requires the Commonwealth to provide timely notice to each NRMSIR or a Central Repository (and any SID then existing) of the following events if such events are material with respect to the Bonds:

- \* principal and interest payment delinquencies;
- \* nonpayment related defaults;
- \* unscheduled draws on debt service reserves reflecting financial difficulties;
- \* unscheduled draws on credit enhancements reflecting financial difficulties;
- \* substitution of credit or liquidity providers, or their failure to perform;
- \* adverse tax opinions or events affecting the tax-exempt status of the Bonds;
- \* modifications to the rights of holders of the Bonds;
- \* Bond calls;
- \* defeasances;



- \* release, substitution, or sale of property securing repayment of the Bonds; and
- \* rating changes.

The eleven events listed above are specified by the Rule but some of them may not be relevant to the Bonds.

*Limitations, Remedy and Amendments.* The Continuing Disclosure Agreement requires the Commonwealth to provide only limited information at limited times, and such information may not include all information necessary to determine the value of the Bonds at any time. The Commonwealth may also make other information available on a voluntary basis, but it is not contractually obligated to do so. See “ADDITIONAL INFORMATION” herein for the availability of other information from the Commonwealth’s Office of the Budget.

The sole and exclusive remedy for any breach by the Commonwealth of its obligations under the Continuing Disclosure Agreement is an action to compel specific performance by the Commonwealth of its obligations. No assurance can be provided as to the outcome of any such proceeding. A breach by the Commonwealth of its obligations under the Continuing Disclosure Agreement does not constitute a default under the Bonds.

The Commonwealth reserves the right to amend the Continuing Disclosure Agreement consistent with the provisions of the Rule as then in effect.

The Commonwealth has never failed to comply in all material respects with any previous continuing disclosure undertaking.

*NRMSIRs.* As of the date of this Official Statement, the Securities and Exchange Commission has recognized the following NRMSIRs:

Bloomberg Municipal Repository  
 100 Business Park Drive  
 Skillman, NJ 08558  
 Phone: (609) 279-3225  
 Fax: (609) 279-5962  
 E-mail: [munis@bloomberg.com](mailto:munis@bloomberg.com)

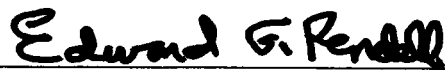
Standard & Poor’s Securities Evaluations, Inc.  
 55 Water Street  
 45<sup>th</sup> Floor  
 New York, NY 10041  
 Phone: (212) 438-4595  
 Fax: (212) 438-3975  
 E-mail: [nrmsir\\_repository@sandp.com](mailto:nrmsir_repository@sandp.com)

DPC Data Inc  
 One Executive Drive  
 Fort Lee, NJ 07024  
 Phone: (201) 346-0701  
 Fax: (201) 947-0107  
 E-mail: [nrmsir@dpccdata.com](mailto:nrmsir@dpccdata.com)

FT Interactive Data  
 Attn: NRMSIR  
 100 William Street  
 New York, NY 10038  
 Phone (212) 771-6999  
 Fax: (212) 771-7390  
 E-mail: [nrmsir@interactivedata.com](mailto:nrmsir@interactivedata.com)

A current list of all NRMSIRs can be obtained at any time from the Securities and Exchange Commission. The Commonwealth makes no representation as to the scope of services provided to the secondary market by any NRMSIR or as to the costs of any such services.

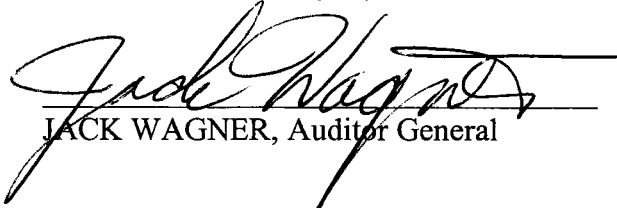
The execution of this Official Statement has been authorized in the Resolutions.



EDWARD G. RENDELL, Governor



ROBERT P. CASEY, Jr., State Treasurer



JACK WAGNER, Auditor General

**CERTIFICATE OF THE AUDITOR GENERAL**  
**Pursuant to**  
**ARTICLE VIII, SECTION 7(a)(4) and (c)**  
**of the**  
**CONSTITUTION OF PENNSYLVANIA**  
**and**  
**Section 304 of the Capital Facilities Debt Enabling Act**

To the Governor and the General Assembly:

I, Jack Wagner, Auditor General of the Commonwealth of Pennsylvania, pursuant to the Pennsylvania Constitution Article VIII, (Section 7(a)(4) and Section 304 of Capital Facilities Debt Enabling Act (Act 1 of 1999) certify as follows:

The average annual tax revenues deposited in all funds in the five fiscal years ended preceding the date of August 31, 2006 .....	\$ 27,536,515,720
(i) The amount of outstanding net debt as of the end of the preceding fiscal year .....	\$ 6,487,618,757
(ii) The amount of such net debt as of February 28, 2006.....	\$ 6,399,655,454
(iii) The difference between the limitation upon all net debt outstanding as provided in Article VIII, Section 7 (a) (4) of the Constitution of Pennsylvania and the amount of such net debt as of the date of August 31, 2006 .....	\$ 41,789,247,056
(iv) The amount of such debt scheduled to be repaid during the remainder of the current fiscal year .....	\$ 371,462,789
(v) The amount of debt authorized by law to be issued, but not yet incurred .....	\$ 57,015,471,468
(vi) The amount of outstanding obligations excluded from outstanding debt as self sustaining pursuant to Article VIII, Section 7(c)(1), (2) and (3) of the Constitution of Pennsylvania .....	\$ 4,779,120,224

IN TESTIMONY WHEREOF, I have set my hand and affixed the seal of the Auditor General, this 9th day of November 2006.

(Seal)	/s/Jack Wagner JACK WAGNER Auditor General Commonwealth of Pennsylvania
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## SELECTED DATA ON THE COMMONWEALTH OF PENNSYLVANIA

### General

The Commonwealth of Pennsylvania is one of the most populous states, ranking sixth behind California, Texas, New York, Florida, and Illinois. Pennsylvania is an established state with a diversified economy. Pennsylvania had been historically identified as a heavy industrial state. That reputation has changed over the last thirty years as the coal, steel and railroad industries declined. The Commonwealth's business environment readjusted with a more diversified economic base. This economic readjustment was a direct result of a long-term shift in jobs, investment, and workers away from the northeast part of the nation. Currently, the major sources of growth in Pennsylvania are in the service sector, including trade, medical, health services, education and financial institutions.

Pennsylvania's agricultural industries remain an important component of the Commonwealth's economic structure, accounting for more than \$4.8 billion in crop and livestock products annually. In 2005, agribusiness and food related industries reached record export sales surpassing \$1 billion in economic activity. Over 58,000 farms form the backbone of the State's agricultural economy. Farmland in Pennsylvania includes over four million acres of harvested cropland and three million acres of pasture and farm woodlands - nearly one-third of the Commonwealth's total land area. Agricultural diversity in the Commonwealth is demonstrated by the fact that Pennsylvania ranks among the top ten states in the production of a variety of agricultural products. Agriculture exports have grown by more than 4% since 2003.

Pennsylvania's extensive public and private forests provide a vast source of material for the lumber, furniture, and paper products industries. The forestry and related industries accounts for 1.5% of employment with economic activity of nearly \$5 billion in domestic and international trade. Additionally, the Commonwealth derives a good water supply from underground sources, abundant rainfall, and a large number of rivers, streams, and lakes. Other natural resources include major deposits of coal, petroleum, and natural gas. Annually, about 80 million tons of anthracite and bituminous coal, 175 billion cubic feet of natural gas, and about 1.4 million barrels of oil are extracted from Pennsylvania.

Pennsylvania is a Mid-Atlantic state within easy reach of the populous eastern seaboard and, as such, is the keystone to the Midwest. A comprehensive transportation grid enhances the Commonwealth's strategic geographic position. The Commonwealth's water systems afford the unique feature of triple port coverage, a deep-water port at Philadelphia, a Great Lakes port at Erie and an inland water port at Pittsburgh. Between air, rail, water, and road, Pennsylvania is easily accessible for both inter and intra state trade and commerce.

## Population

The Commonwealth is highly urbanized. Of the Commonwealth's 2005 mid-year population estimate, 79 percent resided in the 15 Metropolitan Statistical Areas ("MSAs") of the Commonwealth. The largest MSAs in the Commonwealth are those that include the cities of Philadelphia and Pittsburgh, which together contain almost 44 percent of the State's total population. The population of Pennsylvania, 12.4 million people in 2005, according to the U.S. Bureau of the Census, represents a population growing slower than the nation with a higher portion than the nation or the region comprised of persons 45 or over. The following tables present the population trend from 1996 to 2005 and the age distribution of the population for 2005.

### Population Trends Pennsylvania, Middle Atlantic Region and the United States 1996-2005

As of <u>July 1</u>	Total Population In Thousands			Total Population as a % of 1996 base		
	<u>PA</u>	<u>Middle Atlantic Region<sup>(a)</sup></u>	<u>U.S.</u>	<u>PA</u>	<u>Middle Atlantic Region<sup>(a)</sup></u>	<u>U.S.</u>
1996 .....	12,038	38,191	265,228	100%	100%	100%
1997 .....	12,015	38,213	267,783	99	100	101
1998 .....	12,002	38,257	270,248	99	100	102
1999 .....	11,994	38,334	272,690	99	100	103
2000 .....	12,286	38,718	282,193	102	101	107
2001 .....	12,296	39,892	285,108	102	104	108
2002 .....	12,324	40,065	287,985	102	105	109
2003 .....	12,365	40,233	290,850	102	105	110
2004 .....	12,394	40,360	293,657	103	105	111
2005 .....	12,430	40,402	296,410	103	105	112

<sup>(a)</sup> Middle Atlantic Region: Pennsylvania, New York, New Jersey  
Source: U.S. Department of Commerce, Bureau of the Census

### Population By Age Group — 2005 Pennsylvania, Middle Atlantic Region and the United States

<u>Age</u>	<u>Pennsylvania</u>	<u>Middle Atlantic Region<sup>(a)</sup></u>	<u>United States</u>
Under 5 years .....	5.8 %	6.3 %	7.0 %
5-24 years .....	26.3	26.5	27.5
25-44 years .....	26.4	28.1	28.4
45-64 years .....	26.3	25.4	25.0
65 years and over.....	15.2	13.7	12.1

<sup>(a)</sup> Middle Atlantic Region: Pennsylvania, New York, New Jersey.  
Source: U.S. Department of Commerce, Bureau of the Census

## Employment

Non-agricultural employment in Pennsylvania over the ten years ending in 2005 increased at an average annual rate of 0.8 percent compared with a 0.8 percent rate for the Middle Atlantic region and 1.2 percent rate for the U.S. The following table shows employment trends from 1996 through 2005.

### Non-Agricultural Establishment Employment Trends Pennsylvania, Middle Atlantic Region and the United States 1996-2005

Calendar Year	Total Establishment Employment In Thousands			Total Establishment Employment as a % of 1996 base		
	PA	Middle Atlantic Region <sup>(a)</sup>	U.S.	PA	Middle Atlantic Region <sup>(a)</sup>	U.S.
1996 .....	5,306	16,884	119,708	100 %	100 %	100 %
1997 .....	5,406	17,198	122,776	102	102	103
1998 .....	5,495	17,532	125,930	104	104	105
1999 .....	5,586	17,943	128,993	105	106	108
2000 .....	5,691	18,321	131,785	107	109	110
2001 .....	5,682	18,271	131,826	107	108	110
2002 .....	5,640	18,083	130,341	106	107	109
2003 .....	5,611	17,997	129,999	106	117	109
2004 .....	5,644	18,105	131,435	106	107	110
2005 .....	5,704	18,275	133,463	108	108	111

<sup>(a)</sup> Middle Atlantic Region: Pennsylvania, New York, New Jersey.  
Source: U.S. Department of Labor, Bureau of Labor Statistics.

Non-manufacturing employment in Pennsylvania has increased in recent years and reached 88 percent of total employment by 2005. Consequently, manufacturing employment constitutes a diminished share of total employment within the Commonwealth. Manufacturing, contributing 12.0 percent of 2005 non-agricultural employment, has fallen behind both the services sector and the trade sector as the largest single source of employment within the Commonwealth. In 2005, the services sector accounted for 43.9 percent of all non-agricultural employment while the trade sector accounted for 16.4 percent. The following table shows trends in employment by sector for Pennsylvania from 2001 through 2005.

**Non-Agricultural Establishment Employment by Sector**  
**Pennsylvania**  
**2001-2005**  
(In Thousands)

	CALENDAR YEAR									
	2001		2002		2003		2004		2005	
	Employees	%	Employees	%	Employees	%	Employees	%	Employees	%
Manufacturing:										
Durable.....	492.1	8.7	448.8	8.0	418.3	7.5	412.0	7.3	412.9	7.2
Non-Durable.....	328.5	5.8	310.1	5.5	293.3	5.2	278.1	4.9	268.9	4.7
Total										
Manufacturing <sup>(d)</sup> .....	820.6	14.4	758.9	13.5	711.6	12.7	690.1	12.2	681.8	12.0
Non-Manufacturing:										
Trade <sup>(a)</sup> .....	899.4	15.8	890.8	15.8	888.0	15.8	892.0	15.8	935.4	16.4
Finance <sup>(b)</sup> .....	338.3	6.0	336.2	6.0	337.9	6.0	335.7	5.9	335.6	5.9
Services.....	2,397.0	42.2	2,421.3	42.9	2,438.7	43.5	2,486.8	44.1	2,506.7	43.9
Government.....	728.3	12.8	738.9	13.1	745.6	13.3	744.4	13.2	745.3	13.1
Utilities <sup>(c)</sup> .....	230.5	4.1	228.6	4.1	226.6	4.0	228.0	4.0	226.3	4.0
Construction.....	249.9	4.4	248.1	4.4	245.7	4.4	249.2	4.4	253.8	4.4
Mining.....	18.5	0.3	18.0	0.3	17.2	0.3	18.0	0.3	18.8	0.3
Total										
Non-Manufacturing <sup>(d)</sup> .....	4,861.9	85.6	4,881.9	86.3	4,899.7	87.3	4,954.1	87.8	5,021.9	88.0
Total Employees <sup>(d)(e)</sup> .....	5,682.5	100.0	5,640.8	99.8	5,611.3	100.0	5,644.2	100.0	5,703.7	100.0

<sup>(a)</sup> Wholesale and retail trade.

<sup>(b)</sup> Finance, insurance and real estate.

<sup>(c)</sup> Includes transportation, communications, electric, gas and sanitary services.

<sup>(d)</sup> Discrepancies occur due to rounding.

<sup>(e)</sup> Does not include workers involved in labor-management disputes.

Source: PA Bureau of Labor & Industry

The following table presents the percentages of non-agricultural employment in various sectors in Pennsylvania and the United States in 2005.

**Non-Agricultural Establishment Employment by Sector**  
**Pennsylvania and the United States**

	2005 Calendar Year	
	Pennsylvania	United States
Manufacturing.....	12.0%	10.6%
Trade <sup>(a)</sup> .....	16.4	16.2
Finance <sup>(b)</sup> .....	5.9	6.1
Services.....	43.9	42.1
Government.....	13.1	16.3
Utilities <sup>(c)</sup> .....	4.0	2.9
Construction.....	4.4	5.4
Mining.....	0.3	0.4
Total <sup>(d)</sup> .....	100.0%	100.0%

<sup>(a)</sup> Wholesale and retail trade.

<sup>(b)</sup> Finance, insurance and real estate.

<sup>(c)</sup> Includes transportation, communications, electric, gas and sanitary services.

<sup>(d)</sup> Discrepancies occur due to rounding.

Source: U.S. Department of Labor, Bureau of Labor Statistics.



Within the manufacturing sector of Pennsylvania's economy, which now accounts for less than one-eighth of total non-agricultural employment in Pennsylvania, the fabricated metals industries employed the largest number of workers. Employment in fabricated metals industries was 13.2 percent of Pennsylvania manufacturing employment but only 0.1 percent of total Pennsylvania non-agricultural employment in 2005. The following table shows trends in manufacturing employment by industry for Pennsylvania from 2001 through 2005.

**Manufacturing Establishment Employment by Industry**  
**Pennsylvania**  
**2001-2005**  
(In Thousands)

	2001		2002		2003		2004		2005	
	Employees	%	Employees	%	Employees	%	Employees	%	Employees	%
Durable Goods:										
Primary Metals.....	53.7	7.8	48.3	6.4	44.6	6.3	43.1	6.2	42.7	6.3
Fabricated Metals.....	101.1	9.2	94.9	12.5	88.9	12.5	88.6	12.8	90.3	13.2
Machinery (excluding electrical)....	68.2	11.4	60.5	8.0	56.0	7.9	54.8	7.9	55.3	8.1
Electrical Equipment.....	29.8	8.1	26.6	3.5	25.4	3.6	25.6	3.7	25.8	3.8
Transportation Equipment....	50.5	5.5	44.4	5.9	41.5	5.8	42.7	6.2	43.8	6.4
Furniture Related Products.....	26.6	4.1	25.5	3.4	24.4	3.4	24.4	3.5	23.9	3.5
Other Durable Goods.....	162.2	11.5	148.6	19.6	137.5	19.3	132.8	19.2	131.1	19.2
Total Durable Goods <sup>(a)</sup> .....	492.1	57.7	448.8	59.1	418.3	58.8	412.0	59.7	412.9	60.6
Non-Durable Goods:										
Pharmaceutical/Medicine...	25.8	4.3	27.2	3.6	25.6	3.6	22.6	3.3	21.9	3.2
Food Products.....	76.7	9.0	75.1	9.9	74.5	10.5	72.6	10.5	71.3	10.5
Chemical Products.....	61.9	7.3	61.4	8.1	57.8	8.1	53.0	7.7	51.8	7.6
Printing and Publishing.....	44.4	8.7	41.1	5.4	39.3	5.5	37.7	5.5	37.0	5.4
Plastics/Rubber Products.....	47.5	2.3	44.5	5.9	42.0	5.9	40.9	5.9	39.9	5.9
Paper Products.....	32.8	3.9	30.5	4.0	28.8	4.0	27.6	4.0	26.9	3.9
Other Non-Durable Goods...	39.4	6.8	30.3	4.0	25.3	3.6	23.7	3.4	20.1	2.9
Total Non-Durable Goods <sup>(a)</sup> .....	328.5	42.5	310.1	40.9	293.3	41.2	278.1	40.3	268.9	39.4
Total Manufacturing Employees <sup>(a)</sup> .....	820.6	100.0	758.9	100.0	711.6	100.0	690.1	100.0	681.8	100.0

<sup>(a)</sup> Discrepancies occur due to rounding

Source: U.S. Department of Labor, Bureau of Labor Statistics.

## Unemployment

Pennsylvania's annual average unemployment rate was equivalent to the national average throughout the 2000's. Slower economic growth caused the unemployment rate in the Commonwealth to rise to 5.7 percent in 2003. The resumption of faster economic growth resulted in a decrease in the Commonwealth's annual unemployment rate to 5.0 percent in 2005. From 1996 through 2005, Pennsylvania's annual average unemployment rate was at or below the Middle Atlantic Region's average. Since 2002 Pennsylvania's annual average has been at or below both the Middle Atlantic and the United States. As of July 2006, the most recent month for which figures are available, Pennsylvania had a seasonally adjusted annual unemployment rate of 4.8 percent. The following table represents the annual non-adjusted unemployment rate in Pennsylvania, the Middle Atlantic Region, and the United States from 1996 through 2005.

**Annual Average Unemployment Rate  
Pennsylvania, Middle Atlantic Region and the United States  
1996-2005**

<u>Calendar Year</u>	<u>Pennsylvania</u>	<u>Middle Atlantic Region<sup>(a)</sup></u>	<u>United States</u>
1996 .....	5.4 %	6.0 %	5.4 %
1997 .....	5.1	5.8	4.9
1998 .....	4.6	5.1	4.5
1999 .....	4.4	4.8	4.2
2000 .....	4.2	4.2	4.0
2001 .....	4.8	4.7	4.7
2002 .....	5.6	5.9	5.8
2003 .....	5.7	6.1	6.0
2004 .....	5.4	5.5	5.5
2005 .....	5.0	4.9	5.1

<sup>(a)</sup> Middle Atlantic Region: Pennsylvania, New York, New Jersey.  
Source: U.S. Department of Labor, Bureau of Labor Statistics.

The following table presents the thirty largest non-governmental employers in Pennsylvania:

**Commonwealth of Pennsylvania  
Thirty Largest  
Non-Governmental Employers  
December 2005**

<u>Company</u>	<u>Rank</u>	<u>Company</u>	<u>Rank</u>
Wal-Mart Associates .....	1	Lowe's Home Centers Inc.....	16
University of Pennsylvania .....	2	US Airways Inc .....	17
Pennsylvania State University .....	3	Vanguard Group Inc. ....	18
United Parcel Service Inc .....	4	Target Div of Target Corp.....	19
Giant Food Stores .....	5	Pennsylvania Blue Shield .....	20
University of Pittsburgh .....	6	Temple University .....	21
Weis Markets Inc .....	7	May Department Stores Co.....	22
UPMC Presbyterian .....	8	Verizon Pennsylvania Inc.....	23
Merck & Co Inc.....	9	GMR Restaurants of Pennsylvania Inc .....	24
Giant Eagle Inc.....	10	Acme Markets Inc .....	25
KMART of Pennsylvania LP.....	11	Eat'n Park Restaurants Inc .....	26
The Home Depot USA INC.....	12	The Children Hospital of Philadelphia.....	27
PNC Bank NA .....	13	Wachovia Bank .....	28
Sears Roebuck & Co.....	14	J C Penney Company Inc .....	29
Heartland Employment.....	15	Hershey Foods Corporation .....	30

Source: Pennsylvania Department of Labor, Office of Employment Security.

## Personal Income

Personal income in the Commonwealth for 2005 is \$433.75 billion, an increase of 5.0 percent over the previous year. During the same period, national personal income increased at a rate of 5.6 percent. Based on the 2005 personal income estimates, per capita income for 2005 is at \$34,897 in the Commonwealth compared to per capita income in the United States of \$34,586. The following tables represent annual personal income data and per capita income from 1996 through 2005.

### Personal Income Pennsylvania, Mideast Region and the United States 1996-2005

Year	Total Personal Income Dollars in Millions			Total Personal Income As a % of 1996 base		
	PA	Mideast Region <sup>(a)</sup>	U.S. <sup>(b)</sup>	PA	Mideast Region <sup>(a)</sup>	U.S.
1996 .....	\$ 297,493	\$1,252,041	\$ 6,512,485	100 %	100 %	100 %
1997 .....	311,508	1,319,270	6,907,332	105	105	106
1998 .....	330,160	1,404,640	7,415,709	111	112	113
1999 .....	342,610	1,467,261	7,796,137	115	117	119
2000 .....	364,837	1,580,733	8,422,074	122	126	129
2001 .....	372,339	1,627,895	8,716,992	125	130	133
2002 .....	382,251	1,648,004	8,872,871	128	132	136
2003 .....	392,791	1,686,808	9,157,257	132	135	140
2004 .....	412,890	1,790,581	9,705,504	138	143	149
2005 .....	433,752	1,890,698	10,251,639	145	151	157

<sup>(a)</sup> Mideast Region: Pennsylvania, New York, New Jersey, Maryland, District of Columbia, and Delaware.

<sup>(b)</sup> Sum of States.

Source: U.S. Department of Commerce, Bureau of Economic Analysis

### Per Capita Income Pennsylvania, Mideast Region and the United States 1996-2005

Calendar Year	Per Capita Income			As a % of U.S.	
	PA	Mideast Region <sup>(a)</sup>	U.S.	PA	Mideast Region <sup>(a)</sup>
1996 .....	\$ 24,344	\$ 27,588	\$ 24,175	101 %	114 %
1997 .....	25,475	28,944	25,334	101	114
1998 .....	26,961	30,654	26,883	100	114
1999 .....	27,937	31,824	27,939	100	114
2000 .....	29,695	34,076	29,845	99	114
2001 .....	30,281	34,906	30,574	99	112
2002 .....	31,016	35,155	30,810	101	114
2003 .....	31,767	35,797	31,484	101	114
2004 .....	33,312	37,851	33,050	101	115
2005 .....	34,897	39,891	34,586	101	115

<sup>(a)</sup> Mideast Region: Pennsylvania, New York, New Jersey, Maryland, District of Columbia, and Delaware.

Source: U.S. Department of Commerce, Bureau of Economic Analysis

The following table presents growth rates in personal income and selected components of personal income for Pennsylvania, the Mideast Region and the United States from 2001 through 2005.

**Annual Growth Rates  
Personal Income and Selected Components of Personal Income  
Pennsylvania, Mideast Region and the United States**

<u>Calendar Year</u>	<u>Pennsylvania</u>	<u>Mideast Region<sup>(a)</sup></u>	<u>United States</u>
<b>Total Personal Income</b>			
2001 .....	3.4%	3.3 %	7.9%
2002 .....	2.7	1.2	1.8
2003 .....	2.8	2.4	3.2
2004 .....	5.1	6.2	6.0
2005 .....	5.0	5.6	5.6
<b>Manufacturing</b>			
2001 .....	-1.5%	-1.5%	-3.2%
2002 .....	-0.9	-0.7	-0.4
2003 .....	-0.1	1.2	2.8
2004 .....	1.6	1.5	1.8
2005 .....	3.1	2.9	4.7
<b>Trade<sup>(b)</sup></b>			
2001 .....	1.6%	1.0%	1.0%
2002 .....	2.3	1.7	1.6
2003 .....	5.1	4.0	2.9
2004 .....	5.2	4.4	8.4
2005 .....	6.5	6.1	6.8
<b>Finance<sup>(c)</sup></b>			
2001 .....	5.8%	4.8%	6.5%
2002 .....	5.4	-3.7	2.4
2003 .....	5.3	1.3	5.0
2004 .....	5.9	10.8	8.3
2005 .....	3.0	8.3	6.0
<b>Services</b>			
2001 .....	6.4%	6.3%	5.7%
2002 .....	0.2	-1.5	-1.9
2003 .....	2.0	1.6	1.7
2004 .....	10.1	7.4	7.0
2005 .....	9.9	9.0	9.9
<b>Utilities<sup>(d)</sup></b>			
2001 .....	3.6%	3.9%	4.0%
2002 .....	4.8	10.0	5.2
2003 .....	5.0	3.4	3.2
2004 .....	1.4	1.7	5.6
2005 .....	-2.8	3.9	5.3
<b>Construction</b>			
2001 .....	5.7%	7.5%	5.1%
2002 .....	2.7	2.7	1.6
2003 .....	1.2	1.3	1.4
2004 .....	3.7	4.8	8.3
2005 .....	9.5	7.6	10.6
<b>Mining</b>			
2001 .....	4.7%	5.0%	9.5%
2002 .....	-2.0	-4.1	-2.9
2003 .....	-2.1	-1.1	2.8
2004 .....	11.2	10.5	11.9
2005 .....	10.3	9.4	13.1

<sup>(a)</sup> Mideast Region: Delaware, District of Columbia, Maryland, Pennsylvania, New York, and New Jersey.

<sup>(b)</sup> Wholesale and retail trade.

<sup>(c)</sup> Finance, insurance and real estate.

<sup>(d)</sup> Includes transportation, communications, electric, gas and sanitary services.

Source: U.S. Department of Commerce, Bureau of Economic Analysis

The Commonwealth's average hourly wage rate of \$17.46 for manufacturing and production workers compares to the national average of \$18.21 for 2005. The following table presents the average hourly wage rates for 2001 through 2005.

**Average Hourly Wages  
Production Workers on Manufacturing Payrolls  
Pennsylvania and the United States  
2001-2005**

<u>Calendar Year</u>	<u>PA</u>	<u>U.S.</u>
2001.....	\$ 14.85	\$ 16.23
2002.....	15.99	17.18
2003.....	16.70	17.75
2004.....	17.29	18.09
2005.....	17.46	18.21

Source: U.S. Department of Labor, Bureau of Labor Statistics

**Market and Assessed Valuation of Real Property**

Annually, the State Tax Equalization Board (the "STEB") determines an aggregate market value of all taxable real property in the Commonwealth. The STEB determines the market value by applying assessment to sales ratio studies to assessment valuations supplied by local assessing officials. The market values certified by the STEB do not include property that is tax exempt but do include an adjustment correcting the data for preferential assessments granted to certain farm and forestlands.

The table below shows the assessed valuation as determined and certified by the counties and the market value and the assessed to market value ratio determined by the STEB for real property over the last ten years. Increases in valuations shown below result from reassessment valuations by the counties, changes in property tax rolls and increases in the real value of existing property. In computing the market values for uneven-numbered years, the STEB is statutorily restricted to certifying only those changes in market value that result from properties added to or removed from the assessment rolls. The STEB is permitted to adjust the market valuation to reflect any change in real estate values or other economic change in value only in even-numbered years. This restriction accounts for the two-year pattern of market value changes apparent in the data below.

**Valuations of Taxable Real Property  
1996-2005**

<u>Year</u>	<u>Market Value<sup>(a)</sup></u>	<u>Assessed Valuation</u>	<u>Ratio of Assessed Valuation to Market Value<sup>(a)</sup></u>
1996	\$ 359,993,651,000	\$ 102,107,687,304	28.4%
1997	366,096,581,900	123,734,109,457	37.2
1998	388,146,465,800	204,581,152,222	52.7
1999	390,136,860,900	208,896,190,899	53.5
2000	420,041,123,600	241,060,798,812	57.4
2001	430,102,389,400	310,111,943,560	72.1
2002	467,311,009,700	325,451,064,697	69.6
2003	478,362,689,800	348,726,965,926	72.9
2004	523,595,339,800	352,014,550,601	67.2
2005	533,700,991,300	378,014,057,174	70.8

<sup>(a)</sup> Value adjusted for difference between regular assessment and preferential assessment permitted on certain farm and forestlands.  
Source: Annual Certifications by the State Tax Equalization Board July 2006.

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## COMMONWEALTH GOVERNMENT AND FISCAL ADMINISTRATION

The government of the Commonwealth is composed of three separate branches. A general organization chart of the Commonwealth's government is shown on the following page.

### Legislative Branch

The legislative branch consists of the General Assembly and its staff. The General Assembly is bicameral, composed of the Senate and the House of Representatives. The 50 members of the Senate serve staggered four-year terms and the 203 Representatives serve identical two-year terms. The General Assembly meets in regular session biannually beginning on the first Tuesday of January following elections. Special sessions may be called by the Governor on petition of a majority of the members of each house or whenever the Governor determines that public interest so requires. Legislative leadership includes majority and minority leaders in each house, a President Pro Tempore of the Senate and a Speaker of the House of Representatives.

### Executive Branch

The Executive Branch is headed by five elected officials and encompasses 19 departments and approximately 36 independent commissions, boards, authorities and agencies.

The five elected officials are the Governor, the Lieutenant Governor, the Attorney General, the State Treasurer and the Auditor General. The Governor and the Lieutenant Governor are elected on the same ballot and serve a four-year term. The Governor is eligible to succeed himself for one term. The Auditor General, the Attorney General and the State Treasurer are elected for four-year terms in an even-year election held between gubernatorial elections.

The Governor is the chief executive officer of the Commonwealth. All departments except those of the State Treasurer, the Attorney General and the Auditor General are under the direct jurisdiction of the Governor. The head of each of the remaining departments is a Secretary who is appointed by the Governor and confirmed by a majority vote of the Senate. Each Secretary serves at the Governor's pleasure and is a member of the Governor's Cabinet.

The Lieutenant Governor presides over the Senate and serves as Acting Governor during the disability of the Governor and becomes Governor in the case of the death, conviction or impeachment, failure to qualify or resignation of the Governor.

The Attorney General is the chief law enforcement officer of the Commonwealth and is responsible for upholding and defending the constitutionality of all statutes. He is also responsible for reviewing the form and legality of all proposed rules and regulations, deeds, leases and contracts to be executed by Commonwealth agencies. The Office of Attorney General is under the Attorney General's direct jurisdiction.

The State Treasurer is charged with receiving, depositing and investing all Commonwealth funds and is responsible for the pre-audit approval of all requisitions for the disbursements of monies in the State Treasury. The Treasury Department is under the State Treasurer's direct jurisdiction.

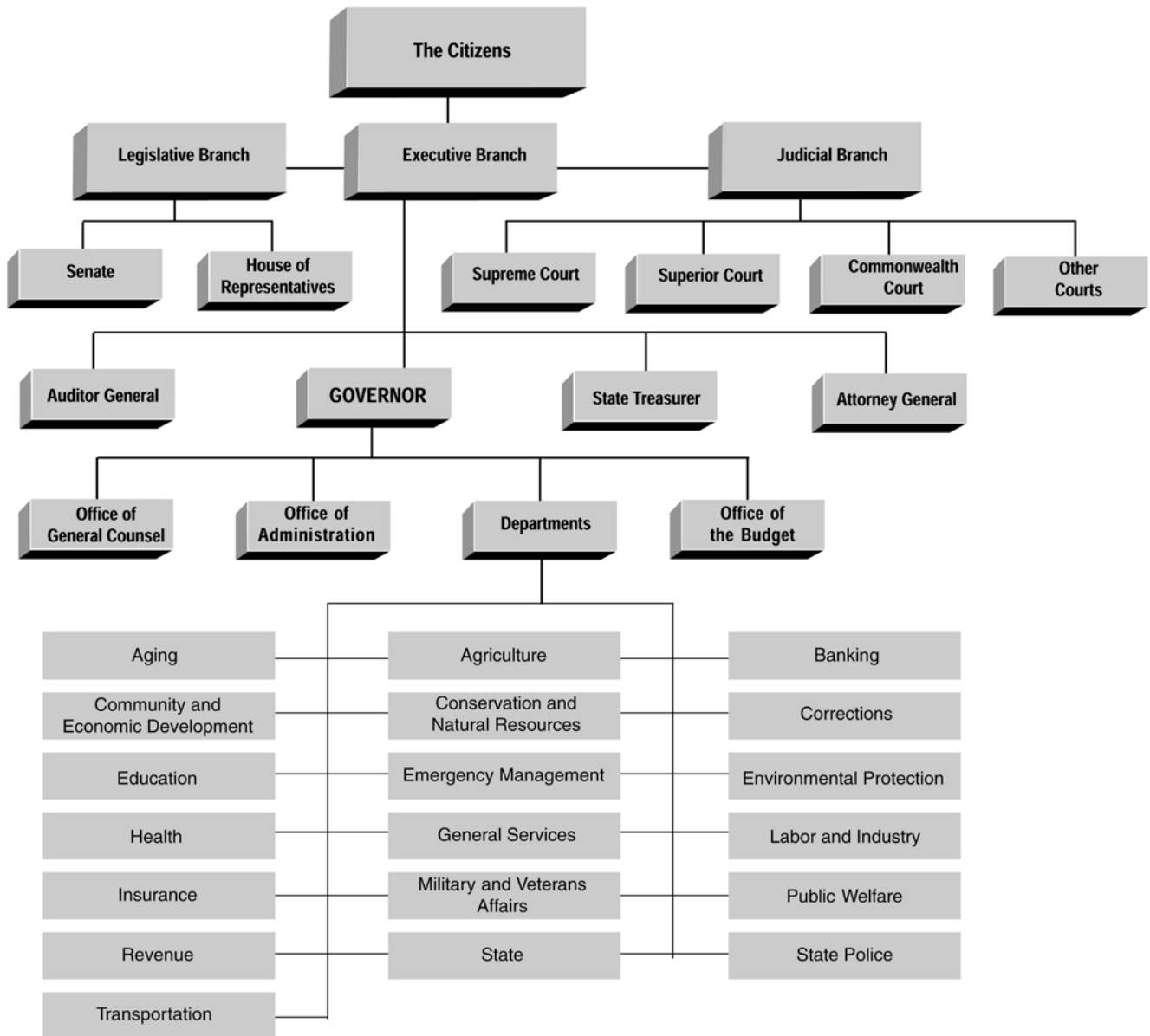
The Auditor General is charged with making audits of completed financial transactions. The Department of the Auditor General is under the Auditor General's direct jurisdiction.

Activities of state government are also conducted by various independent commissions, boards, authorities and agencies created by statute and not under the direct jurisdiction of the executive and legislative branches.

### Judicial Branch

The judicial power of the Commonwealth is vested in a unified judicial system consisting of a Supreme Court and various other courts of original and appellate jurisdiction which are under the supervision and authority of the Supreme Court. All justices, judges and district justices are elected to office.

# Commonwealth of Pennsylvania Organization Chart



**AGENCIES**

Higher Education Assistance  
Housing Finance  
Interstate Agencies

**AUTHORITIES**

Commonwealth Financing  
Energy Development  
Higher Education Facilities  
Industrial Development  
Infrastructure Investment  
Minority Business Development  
Public School Building

**BOARDS**

Claims  
Environmental Hearing  
Gaming Control  
Finance and Revenue  
Liquor Control  
Milk Marketing  
Municipal Retirement  
Pardons  
Probation and Parole  
Public School Employees' Retirement  
State Employees' Retirement  
Tax Equalization

**COMMISSIONS**

Civil Service  
Crime and Delinquency  
Ethics  
Fish and Boat  
Game  
Harness Racing  
Historical and Museum  
Horse Racing  
Human Relations  
Juvenile Court Judges  
Public Employee Retirement  
Public Television Network  
Public Utility  
Securities  
Turnpike



## **Fiscal Organization**

Each branch of the Commonwealth's government is responsible for its respective fiscal operations subject to restrictions embodied in the Constitution, the Administrative Code, and the Fiscal Code. Such restrictions are enforced and other central administrative functions are provided by five departments: the Office of the Budget ("OB"), the Office of Administration ("OA"), the Treasury Department, the Department of Revenue and the Department of the Auditor General. OB and OA are administrative offices within the Governor's offices. The Secretary of the Budget and the Secretary of Administration are appointed by the Governor and are responsible for the operations of their respective offices. The Department of Revenue is led by the Secretary of Revenue, who is appointed by the Governor subject to the advice of the Senate. The Treasury Department and the Department of the Auditor General are headed by the respective elected officials.

OB monitors the operation of the Commonwealth's departments, operates a central accounting system, compiles and publishes the Commonwealth's financial reports, assists in the preparation and publication of the budget, coordinates capital improvements and is responsible for the issuance of the Commonwealth's debt. OA is responsible for personnel policy and programs, management policy and organizational structure, data processing service, and electronic data processing policy and planning. The Treasury Department receives, invests and disburses all funds and maintains central cash records. The Department of Revenue administers the collection of most taxes. The Department of the Auditor General oversees the examination of the majority of financial transactions.

Commissions, authorities and agencies that are both independent by statute and financially self-supporting, operate autonomously although their capital projects and financing are reviewed by OB and included in the capital budget.

## **The Budgetary Process**

The Commonwealth operates on a fiscal year beginning July 1 and ending June 30. For example, "fiscal year 2007" refers to the fiscal year ending on June 30, 2007.

The budget process commences in September, nine months prior to the beginning of the fiscal year, as departments formulate their initial budgets in response to Program Policy Guidelines issued by the Governor and hold preliminary hearings with OB and other members of the Governor's staff. By November 1, formal budget requests are submitted to OB by all government departments and other institutions requesting appropriations. OB, under the direction of the Secretary of Budget, reviews the requests through November and December and may hold formal hearings.

The Department of Revenue, in conjunction with OB, prepares revenue estimates. In the preparation of such estimates, internal analysis, information from selected departments and econometric analysis are utilized. The Commonwealth subscribes to economic forecasts prepared by Global Insight for national and Pennsylvania economic data that are used to estimate economically sensitive Commonwealth revenues. Other econometric forecasts are also consulted.

The Constitution requires that the Governor submit annually to the General Assembly a budget consisting of three parts:

- (a) a balanced operating budget for the ensuing fiscal year setting forth proposed expenditures and estimated revenues from all sources and, if estimated revenues and available surplus are less than proposed expenditures, recommending specific additional sources of revenue sufficient to pay the deficiency;
- (b) a capital budget for the ensuing fiscal year setting forth in detail proposed expenditures to be financed from the proceeds of obligations of the Commonwealth or of its agencies or authorities or from operating funds; and
- (c) a financial plan for not less than the succeeding five fiscal years, which includes for each year (i) projected operating expenditures classified by department or agency and by program, and estimated revenues by major categories from existing and additional sources, and (ii) projected expenditures for capital projects specifically itemized by purpose and their proposed sources of financing.

All funds received by the Commonwealth are subject by statute to appropriation in specific amounts by the General Assembly or by executive authorizations by the Governor. The Governor's budget encompasses both annual appropriations and executive authorizations.

The Governor is required to submit the proposed budget as soon as possible after the organization of the General Assembly but not later than the first full week in February except in his first year of office. The Governor's submission begins with the Budget Message delivered in joint session. The budget in the form of a proposed bill is delivered to the appropriations committee of one of the houses. Hearings are held on the bills constituting the budget. In an iterative process, bills are reported from committee to floor and considered in and between houses.

The operating budget is considered in the form of the General Appropriations Bill and its supplements. The Bill is limited to appropriations for debt service, public schools and the executive, legislative and judicial branches. Its supplements cover appropriations from special revenue funds not included in the General Appropriations Bill and for such subjects as capital projects funded from current revenues. The operating budget also includes single subject bills covering appropriations made to any charitable or educational institutions not under the absolute control of the Commonwealth other than certain State-owned schools (“non-preferred appropriations”).

The Constitution mandates that total operating budget appropriations made by the General Assembly may not exceed the sum of (a) the actual and estimated revenues in a given year, and (b) the surplus of the preceding year. The Constitution further specifies that a surplus of operating funds at the end of the fiscal year shall be appropriated. That is, if funds remain from the end of a fiscal year they must be appropriated for the ensuing year. Also, if a deficit occurs at year-end, funds must be provided for such a deficit.

Pursuant to the Administrative Code, the executive branch establishes the revenue estimates used in the budget. In practice, the revenue estimates used to balance the operating budget consist of the appropriate fund’s available surplus and its estimated cash receipts for the fiscal year as well as net accruals. Appropriation lapses estimated to occur during the year or at year-end are not included; lapses are not available for re-appropriation until they occur.

Under this budgetary process a deficit can occur if revenues are less than those estimated in the budget and the shortfall is not offset by any unappropriated surplus or by appropriation lapses during or at the end of the year or by legislative action to increase revenues or reduce appropriation.

The Administrative Code was amended in 1978 to provide for stronger executive control of expenditures. All departments under the Governor’s jurisdiction may be required to submit estimates of expenditures during the ensuing month, quarter or any other such period as requested by the Governor. These estimates are subject to the approval of the Secretary of Budget. The Governor is empowered to request the State Treasurer to withhold funds from any such department not spending within such estimates. The Secretary of Budget is empowered to set personnel levels for departments. Departments are required to provide personnel data monthly so that the Commonwealth’s computerized data file on personnel levels can be maintained and used to monitor the Commonwealth’s largest operating expense.

The proposed capital budget is considered in the form of the Capital Budget Bill and its supplements. The capital budget determines limits for the amount of debt that can be issued in that fiscal year for categories of capital projects, itemizes for funding all capital projects not previously itemized, authorizes the issuance of debt to finance these projects and appropriates the proceeds from the issuance of debt.

All appropriations require the majority vote of all members in each house except for non-preferred appropriations and appropriations from the Budget Stabilization Reserve Fund and from the Health Endowment Account portion of the Tobacco Settlement Fund which require passage by a two-thirds vote. During the legislative process, the General Assembly may add, change or delete any items in the budget proposed by the Governor. Once the bills constituting the budget have passed both houses and are returned to the Governor, he may either veto bills or item veto appropriations within bills. A gubernatorial veto can be overridden only by a two-thirds majority of all members of each house.

In the event that the General Assembly fails to pass or the Governor fails to sign an appropriations act prior to July 1 of any fiscal year for that fiscal year, the Pennsylvania Constitution, the laws of Pennsylvania and certain state and federal court decisions provide that the Commonwealth may continue during such un-budgeted fiscal year to make debt service payments, payments for mandated federal programs such as cash assistance and payments related to the health and safety of the citizens of the Commonwealth such as police and correctional services.

### **Accounting and Budgetary Controls**

Every department of the executive branch that receives appropriations from the Commonwealth, with the exception of the Treasury Department and the Departments of the Auditor General and the Attorney General, has a comptroller appointed by and under the direct jurisdiction of the Governor. These agencies share a centralized encumbrance-based accounting system supervised by OB. Executive departments operating separate additional accounting systems include the Department of Transportation for the Motor License Fund, the Liquor Control Board for the State Stores Fund and the Department of Labor and Industry for the payment of unemployment compensation benefits. Officials within the Treasury Department, the Departments of the Auditor General and the Attorney General and the judicial and legislative branches administer individual operations under the jurisdiction of their respective areas.

Expenditure control occurs at two levels. The first is by appropriations and is enforced by the State Treasurer and individual comptrollers. The second is by allocations and allotments and is enforced by OB for all departments receiving appropriations, except for the legislative branch.

Departments receive authorization to spend and commit funds in the form of appropriations for a specific amount, purpose and time period. Funds appropriated to a single department may be in one or more appropriations as the General Assembly determines. When multiple appropriations to a department are enacted, separate appropriations are made for general operating expenses, special outlays and for specific programs or groupings thereof. The degree to which a department's total appropriations are itemized may vary, but control is exercised over both total and individual appropriations.

The Constitution requires that with the exceptions named, monies may be paid from the Treasury only if appropriated by law. Accordingly, when a voucher is submitted to the State Treasurer, a check will not be issued unless the amount is within the balance of the agency's total appropriation.

Departments are prevented by their comptrollers from incurring obligations in excess of their unexpended individual appropriations by an encumbrance system. Encumbrance control prevents spending beyond remaining individual appropriation balances. When a commitment or obligation is incurred, for example, when a contract or purchase order is signed, the required portion of the corresponding appropriation is reserved. This reserving of funds is called the encumbrance procedure. All obligations anticipating future disbursement of cash in the fiscal year require an encumbrance, with the exception of debt service payments. Since a debt service appropriation is used for no purpose other than debt service, an encumbrance is not necessary.

All individual appropriations are allocated by OB to departments by major object groups. For example, a department's appropriation for operating expenses may be broken down into such major object groups as personnel service, operating expenses and supplies, etc. Additionally, major object groups are subdivided into minor object groups. For example, personnel service would be broken down into salaries, benefits, overtime, etc. Department expenditures are monitored to insure that expenditures within an allocation do not exceed the designated totals. The departments, however, are free to adjust their expenditures between minor object groups as long as they do not exceed the major object group allocation. OB can monitor department expenditures against their allocations on a continuing basis as the records of departments under the Governor's jurisdiction can be accessed from the central system while those of most other departments and branches are provided monthly.

In addition to the preceding controls, another check is provided by the financial reporting process. All department records are reconciled by OB on a monthly basis with the Treasury Department's records of cash transactions and with the Department of Revenue's records of cash collections.

### **Audits**

The Constitution requires that the financial affairs of any entity receiving appropriations and all department boards, commissions, agencies, instrumentalities, authorities and institutions of the Commonwealth be subject to audits made in accordance with generally accepted auditing standards. Any Commonwealth officer whose approval is necessary for any transaction may not be charged with the function of auditing that transaction after its occurrence.

The Department of the Auditor General has the responsibility for auditing all state-related financial transactions except its own, those of the legislative and judicial branches, and boards and commissions on which the Auditor General serves and those of certain funds. At least one audit must be made annually of the fiscal affairs of the executive branch. Audits of the Commonwealth General Purpose Financial Statements since fiscal 1985 have been performed jointly by the Department of the Auditor General and an independent public accounting firm.

The Treasury Department is required to pre-audit all requests for expenditures to insure that they are in accordance with law. In addition, OB conducts, as a matter of administrative policy, periodic audits of comptrollers under the Governor's jurisdiction and performance audits of state and federal programs.

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**INFORMATION REGARDING  
THE DEPOSITORY TRUST COMPANY  
AND ITS BOOK-ENTRY SYSTEM**

The information that follows concerning The Depository Trust Company, New York, New York (“DTC”) and the book-entry only system described below is based solely on information furnished by DTC and is not, and should not be construed as, a representation by the Commonwealth as to its accuracy, completeness or otherwise.

DTC will act as securities depository for the Bonds. The Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC’s partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered Bond certificate will be issued for each maturity of the Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC.

DTC is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds securities that its participants (“Direct Participants”) deposit with DTC. DTC also facilitates the settlement among Participants of securities transactions, such as transfers and pledges, in deposited securities through electronic computerized book-entry changes in Direct Participants’ accounts, thereby eliminating the need for physical movement of securities certificates. Direct Participants include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is owned by a number of its Direct Participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc., and the National Association of Securities Dealers, Inc. Access to the DTC system is also available to others such as securities brokers and dealers, banks, and trust companies that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (“Indirect Participants”). The rules applicable to DTC and its Direct Participants are on file with the Securities and Exchange Commission.

Purchases of Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Bonds on DTC’s records. The ownership interest of each actual purchaser of each Bond (“Beneficial Owner”) is in turn to be recorded on the Direct and Indirect Participants’ records. Beneficial Owners will not receive written confirmation from DTC of their purchase, but Beneficial Owners are expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in Bonds, except in the event that use of the book-entry system for the Bonds is discontinued.

To facilitate subsequent transfers, all Bonds deposited by Direct Participants with DTC are registered in the name of DTC’s partnership nominee, Cede & Co. or such other name as requested by an authorized representative of DTC. The deposit of Bonds with DTC and their registration in the name of Cede & Co. or such other DTC nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Bonds; DTC’s records reflect only the identity of the Direct Participants to whose accounts such Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time.

Beneficial Owners of the Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Bonds, such as redemptions, tenders, defaults, and proposed amendments to the Bond documents. Beneficial Owners of Bonds may wish to ascertain that the nominee holding the Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners, or in the alternative, Beneficial Owners may wish to provide their names and addresses to the Loan and Transfer Agent and request that copies of notices be provided directly to them.

Redemption notices shall be sent to DTC. If less than all of the Bonds within an issue are being redeemed, DTC’s practice is to determine by lot the amount of the interest of each Direct Participant in such issue to be redeemed.

Neither DTC nor Cede & Co. (nor such other DTC nominee) will consent or vote with respect to the Bonds. Under its usual procedures, DTC will mail an Omnibus Proxy to the Commonwealth as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

Principal and interest payments on the Bonds will be made to Cede & Co. or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the Commonwealth or its agent, on the payable date in accordance with their respective holdings shown on DTC's records. Payments by Direct and Indirect Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Direct and Indirect Participants and not of DTC (nor its nominee), the Loan and Transfer Agent, or the Commonwealth, subject to any statutory or regulatory requirements as may be in effect from time to time. Payment of principal and interest to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the Commonwealth or the Loan and Transfer Agent, disbursement of such payments to Direct Participants is the responsibility of DTC, and disbursement of such payments to the Beneficial Owners is the responsibility of Direct and Indirect Participants.

DTC may discontinue providing its services as securities depository with respect to the Bonds at any time by giving reasonable notice to the Commonwealth or the Loan and Transfer Agent. Under such circumstances, in the event that a successor securities depository is not obtained, Bond certificates are required to be printed and delivered.

The foregoing information concerning DTC and DTC's book-entry system has been obtained from information furnished by DTC. No representation or warranty is made by the Commonwealth as to the accuracy or completeness of such information.

The Commonwealth may decide to discontinue use of the system of book-entry transfers through DTC (or a successor securities depository). In that event, Bond certificates will be printed and delivered.

**For so long as the Bonds are registered in the name of DTC, or its nominee Cede & Co., the Commonwealth and the Loan and Transfer Agent will treat Cede & Co. as the registered owner of the Bonds for all purposes, including payments, notices and voting.**

**Neither the Commonwealth nor the Loan and Transfer Agent shall have any responsibility or obligation to any Direct or Indirect Participant or Beneficial Owner with respect to (a) the accuracy of any records maintained by DTC or any Direct or Indirect Participant with respect to any beneficial ownership interest in any Bonds; (b) the payment by any Direct or Indirect Participant of any amount due to any Beneficial Owner in respect of the principal of, premium, if any, and interest on the Bonds; (c) the delivery or timeliness of delivery by any Direct or Indirect Participant of any notice to any Beneficial Owner of any notice with respect to the Bond, including, without limitation any notice of redemption; or (d) other action taken by DTC or Cede & Co., including the effectiveness of any action taken pursuant to an Omnibus Proxy.**

**SELECTED  
CONSTITUTIONAL PROVISIONS  
RELATING TO THE FINANCES  
OF THE COMMONWEALTH**

**Article VIII — TAXATION AND FINANCE**

**Commonwealth Indebtedness**

Section 7. (a) No debt shall be incurred by or on behalf of the Commonwealth except by law and in accordance with the provisions of this section.

- (1) Debt may be incurred without limit to suppress insurrection, rehabilitate areas affected by man-made or natural disaster, or to implement unissued authority approved by the electors prior to the adoption of this article.
- (2) The Governor, State Treasurer and Auditor General, acting jointly, may (i) issue tax anticipation notes having a maturity within the fiscal year of issue and payable exclusively from revenues received in the same fiscal year, and (ii) incur debt for the purpose of refunding other debt, if such refunding debt matures within the term of the original debt.
- (3) Debt may be incurred without limit for purposes specifically itemized in the law authorizing such debt, if the question whether the debt shall be incurred has been submitted to the electors and approved by a majority of those voting on the question.
- (4) Debt may be incurred without the approval of the electors for capital projects specifically itemized in a capital budget if such debt will not cause the amount of all net debt outstanding to exceed one and three-quarters times the average of the annual tax revenues deposited in the previous five fiscal years as certified by the Auditor General. For the purposes of this subsection, debt outstanding shall not include debt incurred under clauses (1) and (2) (i), or debt incurred under clause (2) (ii) if the original debt would not be so considered, or debt incurred under subsection (3) unless the General Assembly shall so provide in the law authorizing such debt.

(b) All debt incurred for capital projects shall mature within a period not to exceed the estimated useful life of the projects as stated in the authorizing law, and when so stated shall be conclusive. All debt, except indebtedness permitted by clause (2) (i), shall be amortized in substantial and regular amounts, the first of which shall be due prior to the expiration of a period equal to one-tenth the term of the debt.

(c) As used in this section, debt shall mean the issued and outstanding obligations of the Commonwealth and shall include obligations of its agencies or authorities to the extent they are to be repaid from lease rentals or other charges payable directly or indirectly from revenues of the Commonwealth. Debt shall not include either (1) that portion of obligations to be repaid from charges made to the public for the use of the capital projects financed, as determined by the Auditor General, or (2) obligations to be repaid from lease rentals or other charges payable by a school district or other local taxing authority, or (3) obligations to be repaid by agencies or authorities created for the joint benefit of the Commonwealth and one or more other State governments.

(d) If sufficient funds are not appropriated for the timely payment of the interest upon and installments of principal of all debt, the State Treasurer shall set apart from the first revenues thereafter received applicable to the appropriate fund a sum sufficient to pay such interest and installments of principal, and shall so apply the money so set apart. The State Treasurer may be required to set aside and apply such revenues at the suit of any holder of Commonwealth obligations.

### **Commonwealth Credit Not to be Pledged**

Section 8. The credit of the Commonwealth shall not be pledged or loaned to any individual, company, corporation or association nor shall the Commonwealth become a joint owner or stockholder in any company, corporation or association.

### **Municipal Debt Not to be Assumed by Commonwealth**

Section 9. The Commonwealth shall not assume the debt, or any part thereof, of any county, city, borough, incorporated town, township or any similar general purpose unit of government unless such debt shall have been incurred to enable the Commonwealth to suppress insurrection or to assist the Commonwealth in the discharge of any portion of its present indebtedness.

### **Audit**

Section 10. The financial affairs of any entity funded or financially aided by the Commonwealth, and all departments, boards, commissions, agencies, instrumentalities, authorities and institutions of the Commonwealth, shall be subject to audits made in accordance with generally accepted auditing standards.

Any Commonwealth officer whose approval is necessary for any transaction relative to the financial affairs of the Commonwealth shall not be charged with the function of auditing that transaction after its occurrence.

### **Gasoline Taxes and Motor License Fees Restricted**

Section 11. (a) All proceeds from gasoline and other motor fuel excise taxes, motor vehicle registration fees and license taxes, operators' license fees and other excise taxes imposed on products used in motor transportation after providing therefrom for (a) cost of administration and collection, (b) payment of obligations incurred in the construction and reconstruction of public highways and bridges shall be appropriated by the General Assembly to agencies of the State or political subdivisions thereof; and used solely for construction, reconstruction, maintenance and repair of and safety on public highways and bridges and costs and expenses incident thereto, and for the payment of obligations incurred for such purposes, and shall not be diverted by transfer or otherwise to any other purpose, except that loans may be made by the State from the proceeds of such taxes and fees for a single period not exceeding eight months, but no such loan shall be made within the period of one year from any preceding loan, and every loan made in any fiscal year shall be repayable within one month after the beginning of the next fiscal year.

(b) All proceeds from aviation fuel excise taxes, after providing therefrom for the cost of administration and collection, shall be appropriated by the General Assembly to agencies of the State or political subdivisions thereof and used solely for: the purchase, construction, reconstruction, operation, and maintenance of airports and other air navigation facilities; aircraft accident investigation; the operation, maintenance and other costs of aircraft owned or leased by the Commonwealth; any other purpose reasonably related to air navigation including but not limited to the reimbursement of airport property owners for property tax expenditures; and costs and expenses incident thereto and for the payment of obligations incurred for such purposes, and shall not be diverted by transfer or otherwise to any other purpose.

### **Governor's Budgets and Financial Plan**

Section 12. Annually, at the times set by law, the Governor shall submit to the General Assembly:

(a) A balanced operating budget for the ensuing fiscal year setting forth in detail (i) proposed expenditures classified by department or agency and by program and (ii) estimated revenues from all sources. If estimated revenues and available surplus are less than proposed expenditures, the Governor shall recommend specific additional sources of revenue sufficient to pay the deficiency and the estimated revenue to be derived from each source;



(b) A capital budget for the ensuing fiscal year setting forth in detail proposed expenditures to be financed from the proceeds of obligations of the Commonwealth or of its agencies or authorities or from operating funds; and

(c) A financial plan for not less than the next succeeding five fiscal years, which plan shall include for each such fiscal year:

- (i) Projected operating expenditures classified by department or agency and by program, in reasonable detail, and estimated revenues, by major categories, from existing and additional sources; and
- (ii) Projected expenditures for capital projects specifically itemized by purpose, and the proposed sources of financing each.

### **Appropriations**

Section 13. (a) Operating budget appropriations made by the General Assembly shall not exceed the actual and estimated revenues and surplus available in the same fiscal year.

(b) The General Assembly shall adopt a capital budget for the ensuing fiscal year.

### **Surplus**

Section 14. All surplus of operating funds at the end of the fiscal year shall be appropriated during the ensuing fiscal year by the General Assembly.

### **Project "70"**

Section 15. In addition to the purposes stated in article eight, section seven of this Constitution, the Commonwealth may be authorized by law to create debt and to issue bonds to the amount of seventy million dollars (\$70,000,000) for the acquisition of land for State parks, reservoirs and other conservation and recreation and historical preservation purposes and for participation by the Commonwealth with political subdivisions in the acquisition of land for parks, reservoirs and other conservation and recreation and historical preservation purposes, subject to such conditions and limitations as the General Assembly may prescribe.

### **Land and Water Conservation and Reclamation Fund**

Section 16. In addition to the purposes stated in article eight, section seven of this Constitution, the Commonwealth may be authorized by law to create debt and issue bonds in the amount of five hundred million dollars (\$500,000,000) for a Land and Water Conservation and Reclamation Fund to be used for the conservation and reclamation of land and water resources of the Commonwealth, including the elimination of acid mine drainage, sewage, and other pollution from the streams of the Commonwealth, the provision of State financial assistance to political subdivisions and municipal authorities of the Commonwealth of Pennsylvania for the construction of sewage treatment plants, the restoration of abandoned strip-mined areas, the control and extinguishment of surface and underground mine fires, the alleviation and prevention of subsidence resulting from mining operations, and the acquisition of additional lands and the reclamation and development of park and recreational lands acquired pursuant to the authority of Article VIII, section 15 of this Constitution, subject to such conditions and liabilities as the General Assembly may prescribe.

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**PROPOSED FORM OF OPINION OF  
THE ATTORNEY GENERAL OF  
THE COMMONWEALTH OF PENNSYLVANIA**

December 21, 2006

TO THE GOVERNOR, AUDITOR GENERAL  
AND STATE TREASURER AS THE ISSUING  
OFFICIALS OF THE COMMONWEALTH:

Re: Commonwealth of Pennsylvania General Obligation Bonds, Second Series of 2006 and First Refunding of 2006

This opinion is furnished to you in connection with the issuance and sale by the Commonwealth of Pennsylvania (the "Commonwealth") on the date hereof of \$950,670,000 aggregate principal amount of Commonwealth of Pennsylvania General Obligation Bonds, consisting of \$700,000,000 aggregate principal amount of General Obligation Bonds, Second Series of 2006 (the "Second Series of 2006 Bonds") and \$250,670,000 aggregate principal amount of General Obligation Bonds, First Refunding Series of 2006 (the First Refunding Series of 2006 Bonds: and together with the Second Series of 2006 Bonds, the "Bonds"). The Bonds are dated the date of issuance and delivery. The Bonds are issued as fully registered bonds without coupons in the denomination of \$5,000 or any integral multiple thereof within a maturity and will bear interest from the date of issuance and delivery, payable semi-annually on March 1 and September 1 of each year commencing March 1, 2007 for the First Refunding Series of 2006 Bonds and September 1, 2007 for the Second Series of 2006 Bonds, until the obligation with respect to the payment of such principal shall have been discharged.

The Bonds are authorized and issued pursuant to and in full compliance with the provisions, restrictions and limitations of Section 7 of Article VIII of the Constitution; the laws of the Commonwealth, including the Capital Facilities Debt Enabling Act, Act No. 1999-1, approved February 9, 1999, as amended, annual capital budget bills and various bond authorization bills enacted by the General Assembly; the Pennsylvania Infrastructure Investment Authority Act, Act No. 1988-16, approved March 1, 1988 (the "1988 Pennvest Act"); the Small Water Systems Assistance Act, Act No.1992-5, approved March 16, 1992 (the "1992 Act" and collectively with the 1988 Pennvest Act, the "Pennvest Acts"); constitutional referendum questions approved by the voters of the Commonwealth on April 26, 1988 (the "1988 Referendum") and April 28, 1992 the "1992 Referendum," and collectively with the 1988 Referendum, the "Pennvest Referenda"); the Act No. 2004-218, approved November 30, 2004 (the Pennworks Act"); the Water and Wastewater Treatment Project Bond Act, Act No. 2004-10, approved February 12, 2004 (the "Water and Wastewater Treatment Project Bond Act " and collectively with the Pennworks Act, the "Pennworks Acts"); a constitutional referendum question approved by the voters of the Commonwealth on April 27, 2004 (the "Pennworks Referendum"); the Growing Greener Environmental Stewardship and Watershed Protection Enhancement Authorization Act, Act No. 2005-1, approved April 13, 2005 (the "Growing Greener Environmental Stewardship and Watershed Protection Enhancement Authorization Act"); the Act No. 2005-45, approved July 13, 2005 (collectively with the Growing Greener Environmental Stewardship and Watershed Protection Enhancement Authorization Act, the "Growing Greener II Acts"). The Bonds are also authorized and issued pursuant to resolutions adopted by the Governor, the State Treasurer, and the Auditor General (the "Issuing Officials") on November 28, 2006, and December 5, 2006 (collectively, the "Resolutions").

The Resolutions, among other things, authorize the issuance and sale of the Bonds, and prescribe the forms thereof, the manner of bidding therefor and the forms of the bidding documents used in connection with the issuance and sale of the Bonds.

Under Section 7(a)(4) of Article VIII of the Constitution, the Commonwealth may incur debt without the approval of the electors to finance such projects, if such debt will not cause the amount of all debt outstanding (as defined for the purposes of that Section) to exceed one and three-quarters times the average of the annual tax revenues deposited in all funds in the previous five fiscal years, as certified by the Auditor General.

I have examined Article VIII, Section 7 and 16 of the Constitution and the statutes referred to above, specimens of the Bonds, the Resolutions, and the other certificates delivered today at the Closing and such other matters and documents as I deemed necessary or appropriate.

I am of the opinion that:

1. Sections 7 and 16 of Article VIII of the Constitution have been duly approved and adopted and have become part of the Constitution of Pennsylvania, and the statutes referred to above have been duly and properly enacted.
2. Pursuant to full and adequate legal power conferred upon them by the Constitution and the statutes referred to above, the Governor, the Auditor General and the State Treasurer have duly adopted the Resolutions and have validly taken all other necessary and proper action to issue and sell the Bonds, and the Bonds have been validly authorized, issued and sold pursuant to proper and appropriate action of such officials.
3. The Bonds are lawful, valid, direct and general obligations of the Commonwealth, and the full faith and credit of the Commonwealth is pledged for the payment of interest thereon as the same shall become due and for the payment of the principal thereof at maturity.
4. Under the provisions of Section 2901 of the Tax Reform Code of 1971, as amended, the Bonds and the interest thereon are exempt from taxation for state and local purposes within the Commonwealth, but this exemption does not extend to (a) gift, estate, succession or inheritance taxes or (b) any other taxes not levied or assessed directly on the Bonds or the interest thereon.
5. The Commonwealth has the power to provide for the payment of the principal of and interest on the Bonds by levying unlimited ad valorem taxes upon all taxable property within the Commonwealth and excise taxes upon all taxable transactions within the Commonwealth, uniform on the same class of subjects, except gasoline and other motor fuel excise taxes, motor vehicle registration fees and license taxes, and operators' license fees and other excise taxes imposed on products used in motor transportation, and aviation fuel excise taxes, the proceeds of which are limited to certain special purposes by Section 11 of Article VIII of the Constitution.
6. If sufficient funds are not appropriated for timely payment of interest on and installments of principal of the Bonds, the Constitution requires the State Treasurer to set apart from the first revenues thereafter received applicable to the appropriate fund, a sum sufficient to pay such interest and installments of principal and to apply said sum to such purposes, and the State Treasurer may be required to set aside and apply such revenues at the suit of the holder of any of the Bonds.

Very truly yours,

Tom Corbett  
Attorney General

PROPOSED FORM OF OPINION OF BOND COUNSEL

December \_\_, 2006

To: The Governor, the Auditor General and the  
State Treasurer, as the Issuing Officials of the  
Commonwealth of Pennsylvania

**Re: Commonwealth of Pennsylvania  
General Obligation Bonds, Second Series of 2006 and  
First Refunding Series of 2006**

We have acted as Bond Counsel to the Commonwealth of Pennsylvania (the "Commonwealth") in connection with the issuance and sale by the Commonwealth of [\$700,000,000] aggregate principal amount of its General Obligation Bonds, Second Series of 2006 (the "Second Series Bonds"), and [\$239,520,000] aggregate principal amount of its General Obligation Bonds, First Refunding Series of 2006 (together with the Second Series Bonds, the "Bonds"). The Bonds are authorized and issued pursuant to and in full compliance with the provisions, restrictions and limitations of the Constitution and laws of the Commonwealth, including Article VIII, Section 7 and Section 16 of the Constitution of the Commonwealth, the Capital Facilities Debt Enabling Act (Act No. 1991-1, approved February 9, 1999, as amended), the Capital Budget Act of 2006-2007 (Act No. 2006-\_\_, approved November \_\_, 2006), and certain other capital budget acts, debt authorizing acts and legislation as described in the Resolutions (as hereinafter defined). The Bonds are also authorized and issued pursuant to certain resolutions adopted by the Governor, the Auditor General and the State Treasurer (collectively, the "Issuing Officials") on November 28, 2006 and December \_\_, 2006, respectively (together, the "Resolutions"). The Resolutions, among other things, authorize the issuance and sale of the Bonds and prescribe the respective forms thereof, the manner of bidding therefor and the forms of the bidding documents used in connection with the issuance and sale of the Bonds.

In our capacity as Bond Counsel to the Commonwealth, we have examined the proceedings relating to the authorization and issuance of the Bonds, including, among other things, (a) the Resolutions; (b) a certificate of the Auditor General as to tax revenues and outstanding debt; (c) an opinion of The Honorable Tom Corbett, Attorney General of the Commonwealth; (d) a specimen copy of the Bonds; (e) certificates of the Commonwealth as to certain material factual matters (including a certificate of the Commonwealth intended to satisfy certain provisions of the Internal Revenue Code of 1986, as amended (the "Code"), and applicable Treasury Regulations); (f) a completed and executed Form 8038-G to be filed with the Internal Revenue Service; (g) the Certificate of \_\_\_\_\_, as purchaser of the Bonds (the "Purchaser"), dated the date hereof; (h) certificates of the Commonwealth and Manufacturers & Traders Trust Co., National Association, as Loan and Transfer Agent, with respect to the execution and authentication of the Bonds and certain other matters; and (i) the other documents, certificates and opinions executed and delivered at the closing held this day.

In rendering the opinions set forth below, we have assumed the genuineness, authenticity, truthfulness and completeness of all documents, records and other instruments we have examined and the genuineness of all signatures thereon. As to questions of fact material to our opinion, we have relied upon the representations of the

Commonwealth contained in the proceedings relating to the issuance of the Bonds and other certifications furnished to us without undertaking to verify the same by independent investigation. Except as set forth in paragraphs 7 and 8 below, our opinions are given only with respect to the laws of the Commonwealth as enacted and construed on the date hereof.

Based and in reliance upon the foregoing, our attendance at the closing held this day and subject to the caveats, qualifications, exceptions and assumptions set forth herein, it is our opinion that, as of the date hereof, under existing law:

1. The Bonds are valid and binding direct obligations of the Commonwealth, enforceable in accordance with their terms, and the full faith and credit of the Commonwealth are pledged for the payment of interest thereon as the same shall become due and the payment of the principal thereof at maturity.
2. The principal amount of the Bonds is within all applicable debt and other limitations fixed by the Constitution and the laws of the Commonwealth.
3. The Bonds have been validly authorized, issued and sold pursuant to all necessary action of the Issuing Officials.
4. The Commonwealth has the power to provide for the payment of principal of and interest on the Bonds by levying unlimited ad valorem taxes upon all taxable property within the Commonwealth and excise taxes upon all taxable transactions within the Commonwealth, uniform on the same class of subjects, except gasoline and other motor fuel excise taxes, motor vehicle registration fees and license taxes and operators' license fees and other excise taxes imposed on products used in motor transportation and aviation fuel excise taxes, the proceeds of which are limited to certain special purposes by Article VIII, Section 11 of the Constitution of the Commonwealth.
5. If sufficient funds are not appropriated for the timely payment of interest upon and installments of principal of the Bonds, the Constitution of the Commonwealth requires the State Treasurer to set apart from the first revenues thereafter received applicable to the appropriate fund a sum sufficient to pay such interest and installments of principal and to apply said sum to such purposes, and the State Treasurer may be required to set aside and apply such revenues at the suit of the holder of any of the Bonds.
6. Under the laws of the Commonwealth, as currently enacted and construed, the Bonds are exempt from personal property taxes in the Commonwealth, and interest on the Bonds is exempt from the Commonwealth's personal income tax and corporate net income tax. However, under the Commonwealth's laws as presently enacted and construed, any profits, gains or income derived from the sale, exchange or other disposition of the Bonds will be subject to the Commonwealth's state and local taxes.
7. The Bonds are exempt from registration under the provisions of the Securities Act of 1933, as amended.
8. Interest on the Bonds is excluded from gross income for federal income tax purposes under existing law, as currently enacted and construed. Interest on the Bonds is not an item of tax preference for purposes of the federal alternative minimum tax imposed upon individuals and corporations. Interest on a Bond held by a corporation (other than an S Corporation, regulated investment company, real estate investment trust or real estate mortgage investment conduit) may be indirectly subject to alternative minimum tax because of

its inclusion in the earnings and profits of the corporate holder. Interest on a Bond held by a foreign corporation may be subject to the branch profits tax imposed by the Code.

Ownership of the Bonds may give rise to collateral federal income tax consequences to certain taxpayers, including, without limitation, financial institutions, property and casualty insurance companies, S Corporations with Subchapter C earnings and profits, individual recipients of Social Security or Railroad Retirement benefits and taxpayers who may be deemed to have incurred or continued indebtedness to purchase or carry the Bonds. We express no opinion as to such collateral federal income tax consequences.

In providing this opinion, we advise you as follows:

- a. It may be determined in the future that interest on the Bonds, retroactive to the date of issuance thereof, will not be excluded from gross income of the owners of the Bonds for federal income tax purposes if certain requirements of the Code are not met subsequent to the issuance of the Bonds. The Commonwealth has covenanted to comply with these requirements. Our opinions expressed herein assume continued compliance with these covenants, and we have not undertaken to determine (or to inform any person) whether any actions taken (or not taken) or events occurring (or not occurring) after the date of issuance of the Bonds may affect the tax status of interest on the Bonds.
- b. The enforceability (but not the validity) of the documents mentioned herein may be limited by bankruptcy, insolvency, reorganization, moratorium or other similar laws now or hereafter enacted by any state or the federal government affecting the enforcement of creditors' rights generally, or the legal or equitable principles affecting creditors rights and "enforceable in accordance with its (their) terms" shall not mean that specific performance would necessarily be available as a remedy in every situation.

This opinion is rendered solely for the benefit of the addressee hereof in connection with the initial issuance of the Bonds. The addressee may not rely on this opinion letter for any other purpose and no other person may rely on this opinion letter for any purpose without the express written consent of the undersigned. This opinion letter is limited to the matters set forth herein. This opinion is subject to future changes in applicable law and we do not undertake any obligation to update any of the opinions expressed in this letter. No opinion may be inferred or implied beyond the matters expressly stated herein, and our opinions expressed herein must be read in conjunction with the assumptions, limitations, exceptions and qualifications set forth herein. The law covered by the opinions expressed herein is limited to the laws of the Commonwealth and the federal law of the United States of America. We express no opinion herein as to any matter not set forth in the numbered paragraphs herein, including, without limitation, any other federal and state tax consequences arising with respect to the Bonds or with respect to the accuracy or completeness of the Preliminary Official Statement, dated November \_\_, 2006 (the "Preliminary Official Statement"), or the Official Statement, dated December \_\_, 2006 (the "Official Statement") prepared in respect of the offering of the Bonds, and make no representation that we have independently verified the contents thereof. We express no opinion with respect to whether the Commonwealth, in connection with the sale of the bonds or the preparation of the Preliminary Official Statement or the Official Statement, has made any untrue statement of a material fact necessary in order to make any statements made therein not misleading.

Very truly yours,

STRADLEY RONON STEVENS & YOUNG, LLP

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**NOTICE OF SALE**  
**\$939,520,000\***  
**Commonwealth of Pennsylvania**  
**General Obligation Bonds**  
**\$700,000,000 Second Series of 2006**  
**\$239,520,000\* First Refunding Series of 2006**

Electronic bids will be received by the Commonwealth of Pennsylvania (the "Commonwealth"), via **PARITY**<sup>®</sup> ("Parity") in the manner described below, up to 11:00 A.M., Eastern Standard Time, on

**Tuesday, December 5, 2006**

or such other subsequent date ("Amended Bid Date") to be announced in an Amended Notice of Sale (as hereinafter defined) to be distributed not later than 4:00 P.M. on the last business day prior to the Amended Bid Date, for the purchase of all, but not less than all, of \$700,000,000 aggregate principal amount of Commonwealth of Pennsylvania General Obligation Bonds, Second Series of 2006 (the "Second Series Bonds") and such principal amount of Commonwealth of Pennsylvania General Obligation Bonds, First Refunding Series of 2006 (the "First Refunding Series Bonds" and collectively with the Second Series Bonds, the "Bonds") as the Commonwealth shall specify to the successful bidder not later than six (6) hours after the bids have been received and opened, such principal amount of the Bonds to be not less than 98½ percent nor more than 119 percent of the aggregate principal amount of the Bonds proposed. The details of any such adjustment of principal amount of the First Refunding Series, and consequently each corresponding serial maturity of the Bonds, is described below under the paragraph heading "Adjustment of Principal Amounts."

Bids must be submitted in accordance with this Notice of Sale. All bids must be submitted in their entirety on the Parity web site. All bids must be submitted prior to the deadline of 11:00 A.M. Eastern Standard Time. No bid will be accepted after the bid deadline.

**Right to Amend**

The Commonwealth reserves the right, in its sole discretion, to change the date it will receive and open electronic bids to purchase the Bonds and to increase or decrease the principal amount of Bonds being offered. Changes to the Bonds being offered, if made, will be contained in an Amended Notice of Sale (the "Amended Notice") to be transmitted via the Bond Buyer Wire not later than 4:00 P.M. on the last business day prior to the Amended Bid Date. The Amended Notice shall (i) state the Amended Bid Date (a date not before December 5, 2006) and the time by which bids to purchase the Bonds must be received by the Commonwealth; (ii) state the revised principal amounts; (iii) state the proposed closing date; and (iv) supplement and update the information contained herein to the extent deemed necessary by the Commonwealth.

**Security**

The Bonds will be direct and general obligations of the Commonwealth, issued pursuant to and within the applicable debt limits prescribed by Sections 7 and 16 of Article VIII of the Constitution of Pennsylvania and various implementing acts of the General Assembly.

**Bond Details**

The Bonds will be dated the date of issuance and delivery, and will bear such rate or rates of interest, payable semiannually on March 1 and September 1, commencing March 1, 2007 for the First Refunding Series Bonds and September 1, 2007 for the Second Series Bonds, as shall be fixed by the purchaser in its proposal for the purchase of the Bonds (See "Interest Rate and Bidding Details" herein). The Bonds shall mature serially on the respective days and years and in the respective amounts set forth in the following table:

---

\*Proposed, subject to change.

Second Series of 2006		First Refunding Series of 2006	
Due March 1	Principal Amount	Due September 1	Principal Amount*
2007	---	2007	\$50,000
2008	\$14,885,000	2008	10,260,000
2009	22,435,000	2009	9,995,000
2010	23,555,000	2010	9,710,000
2011	24,735,000	2011	235,000
2012	25,970,000	2012	245,000
2013	27,270,000	2013	255,000
2014	28,630,000	2014	13,780,000
2015	30,065,000	2015	300,000
2016	31,565,000	2016	43,920,000
2017	33,145,000	2017	29,950,000
2018	34,800,000	2018	15,255,000
2019	36,545,000	2019	15,225,000
2020	38,370,000	2020	53,065,000
2021	40,290,000	2021	37,275,000
2022	42,300,000	2022	...
2023	44,420,000	2023	...
2024	46,640,000	2024	...
2025	48,970,000	2025	...
2026	51,420,000	2026	...
2027	53,990,000	2027	...

\*Proposed, subject to change. See "Adjustment of Principal Amounts."

Delivery of the Bonds is proposed to occur on December 21, 2006, unless another date is set forth in any Amended Notice (the "Closing Date").

The Bonds will be issued and sold by means of a book-entry only system with no distribution of Bond certificates made to the public. Bond certificates representing the aggregate principal amount of the Bonds of each respective series maturing in each year will be issued and fully registered as to principal and interest in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"), a depository registered with the Securities and Exchange Commission. Individual ownership of the Bonds will be made in principal amounts of \$5,000 or integral multiples thereof within a maturity pursuant to the rules and procedures established between DTC and its participants. Transfers of beneficial ownership will be effected through records maintained by DTC and its participants pursuant to rules and procedures established by DTC. The responsibility for maintaining, reviewing and supervising such records rests collectively with DTC and its participants. The winning bidder, as a condition to the delivery of the Bonds, shall be required to deposit the Bond certificates in its account at DTC, registered in the name of Cede & Co. Interest on the Bonds will be payable on each semi-annual interest payment date and principal of the Bonds will be paid annually as set forth in the foregoing maturity schedule, in same-day funds to DTC or its nominee as registered owner of the Bonds. Transfer of principal and interest payments to the beneficial owners by participants of DTC will be the responsibility of such DTC participants and other nominees of beneficial owners. The Commonwealth will not be responsible or liable for maintaining, supervising or reviewing the records maintained by DTC, its participants or persons acting through such participants.

### **Optional Redemption**

The Second Series Bonds maturing in the years 2008 to 2017, inclusive, are not subject to redemption. The Second Series Bonds, or portions thereof in integral multiples of \$5,000, maturing on and after March 1, 2018, are subject to redemption at the option of the Commonwealth prior to scheduled maturity on or after March 1, 2017, as a whole or in part at any time and from time to time, in any order of maturity determined by the Commonwealth and by lot within a maturity in such manner as the Commonwealth in its discretion may determine, on at least 30 days' (but not

more than 60 days') notice, at a redemption price equal to par (100% of stated principal amount) plus accrued interest to the date fixed for redemption.

The First Refunding Series Bonds maturing in the years 2007 to 2016, inclusive, are not subject to redemption. The First Refunding Series Bonds, or portions thereof in integral multiples of \$5,000, maturing on and after September 1, 2017, are subject to redemption at the option of the Commonwealth prior to scheduled maturity on or after September 1, 2016, as a whole or in part at any time and from time to time, in any order of maturity determined by the Commonwealth and by lot within a maturity in such manner as the Commonwealth in its discretion may determine, on at least 30 days' (but not more than 60 days') notice, at a redemption price equal to par (100% of stated principal amount) plus accrued interest to the date fixed for redemption.

### **Adjustment of Principal Amounts**

The aggregate principal amount and the principal amount of each serial maturity of the First Refunding Series Bonds, and consequently each corresponding serial maturity of the Bonds, are subject to adjustment by the Commonwealth of Pennsylvania after the receipt for their purchase. Changes to be made will be communicated to the successful bidder not later than six (6) hours after the bids have been received and opened and will be made only as necessary to comply with the requirement of federal tax law applicable to refunding obligations in order to maintain exemption from federal income tax for interest payable thereon and in no case will reduce or increase the aggregate principal amount of the First Refunding Series Bonds by more than 15 percent. The dollar amount bid for principal by the successful bidder will be adjusted proportionally to reflect any reduction or increase in the aggregate principal amount of the Bonds, but the interest rates specified by the successful bidder for all maturities will not change. The successful bidder may not withdraw its bid as a result of any changes within these limits.

### **Interest Rate and Bidding Details**

No bid for the Bonds at a price less than 98½% nor more than 119% of their par value, exclusive of accrued interest, will be considered. No bid will be considered which does not offer to purchase all of the Bonds. Bids for the Bonds, in order to be considered for award, must also comply with all of the specific requirements set forth below for each series of Bonds.

#### ***Second Series Bonds***

Each bidder shall designate a rate of interest per annum to be paid on the Second Series Bonds of each maturity, subject to the following limitations:

- (i) all Second Series Bonds of the same maturity date must bear the same rate of interest and no one Second Series Bond shall bear more than one rate of interest; and
- (ii) no interest rate shall be other than a whole multiple of one-twentieth (1/20) or one-eighth (1/8) of one percent (1%) and a zero rate of interest may not be named; and
- (iii) the reoffering price for Second Series Bonds of any maturity must be greater than 98½% and less than 119% of that maturity's par value.

Bids on the Second Series Bonds may specify any number of interest rates subject to (i) through (iii) above.

#### ***First Refunding Series Bonds***

Each bidder shall designate a rate of interest per annum to be paid on the First Refunding Series Bonds of each maturity, subject to the following limitations:

- (i) the bidder's rate of interest per annum shall not exceed four and three-quarters (4.75) percent to be paid on the First Refunding Series Bonds of each maturity; and
- (ii) no interest rate shall be other than a whole multiple of one-twentieth (1/20) or one-eighth (1/8) of one percent (1%) and a zero rate of interest may not be named; and
- (iii) the reoffering price for First Refunding Series Bonds of any maturity must be greater than 98½% and less than 119% of that maturity's par value.

## **Electronic Bidding Procedure**

Solely as an accommodation to bidders, the Commonwealth will receive bids delivered electronically through Parity. Further information about Parity, including any fee charged and applicable requirements, may be obtained from:

i-Deal LLC  
40 West 23<sup>rd</sup> Street  
5th Floor  
New York, NY 10010  
Phone: (212) 404-8102

All electronic bids must be delivered via Parity. If any provision of this Notice of Sale conflicts with information provided by Parity, this Notice of Sale shall control. Each bidder submitting an electronic bid agrees by doing so that it is solely responsible for all arrangements with (including any charges by) Parity, that the Commonwealth does not endorse or encourage the use of Parity, and that Parity is not acting as an agent of the Commonwealth. Instructions for submitting electronic bids must be obtained from Parity, and the Commonwealth does not assume any responsibility for ensuring or verifying bidder compliance with the procedures of Parity. The Commonwealth shall be entitled to assume that any bid received via Parity has been made by a duly authorized agent of the bidder. Acceptance of electronic bids shall be subject to the limitations set forth in “**Warnings Regarding Electronic Bids**” below.

## **Warnings Regarding Electronic Bids**

The Commonwealth and Bond Counsel assume no responsibility for any error contained in any bid submitted electronically, or for failure of any bid to be transmitted or received at the official time for receipt of bids. The Commonwealth assumes no responsibility for informing any bidders prior to the deadline for receiving bids that its bid is incomplete or not received.

The Commonwealth will accept bids in electronic form only through Parity on the official bid form created for such purpose by Parity. Each bidder submitting an electronic bid understands and agrees by doing so that it is solely responsible for all arrangements with Parity, that the Commonwealth neither endorses nor explicitly encourages the use of Parity, and that Parity is not acting as agent of the Commonwealth. Instructions and forms for submitting electronic bids must be obtained from Parity, and the Commonwealth assumes no responsibility for ensuring or verifying bidder compliance with the procedures of Parity. The Commonwealth shall assume that any bid received through Parity has been made by a duly authorized agent of the bidder.

## **Reoffering and Sale of Bonds to Public**

Within thirty minutes after notification of award of the Bonds the successful bidder (the “Underwriter”) shall provide to the Commonwealth the initial offering price to the public (excluding bond houses and brokers or similar persons or organizations acting in the capacity as wholesalers or underwriters) for each maturity of the Second Series Bonds and the First Refunding Series Bonds (the “Initial Reoffering Prices”) and certain other information to enable the Commonwealth to compute the yield on the Bonds for federal tax law purposes. The successful bidder will be required to provide a certificate prior to settlement for the Bonds in form satisfactory to the Commonwealth and Bond Counsel stating the Initial Reoffering Prices at which a substantial amount (at least 10 percent) of each maturity of Bonds has been sold and stating the yield on the Bonds.

Each bidder, by the submission of a bid, agrees that if it is the successful bidder, it will make a *bona fide* public offering of the Bonds at prices not greater than the Initial Reoffering Prices, offer the Bonds only pursuant to the Official Statement and only in jurisdictions where the offer is legal, and deliver a copy of the Official Statement to each person or entity that purchases the Bonds from the Underwriter as required by Securities and Exchange Commission Rule 15c2-12. The Underwriter shall abide by all rules of the Municipal Securities Rulemaking Board (“MSRB”) in connection with the issuance and sale of the Bonds, including the delivery to the MSRB of the Official Statement and any advance refunding documents.

## **Basis of Awards**

Award of the Bonds will be made on or before 5:00 P.M. Eastern Standard Time, on December 5, 2006 or, in the event of the announcement of an Amended Bid Date, the date specified in the Amended Notice. The Bonds will be sold to the bidder making a bid conforming to the terms of the offering which, on the basis of the lowest net effective interest rate for the Bonds, determined in the manner hereinafter stated, is the best bid, subject to the right of the undersigned in their sole discretion to reject any and all bids. The net effective interest rate for the Bonds shall be the interest rate determined on a true interest cost ("TIC") basis by doubling the semi-annual interest rate, compounded semi-annually, necessary to discount the debt service payments to the date of delivery of the Bonds, December 21, 2006, to the price bid, including interest accrued to the date of delivery, if any. In the event of more than one bid specifying such lowest rate, the Bonds will be awarded to the bidder whose bid is selected by lot from among all such lowest bids.

## **Official Bid Form**

All electronic bids shall be deemed to incorporate the provisions of the Official Bid Form. The Commonwealth reserves the right in its sole discretion to waive any minor errors or irregularities in form or content of any bid. No sealed, telephone, facsimile, telegraph or personal delivery bids will be accepted. All bids must be submitted electronically through the Parity web site.

## **Good Faith Check or Surety Bond**

A certified or bank cashier's or treasurer's check drawn on an incorporated bank or trust company, must be provided or a financial surety bond (the "Surety Bond") submitted, payable to the order of the Commonwealth of Pennsylvania in the amount of \$1,000,000 (the "Deposit"). If a check is provided, it must accompany the bid. If a Surety Bond is submitted, it must be from an insurance company acceptable to the Commonwealth and licensed to issue such a bond in the Commonwealth of Pennsylvania, such Surety Bond must be submitted to the Commonwealth prior to the opening of bids and must be in form and substance acceptable to the Commonwealth. The Surety Bond must identify each bidder whose Deposit is guaranteed by such Surety Bond. Checks accompanying bids not accepted will be returned to the bidders within 24 hours from the time of opening the bids. If the Bonds are awarded to a bidder utilizing a Surety Bond, then that successful bidder is required to submit its Deposit in the form of a federal funds wire transfer as instructed by the Commonwealth by not later than 11:00 a.m. Eastern Standard Time on the next business day following the award. If such deposit is not received by that time, the Surety Bond may be drawn upon by the Commonwealth to satisfy the Deposit requirement.

The Commonwealth reserves the right, in its sole discretion, to present the good faith check of the successful bidder for payment and to deposit the proceeds of such check or the draw on the Surety Bond and to invest the Deposit to the date of settlement on the Bonds. The Deposit, but not any earnings from any investment thereof, will be applied to the purchase price of the Bonds, or, if such bid is not performed, such proceeds will be retained by the Commonwealth as liquidated damages, unless the failure of performance shall be caused by an act or omission of the Commonwealth.

## **Official Statement and Continuing Disclosure - SEC Rule 15c2-12**

The Preliminary Official Statement dated November 28, 2006, issued with respect to the Bonds (the "Preliminary Official Statement"), has been deemed final by the Commonwealth as of its date for purposes of SEC Rule 15c2-12 (the "Rule"), except for the omission of information as permitted by the Rule, but is subject to revision, amendment, and completion in the final Official Statement (hereinafter the "Official Statement") to be prepared with respect to the Bonds. A reasonable number of copies (not to exceed 1,000) of the Official Statement, to be dated as of a date prior to settlement, will be furnished to the purchaser within seven business days after the sale date. Copies of the Official Statement in excess of 1,000 will be furnished at the request of the successful bidder at its own expense. The successful bidder will be required to provide pricing information necessary for the Commonwealth to complete the Official Statement.

In order to assist bidders in complying with the Rule, the Commonwealth will execute a written Continuing Disclosure Agreement to provide or cause to be provided, in accordance with the Rule, certain annual financial information and timely notices of the occurrence of certain events, if material, with respect to the Bonds. A description of this Continuing Disclosure Agreement is set forth in the Preliminary Official Statement and will also be set forth in the Official Statement.

### **CUSIP Numbers**

CUSIP numbers will be assigned at the purchaser's expense. The CUSIP numbers will be printed on the Bonds, provided, however, that incorrect numbers shall not constitute grounds for a purchaser of the Bonds to refuse delivery thereof.

### **Delivery of Bonds**

Bond certificates will be delivered through the Loan and Transfer Agent to DTC using DTC's Fast Automated Security Transfer (FAST) System. Payment for the Bonds must be made by wire in immediately available funds for credit at Manufacturers and Traders Trust Company, Loan and Transfer Agent, in Harrisburg, Pennsylvania, at 10:00 A.M., Eastern Standard Time, on the Closing Date, or at such other place and time as may be agreed upon with the successful bidder.

The successful bidder shall have the right, at its option, to cancel its obligation to purchase the Bonds if the Commonwealth shall fail to tender the Bonds for delivery within 60 days from the date herein fixed for the receipt of the bids, and in such event, the successful bidder shall only be entitled to the return of its Deposit, without interest, and shall have no right of action against the Commonwealth.

### **Legal Opinions**

The Commonwealth will deliver to the purchaser without charge: (i) the opinion of the Attorney General of the Commonwealth and (ii) the opinion of Stradley Ronon Stevens and Young, LLP, Philadelphia, Pennsylvania, appointed by the Commonwealth as Bond Counsel, both substantially in the forms of their opinions set forth as appendices to the Preliminary Official Statement.

### **Closing Documents**

The Bonds are offered subject to the delivery at settlement by the Commonwealth of (i) a certificate stating that there is no litigation pending affecting the validity of the Bonds or their issuance and sale to the purchaser; (ii) a certification by the Secretary of the Budget that the financial statements contained in the Official Statement accurately reflect the conditions and facts they purport to reflect, that the estimates contained therein, in light of the information available, are believed to be reliable and that there have been no material adverse changes in the financial position of the Commonwealth since the dates of such financial statements not disclosed in the Official Statement; (iii) a certification by the Governor, the Auditor General and the State Treasurer that the Official Statement, except as to the financial statements contained therein, contains no untrue statement of a material fact and does not omit to state a material fact necessary in order to make the statements made therein, in light of the circumstances under which they were made, not misleading; and (iv) a Continuing Disclosure Agreement to provide or cause to be provided certain annual financial information and timely notices of the occurrence of certain events, if material, with respect to the Bonds.

Prior to settlement the purchasers will be required to deliver the certificate referred to under the caption "Reoffering and Sale of Bonds to Public" above.

### **Copies of Documents**

Additional information and copies of the Preliminary Official Statement, which includes the Official Bid Form as Appendix H issued in connection with the Bonds, may be obtained from the Loan and Transfer Agent, Manufacturers and Traders Trust Company, Harrisburg, Pennsylvania (Telephone 717-231-2613) or from the Office of the Budget,

Seventh Floor, Bell Tower, Harrisburg, Pennsylvania 17101 (Telephone 717-783-3086). The Preliminary Official Statement may also be downloaded from the Office of the Budget area on the Commonwealth's site on the world wide web, [www.budget.state.pa.us](http://www.budget.state.pa.us)

**EDWARD G. RENDELL**  
*Governor*

**ROBERT P. CASEY, JR.**  
*State Treasurer*

**JACK WAGNER**  
*Auditor General*

Dated: November 28, 2006

**OFFICIAL BID FORM**  
**\$939,520,000\***  
**Commonwealth of Pennsylvania**  
**General Obligation Bonds**  
**\$700,000,000 Second Series of 2006**  
**\$239,520,000\* First Refunding Series of 2006**

Honorable Edward G. Rendell, Governor  
Honorable Robert P. Casey, Jr., State Treasurer  
Honorable Jack Wagner, Auditor General

December 5, 2006

Gentlemen:

The undersigned, on behalf of a group which we have formed consisting of the persons, firms and corporations named below, and in accordance with the terms and conditions of the Notice of Sale, dated November 28, 2006 (the "Notice"), which hereby is made a part hereof by reference thereto, for the purchase of \$700,000,000 aggregate principal amount of Commonwealth of Pennsylvania General Obligation Bonds, Second Series of 2006, (the "Second Series Bonds") and \$239,520,000\* aggregate principal amount of Commonwealth of Pennsylvania General Obligation Bonds, First Refunding Series of 2006, (the "First Refunding Series Bonds" and collectively with the Second Series Bonds, the "Bonds"), and subject to the conditions hereinafter stated, hereby agree to purchase all, but not less than all, of the Bonds and pay therefor the sum of:

\$ .....  
(Purchase price not to be less than \$925,427,200.00\*)

together with accrued interest, if any, to the date of delivery. The Bonds will be initially dated the date of issuance and delivery, and will mature serially on the dates and in the respective principal amounts set forth in the following table, and will bear interest from the date of issuance and delivery, payable semiannually on March 1 and September 1 in each year commencing March 1, 2007 for the First Refunding Series Bonds and commencing on September 1, 2007 for the Second Series Bonds, at the respective rates, all as set forth in the following table, and subject to redemption as set forth in the Notice:

<u>Due</u> <u>March 1</u>	Second Series of 2006 Principal <u>Amount</u>	Interest <u>Rate</u>	<u>Due</u> <u>September 1</u>	First Refunding Series of 2006 Principal <u>Amount*</u>	Interest <u>Rate**</u>
2007	...	%	2007	\$50,000	%
2008	\$14,885,000		2008	10,260,000	
2009	22,435,000		2009	9,995,000	
2010	23,555,000		2010	9,710,000	
2011	24,735,000		2011	235,000	
2012	25,970,000		2012	245,000	
2013	27,270,000		2013	255,000	
2014	28,630,000		2014	13,780,000	
2015	30,065,000		2015	300,000	
2016	31,565,000		2016	43,920,000	
2017	33,145,000		2017	29,950,000	
2018	34,800,000		2018	15,255,000	
2019	36,545,000		2019	15,225,000	
2020	38,370,000		2020	53,065,000	
2021	40,290,000		2021	37,275,000	
2022	42,300,000		2022	...	
2023	44,420,000		2023	...	
2024	46,640,000		2024	...	
2025	48,970,000		2025	...	
2026	51,420,000		2026	...	
2027	53,990,000		2027	...	

\* Proposed, subject to change. The aggregate principal amount of each serial maturity of the First Refunding Series Bonds are subject to adjustment by the Commonwealth of Pennsylvania after receipt of bids for their purchase as described in the Notice.

\*\*The interest on these bonds cannot exceed 4.75 percent per annum.



In accordance with the terms of the Notice, there is enclosed herewith a certified or official bank check or a surety bond for \$1,000,000 payable to the order of the Commonwealth of Pennsylvania.

Signature and Title: \_\_\_\_\_ Contact Person: \_\_\_\_\_  
(Print or Type)

Firm: \_\_\_\_\_ Telephone: \_\_\_\_\_

**NOT A PART OF BID**

Net effective interest rate per annum calculated in conformity with the Notice ..... %.

Total amount of interest from date of the Bonds to final maturity \$ .....

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**CIFG ASSURANCE NORTH AMERICA, INC.  
OFFICIAL STATEMENT DISCLOSURE**

**THE BOND INSURER**

**CIFG Assurance North America, Inc.**

The information set forth in the following paragraphs has been provided by CIFG Assurance North America, Inc. (“CIFG” or the “Insurer”) for inclusion in this Official Statement. CIFG does not accept any responsibility for the accuracy or completeness of this Official Statement or any information or disclosure contained herein, or omitted herefrom, other than with respect to the accuracy of the information regarding CIFG set forth under the heading “The Bond Insurer”. CIFG makes no representation regarding the Bonds or the advisability of investing in the Bonds.

**General**

CIFG is a monoline financial guaranty insurance company incorporated under the laws of the State of New York. The address of the principal executive offices of the Insurer is 825 Third Avenue, Sixth Floor, New York, New York 10022; its toll-free telephone number is (866) CIFG-212 and its general telephone number is (212) 909-3939 and its website is located at [www.cifg.com](http://www.cifg.com).

The Insurer is a member of the CIFG Group of financial guaranty companies, which also includes CIFG Europe, a French insurance company licensed to do business in the European Union, and CIFG Guaranty, a dedicated French reinsurance corporation. In addition to its capital and surplus as set forth below, the Insurer is supported by a net worth maintenance agreement from CIFG Guaranty, which provides that CIFG Guaranty will maintain the Insurer’s New York statutory capital and surplus at no less than \$80 million, and may cede a substantial portion (not to exceed 90%) of its exposure on each transaction to CIFG Guaranty through a facultative reinsurance agreement.

Each of the Insurer, CIFG Europe and CIFG Guaranty has received an insurer financial strength rating of “AAA” from Fitch, an insurer financial strength rating of “Aaa” from Moody’s, and an insurer financial enhancement rating of “AAA” from Standard and Poor’s, the highest rating assigned by each rating agency. Each such rating should be evaluated independently. The ratings reflect the respective rating agency’s current assessment of each company’s capacity to pay claims on a timely basis and are not recommendations to buy, sell or hold the Bonds. Such ratings may be subject to revision or withdrawal at any time.

The Insurer is licensed and subject to regulation as a financial guaranty insurance corporation under the laws of the State of New York, its state of domicile, and is licensed to do business in 48 jurisdictions. The Insurer is subject to Article 69 of the New York Insurance Law which, among other things, limits the business of such insurers to financial guaranty insurance and related lines, requires that such insurers maintain a minimum surplus to policyholders, establishes contingency, loss and unearned premium reserve requirements for such insurers, and limits the size of individual transactions and the volume of transactions that may be underwritten by such insurers. Other provisions of the New York Insurance Law applicable to non-life insurance companies such as the Insurer regulate, among other things, permitted investments, payment of dividends, transactions with affiliates, mergers, consolidations, acquisitions or sales of assets and incurrence of liabilities for borrowings.

**Capitalization.** The following tables set forth the capitalization of the Insurer on the basis of accounting principles generally accepted in the United States (“US GAAP”) and statutory accounting practices prescribed or permitted by the New York State Insurance Department, respectively.

	<b>US GAAP</b> <b>June 30, 2006</b> <b>(in thousands of US dollars)</b>	<b>US GAAP</b> <b>December 31, 2005</b> <b>(in thousands of US dollars)</b>
Total Assets .....	\$349,385	\$ 324,134
Total Liabilities .....	\$229,913	\$ 202,042
Shareholder's Equity .....	\$119,472	\$ 122,092
	<b>Statutory Accounting Practices</b> <b>June 30, 2006</b> <b>(in thousands of US dollars)</b>	<b>Statutory Accounting Practices</b> <b>December 31, 2005</b> <b>(in thousands of US dollars)</b>
Admitted Assets.....	\$177,546	\$ 175,333
Liabilities.....	\$70,845	\$ 66,758
Capital and Surplus.....	\$106,701	\$ 108,575

The following table sets forth the capitalization of CIFG Guaranty on the basis of US GAAP.

	<b>US GAAP</b> <b>December 31, 2005</b>	
	(in thousands of euros)	(in thousands of US dollars) (1)
Assets.....	€ 736,208	\$ 871,634
Liabilities.....	€ 196,794	\$ 232,995
Shareholder's Equity .....	€ 539,414	\$ 638,639

(1) The translation of euros into dollars is presented solely for the convenience of the reader, using the observed exchange rate at December 31, 2005 of \$1.18395 to €1.00. The convenience translation should not be construed as representation that the euro amounts have been, could have been, or in the future could be, converted into U.S. Dollars at this or any rate of exchange.

For further information concerning the Insurer and CIFG Guaranty, see the audited financial statements of both companies, including the respective notes thereto, prepared in accordance with US GAAP as of December 31, 2005 and 2004 and for each of the three years in the period ended December 31, 2005, and the unaudited interim financial statements of the Insurer as of June 30, 2006 and for the six-month period ended June 30, 2006, which are available on the CIFG Group's website at [www.cifg.com](http://www.cifg.com). Copies of the most recent audited annual and unaudited interim financial statements of the Insurer prepared in accordance with accounting principles prescribed or permitted by the New York State Insurance Department, are also available on the website and may be obtained, without charge, upon request to the Insurer at its address above, Attention: Finance Department.



CIFG Assurance North America, Inc.
825 Third Avenue, Sixth Floor
New York, NY 10022
For information, contact (212) 909-3939
Toll-free (866) 243-4212

FINANCIAL GUARANTY INSURANCE POLICY

ISSUER: \_\_\_\_\_

Policy No.: CIFG NA-##

CUSIP: \_\_\_\_\_

Effective Date: \_\_\_\_\_, 200\_

OBLIGATIONS: \_\_\_\_\_

CIFG ASSURANCE NORTH AMERICA, INC. ("CIFG NA"), for consideration received, hereby UNCONDITIONALLY AND IRREVOCABLY GUARANTEES to each Policyholder, subject only to the terms and conditions of this Policy (which includes each endorsement hereto), the full and complete payment by or on behalf of the Issuer of Regular Payments of principal of and interest on the Obligations.

For the further protection of each Policyholder, CIFG NA irrevocably and unconditionally guarantees:

- (1) payment of any amount required to be paid under this Policy by CIFG NA following CIFG NA's receipt of notice and instruments of assignment as described in Endorsement No. 1 hereto and
(2) payment of the amount of any distribution of principal of and interest on the Obligations made during the Term of this Policy to such Policyholder that is subsequently avoided in whole or in part as a preference payment under applicable law, all as described in Endorsement No. 1 hereto.

CIFG NA shall be subrogated to the rights of each Policyholder to receive payments under the Obligations to the extent of any payment by CIFG NA hereunder. Upon disbursement in respect of an Obligation, CIFG NA shall become the owner of the Obligation, appurtenant coupon, if any, and all rights to payment of principal thereof or interest thereon.

The following terms shall have the meanings specified below, subject to and including any modifications set forth in any endorsement hereto, for all purposes of this Policy. "Effective Date," "Issuer" and "Obligations" mean, respectively, the Effective Date, Issuer and Obligations referenced above. "Policyholder" means, if the Obligations are in book-entry form, the registered owner of any Obligation as indicated on the registration books maintained by or on behalf of the Issuer for such purpose or, if the Obligations are in bearer form, the holder of any Obligation; provided, however, that any trustee acting on behalf of and for the benefit of such registered owner or holder shall be deemed to be the Policyholder to the extent of such trustee's authority. "Regular Payments" means payments of interest and principal which are agreed to be made during the Term of this Policy in accordance with the original terms of the Obligations when issued and without regard to any amendment or modification of such Obligations thereafter; payments which become due on an accelerated basis as a result of (a) a default by the Issuer or any other person, (b) an election by the Issuer to pay principal or other amounts on an accelerated basis or (c) any other cause, shall not constitute "Regular Payments" unless CIFG NA shall elect, in its sole discretion, to pay such principal due upon such acceleration together with any accrued interest to the date of acceleration. "Term of this Policy" has the meaning set forth in Endorsement No. 1 hereto.

This Policy sets forth in full the undertaking of CIFG NA, and shall not be modified, altered or affected by any other agreement or instrument, including any modification or amendment thereto or to the Obligations (except a contemporaneous or subsequent agreement or instrument given by CIFG NA or to which CIFG NA has given its written consent) or by the merger, consolidation or dissolution of the Issuer. The premiums paid in respect of this Policy are nonrefundable for any reason whatsoever, including payment, or provision being made for payment, of the Obligations prior to maturity. This Policy may not be cancelled or revoked during the Term of this Policy, including for nonpayment of premium due to CIFG NA. Payments under this Policy may not be accelerated except at the sole option of CIFG NA.

In witness whereof, CIFG ASSURANCE NORTH AMERICA, INC. has caused this Policy to be executed on its behalf by its Authorized Officer.

CIFG ASSURANCE NORTH AMERICA, INC.

By \_\_\_\_\_
Authorized Officer

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