

**Long Island Power Authority**

**Biennial Report  
of the  
Consulting Engineer and Rate Consultant  
for the Period  
January 1, 2002 through December 31, 2003**

**August 31, 2004**

**NAVIGANT CONSULTING, INC.**



August 31, 2004

Long Island Power Authority  
Board of Trustees  
333 Earle Ovington Boulevard  
Suite 403  
Uniondale, New York 11553

Chairman and Members of the Board of Trustees:

Navigant Consulting, Inc. ("Navigant Consulting") has been retained by the Long Island Power Authority (the "Authority") as the Authority's Consulting Engineer and Rate Consultant (as such terms are defined in the General Bond Resolution and the General Subordinated Resolution) for the purpose of an examination of, and preparation of a report on, the properties and operations of the System. This report (the "Biennial Report") is to be prepared no less frequently than every other Fiscal Year, commencing with Fiscal Year 1999 (the 12 months ended December 31, 1999) pursuant to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution. Navigant Consulting submits this Biennial Report for the Fiscal-Year 2002 through 2003 period (the "Historical Period") presenting the results of its review and investigations.

In preparation of the Biennial Report, Navigant Consulting has reviewed the operation, maintenance, and repair of the System for the Historical Period and estimated results for the two Fiscal Years ending December 31, 2005. Navigant Consulting has also reviewed the rates, fees, rents, charges, and surcharges of the Authority. For purposes of this assignment, Navigant Consulting has made investigations and analyses, including such investigations conducted previously in connection with issuance of the Authority's Electric System General Revenue Bonds, Series 2003A, discussions with staff and representatives of the Authority and KeySpan Corporation d/b/a "KeySpan", among others, and examinations of reports and projections prepared by consultants and advisors to the Authority, which Navigant Consulting deemed necessary and appropriate to reach its conclusions.

Respectfully submitted,

A handwritten signature in cursive script that reads "Patrick S. Hurley".

Patrick S. Hurley  
Managing Director

# Table of Contents

SECTION 1: INTRODUCTION.....	1
SECTION 2: DESCRIPTION OF THE SYSTEM.....	3
SECTION 3: MANAGEMENT AND OPERATION OF THE SYSTEM .....	5
SECTION 4: TRANSMISSION AND DISTRIBUTION.....	7
SECTION 5: NINE MILE POINT NUCLEAR POWER STATION, UNIT 2.....	16
SECTION 6: ADEQUACY OF RATES AND CHARGES.....	19
SECTION 7: FINDINGS .....	25

## Exhibits

EXHIBIT 1: ACTUAL OPERATING RESULTS.....	27
EXHIBIT 2: PROJECTED OPERATING RESULTS.....	28

## Appendices

Appendix A: SUMMARY OF CERTAIN PROVISIONS OF THE MANAGEMENT SERVICES AGREEMENT .....	A-1
Appendix B: SUMMARY OF CERTAIN PROVISIONS OF THE POWER SUPPLY AGREEMENT .....	B-1
Appendix C: SUMMARY OF CERTAIN PROVISIONS OF THE ENERGY MANAGEMENT AGREEMENT .....	C-1

## SECTION 1 INTRODUCTION

The Long Island Power Authority (the “Authority”) is a corporate municipal instrumentality and political subdivision of the State of New York authorized under the Long Island Power Authority Act (the “Act”). The Authority became the retail supplier of electric service in most of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens County (the “Service Area”) on May 28, 1998 by acquiring the Long Island Lighting Company (“LILCO”) as a wholly owned subsidiary of the Authority through a merger (the “LIPA/LILCO Merger”). Since the LIPA/LILCO Merger, LILCO has done business under the name “LIPA”. Before the LIPA/LILCO Merger, LILCO was a publicly traded, shareholder-owned corporation that, since the early 1900’s, was the sole supplier of both retail electric and gas service in the Service Area. LIPA (LILCO) no longer provides gas service in the Service Area. For the period prior to the LIPA/LILCO Merger, LILCO is referred to herein as “LILCO” and, for the subsequent period, is referred to herein as “LIPA.”

The Authority, through LIPA, owns, among others, the following assets: (i) an electric transmission and distribution system (the “T&D System”) serving most of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens County, including assets, facilities, equipment, and contractual arrangements used to provide the transmission and distribution of electrical capacity and energy to electric customers within the Service Area; (ii) an 18 percent ownership interest in the Nine Mile Point 2 Nuclear Power Station (“NMP2”) located in upstate New York; and (iii) certain other intangible assets resulting from the LIPA/LILCO Merger. These assets, together with all other assets of the Authority and LIPA used in the furnishing of electric service, are referred to as the “System.”

LIPA provides retail electric service to approximately 1.1 million customers within the Service Area. During 2003, the maximum annual peak demand experienced by LIPA totaled approximately 4,794 megawatts (“MW”), inclusive of sales for resale. During this period, LIPA’s total annual revenues approximated \$2.58 billion, of which over \$2.56 billion was derived from retail electric sales.

### **Purpose of the Report**

The Authority had a total of approximately \$7.1 billion of senior lien, subordinate lien, and subsidiary debt outstanding as of June 30, 2004. As of such date, approximately \$5.8 billion of senior lien bonds issued under the Authority’s Electric System General Revenue Bond Resolution (the “General Bond Resolution”) were outstanding. The Authority also had outstanding approximately \$1.2 billion of subordinate lien bonds, issued under the Authority’s Electric System General Subordinated Revenue Bond Resolution (the “General Subordinated Resolution”), and approximately \$155.4 million of New York State Energy Research and Development Authority Financing Notes for which it is primarily responsible, and for which LIPA holds a Promissory Note from KeySpan for an equivalent amount. The General Bond Resolution and General Subordinated Resolution contains certain covenants that require the Authority to undertake certain actions on an annual or periodic basis. One such action involves the performance by the Authority’s Consulting Engineer and Rate Consultant (as such terms are defined in the General Bond Resolution and the General Subordinated Resolution) of an examination of, and preparation of a report on, the properties and operations of the System. This report (the “Biennial Report”) is to be prepared no less frequently than every other Fiscal Year, commencing with Fiscal Year 1999 (the 12 months ended December 31, 1999).

Pursuant to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution, the Biennial Report is to set forth the following:

- (i) “The Consulting Engineer’s advice and recommendations as to the proper operation, maintenance, and repair of the System during the ensuing two Fiscal Years, and an estimate of the amounts of money necessary for such purposes;
- (ii) The Consulting Engineer’s advice and recommendations as to improvements which should be made during the ensuing two Fiscal Years, and an estimate of the amounts of money necessary for such purposes, showing the amount projected to be expended during such Fiscal Years from the proceeds of Bonds and Subordinated Indebtedness issued under or pursuant to the Resolution;
- (iii) The Rate Consultant’s recommendation as to any necessary or advisable revisions of rates, fees, rents, charges and surcharges and such other advice and recommendation as it may deem desirable; and
- (iv) The Consulting Engineer’s findings as to whether the System has been maintained in good repair and sound operating condition, and its estimate of the amount, if any, required to be expended to place such properties in such condition and the details of such expenditures and the approximate time required therefore.”

Navigant Consulting, Inc. (“Navigant Consulting”) has been retained by the Authority to serve as the Consulting Engineer and the Rate Consultant to perform the examination of the properties and operations of the System, as required by the General Bond Resolution and General Subordinated Resolution, and to render its findings with respect to the above subject matter. This Biennial Report covers the Fiscal-Year 2002 through 2003 period (the “Historical Period”) and the Fiscal-Year 2004 through 2005 forecast period (the “Forecast Period”). Information presented herein with respect to LIPA’s historical operations is limited to financial and operating results known to have occurred as of December 31, 2003, except as otherwise noted. Additional information and items of a material nature have been included in this Biennial Report based on information available to Navigant Consulting through the date of this Biennial Report. Navigant Consulting’s findings with respect to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution can be found in Section 7 of this Biennial Report.

#### **Navigant Consulting, Inc.**

Navigant Consulting is a nationally recognized firm of engineers, economists, regulatory specialists, and management consultants headquartered in Chicago, Illinois. Navigant Consulting’s professionals provide services to various industries, including electric and gas utilities, power producers, fuel suppliers, and power marketers. Typical services include power marketing analysis, transmission and distribution system planning, generation facilities evaluation, rate and pricing studies, environmental assessments, conservation and demand-side management (“DSM”) program development and evaluation, strategic planning, marketing studies, and related services.

In addition to serving as the Authority’s Consulting Engineer and Rate Consultant, Navigant Consulting provides day-to-day assistance to the Authority on various issues, including operations, management, and expansion of its facilities, power supply resource development, rates and charges, environmental compliance, financial forecasting, and budget review and development, among other areas.

## **SECTION 2**

### **DESCRIPTION OF THE SYSTEM**

The Service Area encompasses the bulk of Long Island in New York State, and is comprised of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens County, an area of approximately 1,230 square miles, excluding areas served by three existing municipal utilities: the villages of Freeport, Greenport, and Rockville Centre. Suffolk County is the easternmost county within the Service Area and covers an area of approximately 911 square miles, followed by Nassau County with a 287 square mile area, and the Rockaway Peninsula with an area of approximately 32 square miles. The Service Area is bounded by the Atlantic Ocean on the south and east, by the Long Island Sound on the north and by portions of New York City on the west. Based on LIPA's Long Island Population Survey for 2003, the population of the Service Area was approximately 2.9 million people as of January 1, 2003.

#### **Climatic Factors**

Long Island experiences seasonal conditions typical of the northeast United States. Summers are usually hot with high temperatures in excess of 90°F, accompanied by high levels of humidity. Winters include snow and icing conditions that can be damaging to overhead power lines. In addition, the Service Area experiences severe storms, including "nor'easters" and hurricanes, which can be particularly damaging due to Long Island's coastal location. In response to these conditions, the T&D System has been constructed and maintained to minimize damage from high winds and icing, and LIPA has adopted storm response procedures consistent with LILCO's past practices that are designed to restore service expeditiously.

#### **Customer Base**

Approximately 99 percent of LIPA's total revenues are derived from electric sales to retail customers. As of December 31, 2003, LIPA served approximately 1.1 million retail electric customers, of whom approximately 90 percent were residential users. During the year ending December 31, 2003, residential customers provided approximately 52 percent of LIPA's annual retail electric revenues and commercial and industrial customers provided approximately 47 percent of annual retail electric revenues. The balance of retail electric revenues is derived from electric sales for public lighting and sales to public authorities.

Although commercial and industrial customers provide a significant portion of annual electric sales revenues, these customers account for only 10 percent of the retail electric customers served by LIPA. In general, individual commercial and industrial customers are relatively small; with approximately 94 percent of these customers having peak demands less than 75 kilowatts ("kW"). Furthermore, the Service Area contains little traditional "industrial" loads, and customers served under this rate classification are primarily large commercial customers. The single largest customer in the Service Area accounts for just over one percent of total electric sales. Overall, the 20 largest electric customers, in aggregate, accounted for less than four percent of total retail energy sales and revenues during 2003.

LIPA also provides electric transmission service to NYPA for the delivery of NYPA capacity and energy to the three municipal utilities and other NYPA-power recipients on Long Island, including the Suffolk County Electrical Agency ("SCEA") and the Nassau County Public Utility Agency ("NCPUA").

Table 1 provides summary information on annual retail energy sales and retail electric revenues within the Service Area during the 1999 through 2003 period. Included in Table 1 is information on numbers of retail electric customers for this historical period, as well as annual peak demand for electricity and annual energy requirements. Electric sales during 2003 approximated 19,029,906-megawatt hours (“MWh”), an increase of approximately 1.2 percent over the 2002 level.

**TABLE 1  
HISTORICAL STATISTICS<sup>1</sup>**

	1999	2000	2001	2002	2003
Peak Demand (MW) .....	4,622	4,252	4,781	4,929	4,794
Energy (MWh) <sup>2</sup>					
Residential .....	8,049,525	7,933,307	8,351,224	8,791,024	9,010,295
Commercial and Industrial .....	9,059,247	9,440,543	9,449,745	9,613,083	9,593,552
Other .....	431,151	423,098	427,067	411,615	426,059
Total Sales .....	17,539,923	17,796,948	18,228,036	18,815,722	19,029,906
Lost and Unaccounted For <sup>3</sup> .....	1,322,892	1,232,647	1,382,626	1,422,551	1,448,646
Total Energy Requirements ....	18,862,815	19,029,595	19,610,662	20,238,273	20,478,552
System Load Factor (Percent) .....	46.6	51.4	46.8	46.9	48.8
Customers <sup>4</sup>					
Residential .....	941,434	949,840	957,738	965,198	970,746
Commercial and Industrial .....	108,255	109,565	110,606	111,715	112,343
Other .....	4,882	4,924	4,966	5,051	5,023
Total Customers .....	1,054,571	1,064,329	1,073,310	1,081,964	1,088,112
Retail Electric Revenues (\$000) <sup>5</sup> .....	\$2,139,834	\$2,092,923	\$2,250,223	\$2,432,465	\$2,563,542

<sup>1</sup> Provided by KeySpan. Amounts may not total due to rounding.

<sup>2</sup> Excludes Sales for Resale.

<sup>3</sup> Includes Company service.

<sup>4</sup> Numbers of meters at year-end.

<sup>5</sup> Excludes Sales for Resale. Includes fuel and purchased power adjustment clause revenues.

### **Transmission and Distribution System**

The T&D System is an integrated transmission and distribution system with electricity delivered, in part, to the Service Area over five transmission interconnections that are owned in part by or are under contract to LIPA. A sixth transmission interconnection owned by the Cross Sound Cable Company, LLC (the “Cross Sound Cable”), was placed in service in May 2002. During the Historical Period, the Cross Sound Cable has operated on a limited basis due to environmental concerns by the State of Connecticut (as described later in this Biennial Report). These interconnections link the T&D System to utilities outside the Service Area. A more complete description of the T&D System is provided in Section 4 of this Biennial Report.

### SECTION 3 MANAGEMENT AND OPERATION OF THE SYSTEM

The Authority manages the operations, performance, and costs of the System with a senior management team comprised of engineering, legal, financial, accounting and management professionals. The organization and performance of this senior management team is described below. This section also includes a discussion of the responsibilities of KeySpan Corporation (“KeySpan”) under the terms of certain key outsourcing agreements.

#### **Authority Management and Organization**

The Authority manages the performance and cost of electric service within the Service Area with a senior management team and organizational structure intended to maintain a small total work force. The Authority staff is responsible for certain on-going functions, including, but not limited to: (i) certain system planning activities; (ii) certain power marketing efforts; (iii) DSM program definition; and (iv) financing activities. The Authority uses a combination of: (i) a core group of senior managers; (ii) internal professional and administrative support staff; and (iii) outsourced services by specialists to meet the wide variety of skills and experience required to guide the management of the electric utility.

The day-to-day operation of the System, including LIPA’s ownership interest in NMP2, is outsourced principally to KeySpan through the Management Services Agreement (the “MSA”), the Power Supply Agreement (the “PSA”), and the Energy Management Agreement (the “EMA”), using primarily management and other personnel previously performing these functions for LILCO. Summaries of these services and agreements are described more fully in the appendices to this Biennial Report.

The Authority has adopted an organization which includes the following senior management positions: (i) Chairman, President, and Chief Executive Officer; (ii) Senior Vice President and Chief of Staff; (iii) Chief Operating Officer; (iv) Chief Financial Officer; (v) General Counsel; (vi) Vice President of Power Markets; (vii) Vice President of Communications; (viii) Vice President of Retail Services; and (ix) Controller. In addition, the Authority employs experienced support personnel to assist in its day-to-day activities.

In addition to its internal staff and resources available through the MSA, PSA, and EMA, the Authority utilizes outside experts for those tasks or functions that require independent resources or, by their nature, are best performed by contractors. Examples of tasks performed through this arrangement include, but are not limited to, the following:

- Review of actual costs incurred under outsourcing agreements, including related incentive/disincentive compensation provisions;
- Review of electricity and fuel procurement practices;
- Review and evaluation of annual operating and capital budgets;
- Solicitation and evaluation of new capacity and energy supplies;
- Review of system dispatch and off-system sales and purchases;
- Review and evaluation of various regional and federal electricity market design proposals; and



- Review of on-going programs to ensure compliance with applicable environmental, health, and safety requirements.

The Authority provides the continuity of policy making, rate setting, financial planning, and management of the T&D System and NMP2 by maintaining capability on its management team and in-house staff, and by making use of outsourced services.

### **Services Outsourced to KeySpan**

At the time of the LIPA/LILCO Merger, the Authority entered into certain agreements aimed at assisting LIPA with the production, acquisition, and delivery of electricity in the Service Area. These agreements include the MSA, the PSA, and the EMA, as well as certain other related agreements (collectively, the “Agreements”). The Authority entered into the Agreements with separate wholly owned subsidiaries of KeySpan and assigned them to LIPA. The performance of each such KeySpan subsidiary under the respective Agreements, as well as any payment obligations it may have under such Agreements, are guaranteed by KeySpan. The purpose of the Agreements is to provide the Authority and LIPA with the operating personnel and power supply resources necessary for LIPA to continue to provide electric service in the Service Area.

In addition to providing services to the Authority, KeySpan provides a full range of energy-related services to other parties through operations and investments in selected areas of the energy industry. KeySpan’s operations include the natural gas business formerly known as Brooklyn Union Gas, as well as the natural gas operations formerly owned by LILCO. KeySpan’s gas operations form the fifth largest gas utility in the United States, with 1.6 million customers in New York City and Long Island and 800,000 customers in Massachusetts and New Hampshire. KeySpan owns and operates more than 6,200 MW of electric power generation on Long Island and in New York City. Of this, approximately 4,000 MW of on-Island capacity is under long-term contract to LIPA through the PSA. An additional 160 MW of generation capacity owned by KeySpan on Long Island is purchased by LIPA under separate long-term agreements. The unregulated business units of KeySpan market energy and provide energy facility design, construction, financing and management, and energy equipment installation and repair. Through its investments, KeySpan has additional domestic and international interests in natural gas exploration, production, processing, transportation and storage.

The day-to-day operation of the T&D System is provided for under terms of the MSA that expires December 31, 2008. The MSA provides for mandatory competitive bidding of the subject services after December 31, 2005. This schedule allows three years for the procurement of services and the transfer of functions to one or more replacement contractors (if KeySpan is not selected), or to the Authority itself. The Authority believes the three-year period is sufficient to carry out the procurement process and to transition to a replacement service provider if KeySpan is not selected to continue to provide services.

**SECTION 4**  
**TRANSMISSION AND DISTRIBUTION SYSTEM**

The T&D System is an integrated electric system consisting of overhead and underground facilities, vehicles, equipment, land parcels, easements, contractual arrangements and other assets used to provide the transmission and distribution of electric capacity and energy to and within the Service Area. Key components of the T&D System are summarized below.

**Transmission Interconnections**

Electricity is transmitted to and from the Service Area over six transmission interconnections that are owned in part or are under contract to LIPA. These interconnections link the T&D System to other utilities and enable delivery of: (i) capacity and energy produced by NMP2; (ii) additional off-system capacity resources needed to meet the peak demands of the electric customers; (iii) favorably-priced energy to supplement or displace generation from on-island generating resources; and (iv) excess generation from on-island generating facilities to off-island purchasers when conditions merit. Table 2 provides summary information on the transmission interconnections.

**TABLE 2**  
**SERVICE AREA TRANSMISSION INTERCONNECTIONS**

Name	Off System Terminal Locations	Interconnecting Utility <sup>1</sup>	Voltage Level <sup>2</sup>
Dunwoodie to Shore Road.....	Westchester County, NY	Con Edison	345 kV
East Garden City to Sprainbrook.....	Westchester County, NY	NYPA	345 kV
Northport to Norwalk Harbor.....	Norwalk, CT	CL&P <sup>3</sup>	138 kV
Shoreham to New Haven <sup>4</sup> .....	New Haven, CT	UI <sup>5</sup>	150 kV
Jamaica to Lake Success.....	Queens, NY	Con Edison	138 kV
Jamaica to Valley Stream.....	Queens, NY	Con Edison	138 kV

<sup>1</sup> These utilities own the portion of the interconnections not owned by LIPA, except for the interconnection with NYPA, which is entirely owned by NYPA.

<sup>2</sup> Kilovolt or “kV.”

<sup>3</sup> CL&P = Connecticut Light and Power. CL&P is the wholly owned operating subsidiary of Northeast Utilities.

<sup>4</sup> This cable is a +/-150 kV bi-directional high voltage direct current system. Electricity is converted to 138 kV alternating current at LIPA’s Shoreham substation for transmission and delivery to LIPA’s customers.

<sup>5</sup> UI = United Illuminating.

Four submarine cables installed under Long Island Sound form part of the interconnection between the T&D System and other utility systems: (i) Dunwoodie to Shore Road; (ii) East Garden City to Sprainbrook; (iii) Northport to Norwalk Harbor, and (iv) Shoreham to New Haven.

The Dunwoodie to Shore Road line, an 18-mile 345-kilovolt (“kV”) cable designated as the “Y-50” line and placed in operation in August 1978, is jointly owned with Consolidated Edison Company of New York, Inc. (“Con Edison”). This cable is of pipe-type construction in which dielectric fluid is circulated to cool the conductors and maintain the electrical insulation. Between January and May 2002, the Long Island land portion of Y-50 was replaced. In May 2002, the submarine portion of the cable between Davids Island and Pea Island (Con Edison portion) failed. Preliminary analysis indicates that the submarine section experienced mechanical failure, possibly through thermo-mechanical bending, but experts do not agree on the exact cause

of the failure, and investigation is continuing. The cable was repaired and returned to service in June 2002, and as a precaution, the cable was derated (from 600 MW to 400 MW) for Summer 2002 operation to minimize thermal bending. The cable is currently operating at full capacity.

The East Garden City to Sprainbrook 345 kV interconnection (“Y-49”) was installed in 1991 and is approximately 23 miles long. This tie is comprised of a submarine portion and a land-based portion. The submarine portion is constructed of self-contained dielectric fluid-filled cables that operate under high pressure, while the land-based portion is of conventional pipe-type construction. This line is owned entirely by NYPA and is used by LIPA under the terms of a contract with NYPA. LIPA’s agreement for use of Y-49 provides that LIPA will reimburse NYPA for the costs it incurs in connection with the line, including, but not limited to, debt service, reserves, and operation and maintenance expenses. LIPA is contractually obligated to pay such costs based on the full capacity of Y-49; however, to the extent that NYPA allocates capacity to other parties, LIPA’s payment obligations are proportionately reduced. Unlike Y-50, which has experienced failures in the cable itself, failures on Y-49 have generally been limited to equipment at the termination points of the line. In May 2002, a component of a circuit breaker at East Garden City failed. The circuit breaker was repaired and completely overhauled before Summer 2003. Subsequent to the circuit breaker failure at East Garden City, a shunt reactor (an electrical device designed to limit fault currents on the line) failed at the Sprainbrook substation. Additionally, another shunt reactor at Sprainbrook was found to have combustible gas buildup and was removed from service as a precautionary measure. NYPA subsequently ordered two replacement reactors, but delivery is estimated at 24 months. LIPA expects delivery of the replacement reactors prior to Summer 2005. NYPA has developed a switching and operating procedure that would allow use of the line with only two shunt reactors in service in the event that one of the three remaining shunt reactors fails prior to installation of the replacement equipment. On February 27, 2003, one of the submarine cables comprising Y-49 was damaged by a barge anchor. The line was put back in full service on March 8, 2003, using a spare submarine cable that was part of the original installation. The damaged cable was subsequently repaired and returned to service as a spare.

The Northport to Norwalk Harbor line (the “NUSCO Cable”) is a double circuit 138 kV submarine cable. This tie, installed in 1969, extends approximately 12 miles under the Long Island Sound from the Northport Electric Generating Station (“Northport”) in Suffolk County, NY to Norwalk Harbor, Connecticut. LIPA owns that portion of the line from Northport to the New York-Connecticut state boundary. Due to the deteriorated condition of the line, resulting from periodic damage sustained by ship and barge anchors, LIPA and Northeast Utilities are considering the replacement of the submarine cables. Due to on-going conflicts with the State of Connecticut, negotiations between LIPA and Northeast Utilities were stalled until an agreement was reached with the State of Connecticut on June 25, 2004.

The Shoreham to New Haven line (referred to as the “Cross Sound Cable”) is a 24-mile, +/- 150 kV bi-directional high voltage direct current system utilizing voltage source converter technology with a capability of 330 MW. The Cross Sound Cable is connected between the converter stations installed adjacent to United Illuminating’s 345 kV East Shore substation in Connecticut and at LIPA’s Shoreham 138 kV substation. This line was constructed pursuant to a lease entered into between LIPA and Cross Sound Cable Company, LLC (“CSC LLC”) in 2000 pursuant to which LIPA agreed to purchase up to 330 MW of transmission capacity. Due to the existence of bedrock underneath the Cross Sound Cable and the inability to remedy such condition, CSC LLC has not been able to comply with the depth requirement of the permit required to satisfy a condition of the lease agreement between the Authority and CSC LLC. As a result, the Cross Sound Cable did not operate and LIPA was not required to make lease payments.

After the August 14, 2003 blackout affecting much of the northeast United States, at LIPA's request, the United States Secretary of Energy issued an Emergency Order providing for the commercial operation of the Cross Sound Cable. The Emergency Order required that CSC LLC be compensated for the use of the Cross Sound Cable and CSC LLC and the Authority entered into an Interim Firm Transmission Capacity Agreement ("Interim Agreement") for 330 MW of capacity at a rate of approximately \$1.4 million per month. The Interim Agreement remained in place over the term of the Emergency Order. Under the terms of the Interim Agreement, LIPA incurred capacity and other costs totaling \$7.6 million in 2003. The Emergency Order was rescinded in May 2004 and all payments under the Interim Agreement ceased. After the May rescission of the Emergency Order, the Authority sought an order from the Federal Energy Regulatory Commission ("FERC") to require operation of the Cross Sound Cable. On June 25, 2004, an agreement (the "Settlement Agreement") was reached between the Authority, the Connecticut Department of Environmental Protection ("CDEP"), the Connecticut Department of Public Utility Control, CL&P and CSC LLP that provides for the immediate energization and regular, full-time commercial operation of the Cross Sound Cable while CSC LLP seeks to come into compliance with the CDEP permits. As part of the Settlement Agreement, LIPA agreed to start negotiations with Northeast Utilities to jointly replace the NUSCO Cable. In addition, the Settlement Agreement requires that the Authority, CL&P and CSC LLP each contribute \$2,000,000 to a fund for the study and preservation of the Long Island Sound.

The two remaining Service Area transmission interconnections are linked to the Con Edison transmission system in Queens County, New York. LIPA owns these facilities to the border of Nassau and Queens Counties, at which point ownership transfers to Con Edison. These ties are primarily for delivering power to Con Edison from their portion of energy flowing across Y-50.

### **System Import Constraints**

The total import capability into Long Island during Summer 2004 was approximately 1,452 MW under normal conditions, including the capability of the Cross Sound Cable. This figure is based on the Y-49 operating at its dynamic rating of 637 MW, Y-50 operating at 599 MW through rapid circulation for cooling, NUSCO operating at 190 MW, Cross Sound Cable operating at 330 MW, and wheeling to Con Edison of 286 MW. The maximum emergency import capability into Long Island during peak summer conditions is 2,106 MW, based on the New York Independent System Operator ("NYISO") emergency ratings for the interconnections.

In June 2004, the Board of Trustees (the "Trustees") authorized LIPA to negotiate a transmission purchase agreement with Neptune Regional Transmission System, LLC relating to a proposed 67-mile long, 660 MW transmission cable running under the Atlantic Ocean from Sayerville, New Jersey and connecting with LIPA's system at the Newbridge Road substation with a projected in-service date of May 2007 (the "Neptune Project"). The Neptune Project will increase the maximum import capability to Long Island and provide access to additional power supply resources, including those located in the Pennsylvania, New Jersey, Maryland Interconnection ("PJM"). This new interconnection will increase competition between power supply resources on- and off-Island and provide LIPA with greater resource contracting flexibility.

### **Transmission Facilities**

The transmission facilities provide for the delivery of capacity and energy from the transmission interconnections and the on-Island generating stations to LIPA's electric distribution system. As of December 31, 2003, LIPA reported the transmission system consisted of

approximately 1,293 miles of overhead and underground lines, with voltage levels ranging from 23 kV to 345 kV. This transmission system has been constructed following standards similar to those employed by other major electric utilities in the Northeast and includes wood poles, steel poles, and lattice steel towers. Many of the existing transmission structures support distribution circuits and/or connections for telephone, cable television, or fiber optics.

LIPA reports that 36 transmission substations were in service and utilized on the T&D System as of December 31, 2003. The transmission system includes transformation equipment at 17 generating sites that is used to step up the generation voltage to transmission voltage levels. With the exception of certain facilities (e.g., auxiliary and starting transformers) at generating facilities previously owned by LILCO and now under contract to LIPA (the “GENCO” facilities), transformation equipment at these sites is owned by LIPA.

### **Distribution Facilities**

The distribution system is comprised of 13kV and 4kV facilities. LIPA reports there were 141 distribution substations in service at December 31, 2003, that are used to step down the voltage from transmission to distribution levels. LIPA also reports the distribution system included approximately 13,095 primary circuit miles of overhead and underground line at December 31, 2003. Approximately 44 percent of the poles on which LIPA’s distribution facilities have been installed are owned by Verizon (formerly Bell Atlantic) and used by LIPA pursuant to a joint-use agreement.

### **Management Services Agreement**

Pursuant to the MSA, LIPA relies on the Manager to operate and maintain the T&D System in accordance with all applicable laws, prudent utility practices, and the policies and procedures established by the Authority. The Manager’s responsibilities under the MSA include, but are not limited to: (i) the day-to-day operation and maintenance of the T&D system, including emergency repairs, customer service, billings, and meter readings; (ii) routine facility additions and improvements, including customer connections, procurement of goods and services from third parties, and inventory management; (iii) preparing and monitoring budgets, developing load and energy forecasts, and the acquisition, maintenance and use of power resource models and plans; and (iv) maintaining an operation and maintenance manual for the T&D system.

The Authority is responsible for, among other things, (i) setting rates and charges; (ii) line extension policies; (iii) service rules and regulations; (iv) approval of long-term strategic plans; (v) determination of customer service programs; (vi) approval of annual budgets; (vii) approval of the Manager’s load forecast and power resource models and plans; (viii) determination of all energy efficiency, conservation and load management policies and plans; (ix) governmental relations and reporting; (x) overall legal responsibilities; (xi) oversight of the Managers operations and performance; and (xii) community and public relations. The Authority also has the right to approve the appointment of key personnel of the Manager.

In exchange for services rendered under the MSA, the Manager is entitled to receive an annual service fee as compensation. The service fee is paid on a monthly basis and is calculated based on five components, consisting of a: (i) fixed direct fee; (ii) third party cost reimbursement component; (iii) variable payment; (iv) cost incentive fee; and (v) non-cost performance component. In addition to the service fee, the Manager is reimbursed for all approved third-party costs and is paid or reimbursed for certain capital and unforeseeable costs.

The Manager is entitled to incentive payments for cost savings and is subject to penalties for cost overruns on both the operating and capital budgets. With respect to operations, \$5 million of the Manager's annual fee of \$15 million is contingent upon achieving a comparable amount of cost savings each year. In addition, the Manager is entitled to payments equal to 50 percent of any savings in excess of this amount, provided that no incentive is payable for savings in excess of 15 percent of the operating budget. To the extent costs exceed the operating budget, excluding the Manager's fee, the Manager must absorb overruns up to a maximum total of \$15 million. With regard to the capital budget, the Manager is entitled to incentive payments for cost savings and penalties for cost overruns equal to 50 percent of all variances between budgeted and actual capital expenditures, provided that no additional incentive payment will be earned, nor penalty incurred, for cost variances in excess of 15 percent of the capital budget.

In addition to cost savings incentives, the Manager is eligible for certain annual non-cost performance incentives, including T&D System reliability, meter reading accuracy, and worker safety. The MSA provides for additional non-cost incentives related to customer call answering, accounts receivable, and payments-in-lieu of taxes ("PILOT"); however, the Authority and the Manager have not agreed to the incentive mechanisms for these areas of performance. The Manager has generally met or exceeded the MSA non-cost performance incentive maximum allowances.

For a more complete description of the Manager's responsibilities under the MSA, including associated incentive provisions, please see Appendix A.

### **The Manager's Performance Under the MSA**

The following sections provide a summary of the Manager's performance in key areas during the Historical Period.

#### **Reliability**

LIPA is continuing and expanding a program originally commenced in 1992 by LILCO that is intended to improve the reliability and quality of electric service within the Service Area. For the distribution system, this program is focused on three major areas: (i) circuit reconfiguration and reinforcement; (ii) pole replacement; and (iii) circuit conversion and reinforcement projects to serve new customer loads. For the transmission system, the improvement program is focused on: (i) transmission system reliability; (ii) substation reliability improvements; (iii) transmission breaker replacements; and (iv) structure inspection program. These program elements are a key part of LIPA's efforts to achieve reductions in both the frequency and duration of customer outages.

Two standard industry criteria for measuring transmission and distribution system reliability are: (i) System Average Interruption Frequency Index ("SAIFI"), which is a measure of the number of times the average customer's service is interrupted in a year; and (ii) Customer Average Interruption Duration Index ("CAIDI"), which is a measure of the average number of minutes required to restore service to a customer whose service has been interrupted. For both SAIFI and CAIDI, a low value is favorable. A low SAIFI value indicates the lapse of a longer time period between service interruptions, and a low CAIDI value indicates a shorter average duration, less elapsed time, associated with the outages that have occurred. The MSA establishes incentive measures for the Manager to maintain SAIFI and CAIDI indices for the T&D system within prescribed levels. Information on these incentives may be found in Appendix A.

For 2002, the system-wide SAIFI index was 0.99 (or 12.1 months between interruptions), and the CAIDI index was 69.1 minutes. For 2003, the system-wide SAIFI index was 0.89 (or 13.5 months between interruptions), and the CAIDI index was 65 minutes. The composition of these reliability indices by LIPA operating district is provided in Table 3.

**TABLE 3  
T&D SYSTEM RELIABILITY<sup>1,2</sup>**

	MSA Incentive Minimum	Calendar Year	
		2002	2003 <sup>3</sup>
<b>SAIFI<sup>4</sup></b>			
Queens .....	1.23	0.82	0.59
Central .....	1.40	0.86	0.95
W. Suffolk .....	1.60	1.06	0.84
E. Suffolk.....	2.10	1.15	1.11
System Average .....		0.99	0.89
<b>CAIDI<sup>5</sup></b>			
Queens .....	67.2	53.0	50.5
Central .....	81.0	93.3	78.2
W. Suffolk .....	72.6	63.8	65.9
E. Suffolk.....	71.4	64.4	58.3
System Average .....		69.1	65.0

<sup>1</sup> Excludes interruptions of less than five minutes and during major storms.

<sup>2</sup> Lower values are more favorable.

<sup>3</sup> Excludes the effects of the regional blackout in August 2003.

<sup>4</sup> System Average Interruption Frequency Index.

<sup>5</sup> Customer Average Interruption Duration Index.

Over the five-year period 1999 through 2003, LIPA's customers experienced an average of 14.7 months between interruptions and average interruption times of 65.6 minutes. For all New York State utilities (other than Con Edison, whose system is predominately underground), the average time between interruptions during this five-year period was 12.0 months and the average duration of an interruption was 105.8 minutes.

### **Maintenance**

The Manager's substation maintenance group is responsible for the operation and maintenance of the transmission and distribution substations throughout the Service Area. The preventive maintenance program calls for the inspection and major maintenance of over 2,000 individual pieces of substation equipment annually. During the Historical Period, the substation maintenance group completed approximately 99 percent of the scheduled preventive maintenance each year. A completion rate over 90 percent falls within the range of that achieved by other similarly situated utilities.

Prior to 2002, the Manager used a time-based maintenance system (e.g., maintenance of specific equipment items at pre-determined intervals, such as every three years) that relied on hardcopy documentation and stand-alone computer records. Acknowledging that a system in which each equipment item is maintained according to its criticality, load, number of operations, age, and test diagnostics, would be beneficial, the Manager purchased a new computerized maintenance inspection and record-keeping system, known as Maximo, for the substation group.

Maximo was fully integrated by the end of 2001 for both demand and preventive maintenance. This new maintenance system is used for work order management, planning and scheduling, asset management and tracking, resource management, reports and analysis, and integration with the Manager’s financial system. LIPA expects the computerized maintenance system to provide for more targeted maintenance programs in the future.

**Storm Restoration**

Under the terms of the MSA, the Manager is responsible for storm response and storm restoration programs. During these restoration efforts, the Manager utilizes, as necessary, appropriately trained personnel not normally assigned to field duties, as well as gas and generation department personnel, in order to perform electric distribution emergency restoration services. This utilization of personnel increases the availability of field forces to restore service to customers affected by the storm damage. The Manager, on behalf of LIPA, also relies on standard electric utility industry mutual aid programs wherein neighboring and regional utilities provide emergency assistance to one another in the event of widespread outages due to major storms. Table 4 below provides a summary of the total cost of storm damage within the Service Area for the 1999 through 2003 period.

**TABLE 4  
HISTORICAL STORM EXPENDITURES  
FOR THE T&D SYSTEM**

<u>Year</u>	<u>\$000</u>
1999 .....	\$17,093
2000 <sup>1</sup> .....	10,809
2001 .....	7,443
2002 .....	17,354
2003 .....	12,917

<sup>1</sup> Amount does not reflect FEMA reimbursement of approximately \$3.8 million received in 2000 for 1998 storm costs.

Under the MSA, approximately \$4.4 million is included in the annual budget for the Manager to provide storm restoration services. This allowance is intended to cover the cost of direct labor, excluding overtime pay, incurred by the Manager for storm restoration services. The Authority has included in revenue requirements an annual storm allowance of \$9 million, which is available to cover storm restoration costs other than the Manager’s direct labor costs (resulting in a total allowance for storm restoration of approximately \$13.4 million per year). Annual storm losses in excess of \$13.4 million are funded through any unspent accumulated storm reserve balance, with the remainder recovered through retail rates. Depending on the extent of damage, the Authority may also be eligible for funds from the Federal Emergency Management Agency (“FEMA”).

**Condition of the Facilities**

During the August 2003 through July 2004 period, Navigant Consulting conducted limited on-site observations of principal and representative facilities comprising the T&D System. These observations consisted of visual examinations of facilities that Navigant Consulting deemed adequate to allow it to assess the general condition of the facilities. In addition to field observations, Navigant Consulting reviewed historical operation and maintenance records for the T&D System to assess past performance levels and examined written maintenance procedures to evaluate the adequacy of existing maintenance practices. Navigant Consulting did not identify



any material deficiencies in the condition of the T&D System as a result of these observations or review of historical records.

### **Capital Expenditures**

During the period 1999 through 2003, LIPA reported that an average of approximately \$186 million per year was spent on T&D System capital additions and improvements. Such expenditures included interconnection costs associated with new generating stations on Long Island, reliability enhancements, capability expansion, new customer connections, facility replacements and public works. LIPA reports that T&D System capital expenditures for 2002 and 2003 were approximately \$235 million and \$195 million, respectively. The variation in capital expenditure levels during the Historical Period was due in part to differences in the amounts incurred by LIPA for transmission interconnection projects associated with new generating resources. T&D System capital expenditures for 2004 and 2005 are estimated by LIPA to total approximately \$207 million and \$250 million, respectively. The 2004 and 2005 capital expenditure programs provide for a continuation of the historical programs to improve reliability and quality of electric service, as well as expenditures for interconnection facilities for two new generating stations located at one site on Long Island, capability expansion, new customer connections, facility replacements, reliability enhancements and public work projects that are comparable to historical levels.

Amounts reported above for T&D System capital expenditures do not include expenditures for NMP2 or for the Authority's internal administrative and general purposes. NMP2 capital expenditures are discussed in Section 5 of this Biennial Report. The Authority's internal administrative and general capital expenditures have averaged approximately \$2 million per year during the 1999 through 2003 period and are estimated by LIPA to remain at this level during each year of the Forecast Period.

T&D System capital expenditures will continue to be subject to the Authority's annual approval process under the terms of the MSA. In 2001, LIPA initiated a new capital planning and review process that takes into account the priority and benefits of individual capital projects relative to alternative investments. This capital planning process allows LIPA to identify, rank, fund, and manage capital investments. The process involves three phases: (i) selection, in which capital projects are screened, ranked, and selected; (ii) control, whereby an ongoing monitoring process manages selected capital projects to ensure that each investment continues to be required and is completed on schedule and within budget; and (iii) evaluation wherein projects are reviewed upon completion to determine if the capital investment realized its expected mission and business performance goals, and provide feedback to continually improve the capital planning and execution process. The 2004 capital budget was reviewed and approved using an industry-accepted process of ranking projects according to the probability of the occurrence of an outage, the number of customers that would be affected by the outage, and the outage's duration. By utilizing this process, capital investments may be targeted to the most critical projects.

### **Adequacy of Performance**

Operation of the T&D System during the Historical Period was generally consistent with past experience, and no material adverse conditions or occurrences were noted. Such results reflect the relative success of the Manager in operating and maintaining the T&D System under the MSA. LIPA is working with the Manager to implement improvements in several areas of day-to-day operations under the MSA which can be expected to further strengthen the Manager's performance going forward. These include (i) resolution of certain reporting and information issues; (ii) enhanced capital budgeting and system planning procedures; (iii) improvements in

LIPA's customer billing system; and (iv) increased attention to prospective conflicts of interest. LIPA believes such improvements would enhance the operation and management of the T&D System, but does not expect them to be critical to the continued financial health or physical condition of the T&D System.

## SECTION 5

### NINE MILE POINT NUCLEAR POWER STATION, UNIT 2

Nine Mile Point Nuclear Power Station, Unit 2 (“NMP2”) is part of a two-unit nuclear power station (“Nine Mile Point”) located on the south shore of Lake Ontario near the Town of Scriba, New York. NMP2 uses a boiling water reactor (“BWR”) and turbine generator supplied by General Electric Corporation. The plant has a rated capacity of 1,148 MW.

NMP2 is the second of two units at the Nine Mile Point site. Unit 1 (“NMP1”) began commercial operation in 1969. NMP1 and NMP2 are operated under different ownership interests. LIPA’s ownership interest is limited to NMP2. The Fitzpatrick Nuclear Power Plant, owned and operated by Entergy, is located on a site adjacent to Nine Mile Point.

NMP2 began commercial operation in April 1988 under a Nuclear Regulatory Commission (“NRC”) license that expires in 2026. In May 2004, Constellation Nuclear LLC (“Constellation”), the majority owner of Nine Mile Point, applied to the NRC for a 20-year extension of the operating licenses for both units. The review and approval, if granted, of such application by the NRC has typically taken about 24 months. Navigant Consulting cannot predict whether the NRC will grant an extension of the operating licenses for Nine Mile Point or the conditions that may be required if an extension is granted.

#### **NMP2 Ownership and Management**

LIPA has an undivided 18 percent interest in NMP2. Until November 6, 2001, NMP2 was operated by Niagara Mohawk Power Corporation (“NMPC”). On November 7, 2001, Constellation purchased 100 percent of NMP1 and 82 percent of NMP2 from NMPC, with LIPA retaining its 18 percent interest in NMP2. LIPA’s share of the rated capability of NMP2 is approximately 207 MW.

LIPA entered into an amended and restated operating agreement with Constellation for NMP2. Among other things, the revised agreement provides for a management committee comprised of one representative from each co-tenant. Constellation controls the operating and maintenance decisions of NMP2 in its role as operator. The annual NMP2 business plan and the operating and capital budgets are developed by Constellation and submitted to LIPA for review and approval. LIPA receives output from NMP2 and is responsible for operating and capital costs in proportion to its ownership interest. In addition to its involvement through the management committee, LIPA engages KeySpan personnel to provide on-site support to protect its interests.

#### **NMP2 Performance**

Table 5 sets forth capacity factors and generation levels associated with LIPA’s 18 percent share of NMP2 for the period 1999 through 2003. This table also presents comparative industry data for all nuclear generating units in the United States.

In 2003, NMP2 achieved a record capacity factor of 95.2 percent. Two forced outages impacted this capacity factor during 2003. The first outage was caused by equipment failure and lasted approximately 10 days. The second outage was the result of the Northeast electrical grid failure in August and lasted approximately three days. Constellation’s goal for NMP2’s 2004 capacity factor is 87.7 percent. This capacity factor takes into account an outage resulting from the scheduled refueling of the nuclear reactor during 2004.

**TABLE 5  
HISTORICAL NMP2 PERFORMANCE**

Calendar Year	Annual Net Generation (MWh) <sup>1,2</sup>	Annual Net Capacity Factor <sup>1,3</sup>	Three-Year Average Net Capacity Factor <sup>1,4</sup>	Industry Average Net Capacity Factor <sup>5</sup>
1999.....	1,580,815	86.9%	83.2%	88.5%
2000.....	1,440,274	79.1	79.8	89.6
2001.....	1,594,592	87.9	84.6	90.7
2002.....	1,515,151	83.8	83.6	91.9
2003.....	1,722,036	95.2	89.0	89.6

<sup>1</sup> Source: KeySpan.

<sup>2</sup> LIPA's 18 percent share of NMP2 net output.

<sup>3</sup> Net capacity factor is a measure of the utilization of NMP2's theoretical maximum annual output.

<sup>4</sup> The three-year average smoothes the effects of refueling outages.

<sup>5</sup> Includes all nuclear plants operating during the respective year. Source: Nuclear Energy Institute.

### **NMP2 Maintenance Programs and Condition**

In 2000, the NRC established a Reactor Oversight Process that replaced a prior oversight program. Under this new process, the NRC evaluates plant performance in eighteen areas or Performance Indicators (PI). Performance is graded "Green", "White", "Yellow" or "Red". Green signifies satisfactory performance requiring minimal NRC resources for oversight. At the opposite end, Red signifies unsatisfactory performance requiring the most NRC resources for oversight. In 2000, both Nine Mile Point units were graded as Green in all areas. In 2003, one indicator (referred to as "unplanned scrams") was changed to White as a result of the NMP2 outage resulting from the loss of the Northeast power grid. However, this indicator was returned to Green by the end of 2003. In the NRC's March 2, 2004, end-of-cycle performance review letter, it indicated that NMP2 had "operated in a manner that preserved public health and safety, and fully met all cornerstone objectives."

The Institute of Nuclear Power Operations ("INPO") is a nuclear industry assessment organization. In 1999, INPO identified numerous areas needing improvement at NMP2. In response, NMP2 management developed an improvement plan directed at (1) preventive and predictive maintenance optimization; (2) corrective action program enhancements; (3) work management and maintenance planning process improvements; (4) revising the configuration management change process; (5) training improvements; and (6) improving equipment reliability. In 2002, INPO performed another assessment of NMP2 and found that some problems in the above areas had been resolved, but that others remained. Additionally, some problems that had not existed in 1999 were uncovered in 2002. The next INPO plant evaluation is scheduled for September 2004, at which time all aspects of plant operation will be evaluated, including the areas identified above.

During 2000, the corrective maintenance backlog stood at 398 and declined to 196 at the end of 2001. At the end of December 2002, the corrective maintenance backlog stood at 182 activities. By December 2003, the corrective maintenance backlog had decreased to 45 activities.

During normal inspections associated with a scheduled refueling outage of NMP2 in 1998, Niagara Mohawk discovered indications of inter-granular stress corrosion cracking of the reactor shroud. The reactor shroud is a hollow cylinder surrounding the reactor core that serves to channel cooling water re-circulation flow. The shroud cracking is a generic issue facing BWR plants and was anticipated by Niagara Mohawk prior to the inspection. Niagara Mohawk

reported that the cracking indications were not of any safety significance and the NRC allowed NMP2 to resume operations with no restrictions. During 1999, Niagara Mohawk initiated actions to institute a water chemistry program, noble metals chemical addition (“NMCA”), to reduce the rate at which the cracking progresses. The results of an inspection conducted during the 2002 spring refueling outage confirmed that NMCA has been successful in arresting shroud crack growth.

Normal plant inspections were conducted by Constellation during the March-April 2004 refueling outage of NMP2. This effort included inspections of the reactor core shroud to assure that the previously identified stress corrosion cracking was within acceptable limits and that the shroud remained safe for plant operations. Other inspections were performed based on industry experience. Currently, Constellation reports no indications of any problems that will impact plant safety.

### **Capital Expenditures**

NMP2’s historical capital expenditure levels vary with the schedule of refueling and maintenance outages for the facility. Major maintenance activities, including replacement of major plant components and facility improvements, are undertaken concurrent with the refueling outages. Nuclear fuel purchases are capitalized and subsequently expensed based on expended heat content of the fuel rods.

During the 1999 through 2003 period, LIPA reported an average of approximately \$8 million per year was spent on its 18 percent share of NMP2 nuclear fuel, capital additions, and improvements. NMP2 capital expenditures for 2002 and 2003 were reported by LIPA to be approximately \$12 million and \$6 million, respectively. LIPA estimates its NMP2 capital expenditures for 2004 and 2005 will total approximately \$17 million and \$14 million, respectively. The 2004 and 2005 estimated annual capital expenditures for NMP2 continue to reflect the cyclical nature of the two-year refueling schedule. Estimated expenditures for 2005 reflect a restructuring of NMP2’s fuel contracts, which is expected to result in payment for fuel purchases at the end of 2005, rather than the beginning of 2006. A portion of the annual capital expenditures are intended to support projects aimed at maintaining NMP2 in good operating condition and satisfying regulatory requirements.

### **NMP2 Decommissioning Funding**

LIPA is providing for decommissioning costs for NMP2 based on a site-specific study performed in 1995. LIPA’s share of the total decommissioning costs for both the contaminated and non-contaminated portions of NMP2 is estimated to be approximately \$145 million in 1996 dollars. LIPA maintains a trust fund for its share of the decommissioning costs of the contaminated portion of NMP2, which at December 31, 2003, had an approximate value of \$41.9 million. LIPA established a separate decommissioning fund for its share of the non-nontaminated portion of NMP2, which had a value at December 31, 2003, totaling approximately \$7.0 million. Through continued deposits and investment returns on these trusts, LIPA believes that the value of these trusts will, in 2026, be sufficient to meet the LIPA’s decommissioning obligations for NMP2.

## SECTION 6

### ADEQUACY OF RATES AND CHARGES

The Authority's retail rates generally reflect traditional rate designs and include fixed customer charges for all customer classes, seasonal energy rates for all customer classes except lighting, and seasonally differentiated demand charges for the non-residential customer classes (greater than seven kW). Voluntary time-of-use rates are available to all residential and nonresidential customers. Mandatory time-of-use rates apply to nonresidential customers with demands in excess of 145 kW in the summer or 500 kW in the non-summer months. The summer months are June through September, inclusive. Economic development and load retention incentives are provided to a small number of commercial customers.

In addition to the base retail rates, the LIPA Tariff for Electric Service ("Tariff") includes the following adjustments and riders.

#### **Fuel and Purchased Power Cost Adjustment Clause**

LIPA's Tariff includes a fuel recovery provision – the Fuel and Purchased Power Cost Adjustment Clause ("FPPCA") that is applicable to all Service Classifications. The FPPCA mechanism is designed to allow LIPA to recover from or return to customers all current year excess fuel and purchased power costs, including certain load reduction program costs, up to an amount sufficient to achieve \$20 million in net income for the year.

In 2003, at the time that the current FPPCA mechanism was established, the Authority authorized the deferred recovery of approximately \$365 million in fuel and purchased power costs. These deferred costs are being amortized over ten years and recovered through the FPPCA in equal annual amounts.

To protect its customers from significant market price fluctuations for the purchase of fuel oil, natural gas and electricity, LIPA uses derivative financial instruments which are recorded at their market value. Effective with the 2003 modifications to the FPPCA, any unrealized gains and losses derived from these derivatives are deferred as a regulatory asset until realized, at which time they are included in current period results as a component of fuel and purchased power. Prior to the 2003 modifications, unrealized gains and losses were included in fuel and purchased power expense, but were not included in the FPPCA calculation until realized.

#### **Shoreham Property Tax Settlement Rider**

The Authority and certain taxing jurisdictions in Suffolk County have reached an agreement settling various matters related to previous property tax assessments on Shoreham (the "Settlement"). The Settlement results in a rate differential between non-Suffolk County ratepayers (Nassau County and Rockaway Peninsula) and ratepayers in Suffolk County. Initially, this differential was attributable to a smaller amount of Shoreham credits provided to Suffolk County ratepayers. Beginning in June 2003, the differential was entirely attributable to a Shoreham surcharge on Suffolk County ratepayers.

LIPA's rates include a rider that implements the Settlement. The rider describes the calculation of percentage factors to be applied to bills, including the FPPCA portion thereof. Separate factors were established for Nassau County and the Rockaway Peninsula, and for Suffolk County. Under this rider, LIPA expects to collect approximately \$35 to \$40 million during each 12-month period for the remaining years of the Settlement from customers residing in

Suffolk County to pay for the Settlement. No revenues will be recovered from customers residing in Nassau County and the Rockaway Peninsula under the terms of the Settlement.

### **PILOT Payment Recovery Rider**

The Authority is obligated to make payments in lieu of taxes (“PILOTs”) to municipalities and school districts equal to the property taxes that would have been received by each such jurisdiction from LILCO if the acquisition by the Authority had not occurred, and to make PILOTs for certain State taxes (including gross receipts taxes) and local taxes (including temporary transit station maintenance surcharges charged by the Metropolitan Transportation Authority of New York (the “MTA”)) which would otherwise have been imposed on LILCO. LIPA’s rates include a PILOT payments recovery rider that allows the Authority to recover the applicable gross receipts tax PILOTs from each ratepayer. This rider also allows for the recovery of the MTA surcharge from each ratepayer. All other PILOTs are recovered in the Authority’s base electric rates.

### **Adequacy of LIPA Retail Rates and Charges**

As discussed below, LIPA’s currently effective rates and charges, including adjustments and riders, provide for adequate revenue recovery to meet its annual revenue requirements and to satisfy the debt service coverage requirements set forth in the General Bond Resolution, absent the approval of waivers limiting cost recovery.

LIPA’s Tariff has kept pace with many of the developments that have affected large investor owned utilities in New York State. A number of small changes have been made to the Tariff, to keep the terms and conditions of service reasonably comparable to neighboring utilities. LIPA continues to monitor developments at the New York Public Service Commission as well as the major investor owned utilities in New York State and appears to be well positioned to address emerging issues as they arise.

### **Open Access Transmission Tariff**

On May 13, 1998, the Authority adopted an open access transmission tariff consistent with regulations issued by FERC. On November 18, 1999, the NYISO officially assumed control of the New York State bulk power system. The NYISO is responsible for the safe and reliable operation of the New York State electric power system and for providing transmission service on a comparable and non-discriminatory basis. In its role as transmission service provider, the NYISO has adopted an open access transmission tariff (“OATT”) for use of the New York State transmission system. Except in the case of “grandfathered” contracts, the NYISO OATT supersedes the transmission tariff adopted by LIPA.

LIPA’s participation does not limit its ability to recover its transmission costs from wholesale customers that use the system. Under the NYISO OATT, LIPA has specified the Transmission Service Charge (“TSC”) based on LIPA’s determination of its transmission revenue requirements. The TSC applies to all wholesale customers that are located in the Service Area, and is not substantially different from the charge that LIPA adopted previously under its own open access transmission tariff. Additional NYISO OATT charges are designed to compensate LIPA for other usage of its transmission system, including interconnections with adjoining service territories.

In 2003, the LIPA Trustees modified the Open Access Transmission Tariff to authorize the use of a formula rate to update the TSC. As modified, LIPA staff is authorized to update the TSC

calculation each year using verifiable financial information. LIPA expects the automatic adjustment process to reduce the administrative burden of the TSC and better match LIPA's revenues to current expense levels.

### **Unbilled Service**

The financing agreement ("Financing Agreement") between the Authority and LIPA Acquisition Corp., a subsidiary of the Authority formed in connection with the acquisition of LILCO, generally prohibits LIPA from providing services of the System without reasonable compensation. Through discussions with KeySpan, Navigant Consulting has identified situations where LIPA is providing electric service at rates below retail tariff levels. These include electricity consumed at certain KeySpan facilities and use of LIPA's transmission and distribution resources by KeySpan for the attachment of KeySpan-owned telecommunication facilities.

Electric service at certain KeySpan locations is metered (or estimated), but not billed at retail tariff rates. Rather, a rate of 4.6 cents per kWh (plus an allowance for county-specific taxes) is imputed for this consumption, and LIPA's invoices from KeySpan under the MSA are credited for this amount. LIPA continues to monitor this issue.

### **Service Requested by Suffolk County Electrical Agency (SCEA)**

In 1996, SCEA filed a request with FERC under Section 211 of the Federal Power Act to provide 200 MW per hour of energy to residential customers in Suffolk County. The request was filed with the FERC because LILCO refused to provide the necessary transmission, distribution and retail services that would be required by SCEA to realize its proposed service. The FERC issued Opinion No. 467 that, among other things, required SCEA to identify definite resources to be used to provide the generation that would be subject to the requested transmission service. The deadline for identifying such generation resources has expired and no further action on the part of SCEA is anticipated in this matter.

### **Financial Results – Reasonableness of Rates**

Section 702(b)(iii) of the General Bond Resolution sets forth the duties of the Rate Consultant in preparing its respective portion of the Biennial Report. Specifically, this Section states such report shall contain:

*“(iii) the Rate Consultant’s recommendation as to any necessary or advisable revisions of rates, fees, rents, charges and surcharges and such other advise and recommendation as it may deem desirable;”*

The General Bond Resolution itself however is silent regarding the criteria or standards upon which the recommendations of the Rate Consultant are to be based. As a general matter, Navigant Consulting believes there are many quantitative and qualitative factors to consider when assessing rates, fees, charges, and surcharges including: adequacy of total revenue produced to cover all costs; each rate's (service classification's) ability to produce revenue sufficient to cover an appropriate portion of total costs; timeliness of cost recovery; regional competitiveness, understandability; stability; and predictability. Among these, the Navigant Consulting believes the single most important factor is whether the Tariff will produce revenues that are adequate to cover all costs reasonably expected to be incurred. This is predominately a forward-looking test.

For purposes of the Biennial Report, Navigant Consulting refers to Article VII, Sections 701 and 702 of the General Bond Resolution, which set forth both a minimum standard for assessing



the adequacy of Tariff revenue in total and an expectation that the Rate Consultant will, in the preparation of the Biennial Report, make a determination as to whether that minimum standard is satisfied. Furthermore, Navigant Consulting believes that the determinations required by these sections of the General Bond Resolution as to the satisfaction of the minimum standard along with the findings and recommendations of the Rate Consultant are to be measured on both a historical and forward-looking basis. Section 701(a) of the General Bond Resolution states, in part:

*“The Authority shall establish and maintain System fees, rates, rents, charges and surcharges sufficient in each Fiscal Year so that Revenues reasonably expected to be produced in such Fiscal Year, will be at least equal to the sum of (i) 120% ... of Debt Service, and amounts under all Parity Contract Obligations, payable by the Authority in such Fiscal Year, (ii) 100% of the Operating Expenses payable in such Fiscal Year, (iii) 100% of the amount necessary to pay all PILOTS payable in such Fiscal Year, and (iv) 100% of the amount necessary to pay other Required Deposits, all other payments required pursuant to the Resolution and the Financing Agreement, and all other payments required for the System, for such Fiscal Year; ...”*

With reference to the expectation that the Rate Consultant will make a determination regarding the requirements of Section 701(a), Section 701(b) states, in part:

*“If ...the report of the Rate Consultant pursuant to Section 702 [Biennial Report], indicates that the rates, fees, rents, charges and surcharges are, or will be, insufficient to meet the requirements of this Section 701 ...”*

For purposes of preparing this portion of the Biennial Report relating to the adequacy of the currently effective system of rates and surcharges, Navigant Consulting, as Rate Consultant, utilized the provisions established in the aforementioned Section 701(a) as the basis of its determinations. Specifically, the test was whether the requirements (minimum standards or Rate Covenants) set forth in Section 701(a) of the General Bond Resolution have been satisfied for the Historical Period and can reasonably be expected to be satisfied for the Forecast Period. In conducting this test, Navigant Consulting utilized the currently effective Tariff in developing the level of estimated revenues each year of the Forecast Period. To the extent the Trustees have approved waivers of certain provisions of the Tariff during the Historical Period, the effect of these waivers on the reported results and related findings have been recognized in the appropriate year. Navigant Consulting’s analysis for the Forecast Period is based upon the assumption that no provision of the currently effective Tariff will be waived. To the extent the Trustees approve any waiver of the Tariff that would impact either the amount or timing of the recovery of any incurred expense during the Forecast Period, such waiver would have a direct effect on the results of the revenue adequacy test and the related advice and recommendations derived therefrom. The results of the analyses for the Historical Period and Forecast Period are shown on Exhibits 1 and 2, respectively.

Exhibit 1 sets forth the Authority’s annual Statement of Operations for the Historical Period. In accordance with the Authority’s accounting practices, annual operating results shown in Exhibit 1 are presented on an accrual basis and include operating expenses, depreciation and amortization, interest income, PILOTs and interest charges, among other expenses.

As shown in Exhibit 1, the actual level of revenue recovered through the Authority's retail electric rates, including the effects of the waivers of the FPPCA approved by the Trustees (see "Waiver of Certain FPPCA Provisions"), were sufficient during the Historical Period to meet the Authority's operating expenses, PILOTS, and other financial obligations and provide debt service coverage levels in excess of 120 percent of debt service payments on outstanding senior lien bonds, parity reimbursement obligations and parity contract obligations.

In conjunction with the preparation of this Biennial Report, Navigant Consulting has prepared an estimate of the Authority's annual operating results for the Forecast Period, which are included in Exhibit 2. These estimates are based on numerous assumptions with respect to the Authority's future operations and activities. These assumptions are summarized below.

1. The Authority will issue approximately \$200 million of additional senior lien bonds ("Additional Bonds") to fund capital improvements and other uses during August 2004. Annual debt service payments on the Additional Bonds, along with debt already issued by the Authority, will be as set forth in Exhibit 2.
2. KeySpan and its subsidiaries will carry out their obligations in accordance with the terms of the Agreements.
3. LIPA will fund repairs, renewals, and replacements to the T&D System, and the Manager will make such repairs, renewals, and replacements in accordance with prudent utility practices and the MSA, as may be required, to continue the safe and reliable operation of the T&D System.
4. The Authority will retain staff, advisors, and consultants, as necessary, to carry out its responsibilities for financing, contract administration, planning, public relations, and other matters in connection with the ownership, operation, and maintenance of the System.
5. The Authority will approve capital expenditures by GENCO, and GENCO will make repairs, renewals, and replacements in accordance with prudent utility practice and the PSA, as may be required to continue the reliable operation of GENCO's generating facilities.
6. LIPA and Constellation will provide operating and capital funds in a timely manner as needed and required by contract to maintain the reliable, cost effective operation of NMP2 and to meet applicable regulations, including environmental and safety standards.
7. The Trustees will not waive any provision of the Tariff that would impact the recovery of incurred expenses during the Forecast Period.
8. Natural gas transportation facilities to deliver gas to and within the Service Area will, during the Forecast Period, be maintained, improved, and expanded to enable operation of the on-island generating facilities as forecast by the Manager in its resource planning calculations as well as for the operation of other power supply resources under contract or available to LIPA.
9. LIPA will incur fuel and purchased power expenses as set forth in Exhibit 2.

10. Third party costs, PILOTs, incentive payments, and escalation rates for labor and other costs, as applicable, associated with the MSA, PSA, and EMA will be as reflected in Exhibit 2.
11. LIPA's share of NMP2 decommissioning costs will increase from estimated 1996 costs at an average rate of no more than 3.0 percent per year and will be funded through annual deposits by LIPA of approximately \$2.4 million and \$1.1 million for the contaminated and non-contaminated portions, respectively, of NMP2. Annual earnings on the decommissioning funds held by or on-behalf of LIPA will average 6.0 percent.
12. LIPA will maintain a Rate Stabilization Fund at the levels shown in Exhibit 2 of this Report.
13. The Rate Stabilization Fund will be used for the purposes and in the amounts shown in Exhibit 2 of this Report for the Forecast Period.
14. LIPA will realize earnings on its invested funds, including the decommissioning funds, equal to the interest rates reflected in Exhibit 2.
15. There will be no changes in applicable federal, State, or local laws that will establish new limits on the operation and maintenance of the generating facilities under contract to LIPA during the Forecast Period.
16. The Authority will maintain regulations, policies, procedures, and rates and charges that will preclude the undue shifting of fixed costs among retail customers or rate classes as a result of individual customers or groups of customers electing to select power suppliers other than LIPA.
17. There will be no changes in regulations or policies of federal, State, or local agencies with jurisdiction over NMP2 that will cause new capital additions or operation and maintenance costs to exceed the estimated amounts of such costs reflected in Exhibit 2 of this Biennial Report.
18. All NMP2 generic issues, including the reactor internals cracking issue discussed in Section 5 of this Biennial Report, will continue to be successfully addressed within the NMP2 plant modification budget forecast.
19. NMP2's regulatory performance will be sufficient to make increased NRC regulation of NMP2 unnecessary.
20. Any legislation enacted by the federal government that provides for the restructuring of the electric utility industry will not preclude the use of tax-exempt debt by the Authority for the funding of capital improvements or for other purposes contemplated during the Forecast Period and will not preclude LIPA from owning or operating the System as contemplated in this Biennial Report.

As shown on Exhibit 2, the level of revenue estimated to be recovered from the Authority's retail rates are estimated to be sufficient during the Forecast Period to meet the Authority's estimated operating expenses, PILOTs, and other financial obligations and provide debt service coverage levels in excess of 120 percent of debt service payments on outstanding senior lien bonds, parity reimbursement obligations, and parity contract obligations.

## **SECTION 7**

### **FINDINGS**

The results of the analyses performed in the preparation of this Biennial Report and the findings presented herein are predicated upon the general condition that the assumptions presented herein are reasonable and will continue, as stated, for the period covered by the analyses, without major modification or change except as noted herein. Although Navigant Consulting believes the assumptions made are reasonable, Navigant Consulting makes no representation that the assumed conditions will, in fact, occur. In addition, Navigant Consulting was not permitted to review the 1999 and 2002 INPO plant evaluation reports for NMP2 and therefore offers no assurances as to the conclusions and recommendations contained therein. Furthermore, the waiver of any provision of the Tariff by the Trustees that would impact the recovery of incurred expenses during the Forecast Period could impact the adequacy of LIPA's revenue recovery and, therefore, LIPA's ability to satisfy the requirements of Article VII, Sections 701 and 702 of the General Bond Resolution. Navigant Consulting's studies, analyses, investigations, and projections have been based upon its understanding of certain documents and information provided to Navigant Consulting by the Authority, the Authority's legal, financial, and accounting advisors, KeySpan, and others. While Navigant Consulting believes these sources to be reliable, they have not been independently verified for either accuracy or validity, and no assurances are offered with respect thereto. To the best of Navigant Consulting's knowledge, the data and summaries presented herein accurately reflect the information furnished to Navigant Consulting by the Authority, the Authority's legal, financial, and accounting advisors, KeySpan, and others. Further, Navigant Consulting has assumed that all contracts, agreements, or ordinances that have been relied upon in the conduct of its investigations will be fully enforceable in accordance with their terms and conditions. Navigant Consulting makes no representations or warranties, and provides no opinion concerning the enforceability or legal interpretations of such contractual and legal requirements.

Pursuant to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution, Navigant Consulting's findings are as follows:

#### **Operation, Maintenance, and Repair of the System**

1. The Manager has provided services adequate for the operation, maintenance, and repair of the System during the Historical Period.
2. During the Forecast Period, it is reasonable to expect the Manager will provide services adequate for the operation, maintenance, and repair of the System consistent with that experienced during the Historical Period.
3. The amounts included in Exhibit 2 to this Biennial Report for operation, maintenance, and repair expense are expected to be adequate to properly operate, maintain, and repair the System during the Forecast Period.

#### **Improvements to the System**

1. During the Historical Period, LIPA's capital improvement programs: (i) achieved improvements in system reliability and quality of service; and (ii) provided reasonable levels of expenditures for capability expansion, new customer connections, and public works projects.

2. LIPA has approved capital expenditure programs for 2004 (and is expected to approve capital programs for 2005) intended to: (i) maintain system reliability and quality of service; and (ii) provide adequate levels of expenditures for capability expansion, new customer connections, facility replacement, and public works projects.
3. The amounts included in Exhibit 2 and estimated to be available from the proceeds of Bonds during the Forecast Period, together with funds estimated to be available from net revenues of the System, are reasonably expected to be adequate to fund LIPA's identified capital expenditure programs during the Forecast Period.

**Rates, Fees, Charges, and Surcharges**

1. As of the date of this Biennial Report, LIPA's currently effective system of rates and surcharges (if applied without waiver) are expected to be adequate without change to satisfy during the Forecast Period the requirements of Section 701(a) of the General Bond Resolution and Section 7.01 of the General Subordinated Resolution, which provide that the Authority will establish and maintain rates sufficient to produce revenues at least equal to (i) 100 percent of its annual operating expenses, PILOTs, and other financial obligations; and (ii) 120 percent of annual debt service payments on outstanding senior lien bonds, parity reimbursement obligations, and parity contract obligations.

**Condition of the System**

1. As of the date of this Biennial Report, the System is in good repair and sound operating condition to reliably deliver capacity and energy to LIPA's customers.

**EXHIBIT 1**  
**ACTUAL OPERATING RESULTS <sup>1</sup>**  
**STATEMENT OF OPERATIONS**  
**(\$000)**

	<u>2002</u>	<u>2003</u>
<b>Retail Sales of Electricity (MWh)</b> .....	18,812,953	19,029,906
<b>Electric Revenues</b> .....	\$2,459,210	\$2,583,603
<b>Operating Expenses</b>		
Fuel and Purchased Power Costs .....	\$ 924,778	\$1,076,969
Operations and Maintenance .....	767,217	733,655
General and Administrative .....	49,780	44,875
Operating Taxes/Payments In-Lieu of Taxes .....	218,156	213,382
Depreciation and Amortization .....	220,654	230,085
<b>Total Operating Expenses</b> .....	<u>\$2,180,585</u>	<u>\$2,298,966</u>
<b>Operating Income</b> .....	\$ 278,625	\$ 284,637
<b>Other Income and Deductions, Net</b> .....	<u>\$ 52,204</u>	<u>\$ 53,988</u>
<b>Excess of Revenues Over Expenses Before Interest Expense</b>	\$ 330,829	\$ 338,625
<b>Interest Expense</b> .....	<u>\$ 310,717</u>	<u>\$ 318,625</u>
<b>Excess of Revenues Over Expenses</b> .....	<u>\$ 20,112</u>	<u>\$ 20,000</u>
<b>Debt Service Coverage:</b>		
Senior Lien Debt Service .....	1.78	1.66
Senior Lien and Subordinate Debt Service .....	1.64	1.45
Total Debt Service .....	1.49	1.40

<sup>1</sup> Source: LIPA.

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(\$000)**

	<u>2004</u>	<u>2005</u>
<b>Retail Sales of Electricity (MWh) <sup>1</sup></b> .....	19,453,886	19,520,057
<b>Electric Revenues <sup>2</sup></b> .....	\$2,840,063	\$2,975,172
<b>Operating Expenses</b>		
Fuel and Purchased Power Costs <sup>3</sup> .....	\$1,431,545	\$1,507,102
Operations and Maintenance <sup>4</sup> .....	644,762	678,433
General and Administrative <sup>5</sup> .....	38,570	38,694
Revenue Taxes <sup>6</sup> .....	59,085	49,515
Payments In-Lieu of Taxes <sup>7</sup> .....	157,488	165,855
Depreciation and Amortization <sup>8</sup> .....	228,344	234,566
<b>Total Operating Expenses</b> .....	<u>\$2,559,794</u>	<u>\$2,674,165</u>
<b>Operating Income</b> .....	\$ 280,269	\$ 301,007
<b>Other Income and Deductions, Net <sup>9</sup></b> .....	<u>47,232</u>	<u>48,757</u>
<b>Excess of Revenues Over Expenses Before Interest Expense</b> .....	\$ 327,501	\$ 349,764
<b>Interest Expense</b>		
Debt Service Interest Expense <sup>10</sup> .....	\$ 299,042	\$ 325,136
Other Interest Expense and Fees <sup>11</sup> .....	<u>16,535</u>	<u>12,703</u>
<b>Subtotal Interest Expense</b> .....	\$ 315,576	\$ 337,839
Promissory Notes Receipts <sup>12</sup> .....	<u>(8,075)</u>	<u>(8,075)</u>
<b>Net Interest Expense</b> .....	<u>\$ 307,501</u>	<u>\$ 329,764</u>
<b>Excess of Revenues Over Expenses <sup>13</sup></b> .....	<u>\$ 20,000</u>	<u>\$ 20,000</u>

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

	<b>2004</b>	<b>2005</b>
<b>CALCULATION OF CASH AVAILABLE FOR DEBT SERVICE</b>		
<b>Excess of Revenues Over Expenses</b> <sup>14</sup>	\$ 20,000	\$ 20,000
Plus (Minus) Non-Cash Items:		
Amortization of Deferred Shoreham Property Settlement		
Credits <sup>15</sup> .....	\$ 34,777	\$ 34,560
Carrying Charges on Deferred Shoreham Property Tax		
Settlement Costs <sup>16</sup> .....	(31,578)	(32,345)
Deferred Fuel Cost Reconciliation <sup>17</sup> .....	36,528	36,500
NMP2 Amortized Nuclear Fuel Expense <sup>18</sup> .....	5,771	7,481
Prepaid NMP2 Refueling Outage Costs-Net of Amortization <sup>19</sup> .....	(3,591)	3,642
O&M Asset Accretion-Asset Retirement Obligation		
(FASB 143) <sup>20</sup> .....	3,867	4,099
Amortization and Prepaid Hedging Costs <sup>21</sup> .....	13,564	7,711
Depreciation and Amortization <sup>22</sup> .....	228,344	234,566
Other <sup>23</sup> .....	(85,787)	5,100
Interest Expense <sup>24</sup> .....	315,576	337,839
<b>Subtotal</b> .....	<b>\$ 537,471</b>	<b>\$ 659,154</b>
Less:		
Prepaid Fuel Hedging Program Costs <sup>25</sup> .....	\$ 21,275	\$ -
NMP2 Cash Fuel Expense <sup>26</sup> .....	9,600	9,152
Funding for NMP2 Plant Decommissioning <sup>27</sup> .....	3,523	3,523
Bank and Related Fees <sup>28</sup> .....	11,172	11,231
<b>Subtotal</b> .....	<b>\$ 45,570</b>	<b>\$ 23,906</b>
<b>Operating Cash Available for Debt Service Coverage</b> .....	<b>\$ 491,902</b>	<b>\$ 635,247</b>



**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

	<u>2004</u>	<u>2005</u>
<b>RATE COVENANT TEST</b>		
<b>Operating Cash Available for Debt Service and Coverage</b> <sup>29</sup>	\$ 491,902	\$ 635,247
Less Debt Service:		
Senior Lien Debt Service <sup>30</sup> .....	\$ 401,971	\$ 430,266
20 Percent Coverage on Senior Lien Debt Service <sup>31</sup> .....	80,394	-
Subordinate Lien Debt Service <sup>32</sup> .....	56,886	34,895
Subsidiary Unsecured Debt Service <sup>33</sup> .....	8,075	8,075
<b>Subtotal</b> .....	<u>\$ 547,326</u>	<u>\$ 473,236</u>
<b>Revenue Excess (Deficiency)</b> .....	\$ (55,424)	\$ 162,011
Withdrawals from Rate Stabilization Fund <sup>34</sup> .....	55,424	-
<b>Revenue Excess (Deficiency) after Transfer</b> .....	<u>\$ -</u>	<u>\$ 162,011</u>
 <b>PRIORITY OF PAYMENT DEBT SERVICE COVERAGE RATIO</b>		
<b>Operating Cash Available for Debt Service and Coverage</b> <sup>35</sup> .....	\$ 491,902	\$ 635,247
Plus:		
Payments In-Lieu of Taxes <sup>36</sup> .....	216,573	215,370
Capitalized Leases <sup>37</sup> .....	92,719	126,968
<b>Total Cash Available for Debt Service and Coverage Based on Priority of Payments</b> .....	<u>\$ 801,193</u>	<u>\$ 977,585</u>
Senior Lien Debt Service <sup>38</sup> .....	\$ 401,971	\$ 430,266
<b>Coverage on Senior Lien Debt Service</b> .....	1.99	2.27
Senior Lien and Subordinate Debt Service <sup>39</sup> .....	\$ 458,856	\$ 465,161
<b>Coverage on Senior Lien and Subordinate Debt Service</b> .....	1.75	2.10
Total Debt Service <sup>40</sup> .....	\$ 466,932	\$ 473,236
<b>Coverage on Total Debt Service</b> .....	1.72	2.07

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

	<u>2004</u>	<u>2005</u>
<b>FUNDS PROVIDED FROM:</b>		
<b>Excess of Revenues Over Expenses</b> <sup>41</sup> .....	\$ 20,000	\$ 20,000
Plus (Minus) Non-Cash Items:		
Amortization of Deferred Shoreham Property Settlement		
Credits <sup>42</sup> .....	\$ 34,777	\$ 34,560
Carrying Charges on Deferred Shoreham Property Tax		
Settlement Costs <sup>43</sup> .....	(31,578)	(32,345)
Deferred Fuel Cost Reconciliation <sup>44</sup> .....	36,528	36,500
NMP2 Amortized Nuclear Fuel Expense <sup>45</sup> .....	5,771	7,481
Prepaid NMP2 Refueling Outage Costs-Net of Amortization <sup>46</sup> .....	(3,591)	3,642
O&M Asset Accretion-Asset Retirement Obligation		
(FASB 143) <sup>47</sup> .....	3,867	4,099
Amortization and Prepaid Hedging Costs <sup>48</sup> .....	13,564	7,711
Depreciation and Amortization <sup>49</sup> .....	228,344	234,566
Other <sup>50</sup> .....	(85,787)	5,100
Interest Expense <sup>51</sup> .....	315,576	337,839
Proceeds of Bonds, Notes, and Swaps <sup>52</sup> .....	231,000	38,608
<b>Total Sources of Funds</b> .....	<u>\$ 768,471</u>	<u>\$ 697,761</u>
<b>FUNDS USED FOR:</b>		
Prepaid Fuel Hedging Program Costs <sup>53</sup> .....	\$ 21,275	\$ -
Funding for NMP2 Decommissioning <sup>54</sup> .....	3,523	3,523
Bank and Related Fees <sup>55</sup> .....	11,172	11,231
Debt Service Payments <sup>56</sup> .....	466,932	473,236
Capital Expenditures <sup>57</sup> .....	216,937	257,641
NMP2 Cash Fuel Expense Capital Expenditure <sup>58</sup> .....	9,600	9,152
Change in Cash Position Due to Operating, Financing, and		
Investing Activities <sup>59</sup> .....	39,032	(57,022)
<b>Total Uses of Funds</b> .....	<u>\$ 768,471</u>	<u>\$ 697,761</u>

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

	<u>2004</u>	<u>2005</u>
<b>CASH ACCOUNT: FUNDS AVAILABLE FOR OPTIONAL DEFEASED/TENDERED DEBT, WORKING CAPITAL, CAPITAL IMPROVEMENTS, AND OTHER PURPOSES</b>		
<b>Beginning Balance</b> <sup>60</sup> .....	\$ 168,000	\$ 207,032
Change in Cash Position Due to Operating, Financing, and Investing Activities <sup>61</sup> .....	39,032	(57,022)
Withdrawals from Rate Stabilization Fund <sup>62</sup> .....	55,424	-
(Deposits to) Rate Stabilization Fund <sup>63</sup> .....	(55,424)	-
<b>Ending Balance</b> <sup>64</sup> .....	<u>\$ 207,032</u>	<u>\$ 150,010</u>
 <b>RATE STABILIZATION FUND</b>		
<b>Beginning Balance</b> <sup>65</sup> .....	\$ 250,000	\$ 250,000
(Withdrawals From) <sup>66</sup> .....	(55,424)	-
Deposits to <sup>67</sup> .....	55,424	-
<b>Ending Balance</b> <sup>68</sup> .....	<u>\$ 250,000</u>	<u>\$ 250,000</u>
 <b>TOTAL FUNDS</b>		
<b>Beginning Balance</b> <sup>69</sup> .....	\$ 418,000	\$ 457,032
Transfers In (Out) <sup>70</sup> .....	39,032	(57,022)
<b>Ending Balance</b> <sup>71</sup> .....	<u>\$ 457,032</u>	<u>\$ 400,010</u>
 <b>CAPITAL EXPENDITURE FUNDING</b>		
Internal Funding <sup>72</sup> .....	\$ 20,937	\$ 219,033
Bond Proceeds <sup>73</sup> .....	196,000	38,608
<b>Total Capital Expenditures</b> <sup>74</sup> .....	<u>\$ 216,937</u>	<u>\$ 257,641</u>

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

**FOOTNOTES:**

- <sup>1</sup> Includes bundled and Long Island Choice electric sales. Developed by KeySpan.
- <sup>2</sup> Includes revenues from bundled services, Long Island Choice services, Shoreham property tax settlement surcharges, and recoverable fuel and purchased power costs. Also includes revenues from sales for resale, transmission of electricity for others (“wheeling”), pole attachment fees, late payment charges, service activation charges, and other miscellaneous revenues.
- <sup>3</sup> Includes LIPA's cost for fossil and nuclear fuel, cost of purchased capacity and energy, wheeling charges, ISO charges, hedging costs, and deferred fuel cost recovery. Developed based on information provided by KeySpan.
- <sup>4</sup> Includes costs in accordance with the MSA and PSA, NMP2 operation and maintenance expenses and accretion of the asset retirement obligation, Clean Energy and Energy Efficiency Programs costs, assessments, research and development, storm damage reserve, uncollectible accounts, customer service economic development, postage-paid envelopes and other miscellaneous expenses.
- <sup>5</sup> Includes employee salaries and benefits, utilities, rent, legal and consulting fees, and similar administrative and general costs.
- <sup>6</sup> Payments for gross receipts taxes.
- <sup>7</sup> Includes payments in lieu of property taxes to various taxing jurisdictions for NMP2, the T&D System, and merchant power plants.
- <sup>8</sup> Consists of amortization of the acquisition adjustment and depreciation of plant-in-service.
- <sup>9</sup> Includes interest earned on investments from available cash balances and the Nuclear Decommissioning Trust Fund. Also includes carrying charges related to the Shoreham property tax settlement regulatory asset and income from the sales of emission credits.
- <sup>10</sup> Interest expense on the Bonds, Subordinate Indebtedness, Commercial Paper, the Debentures, and NYSERDA Financing Notes. Includes accretion of capital appreciation bonds and amortized interest expense. Also includes amortization of upfront swap payments on derivative financial transactions.
- <sup>11</sup> Bank and letter of credit fees, debt administration costs, interest on customer deposits, amortization of costs associated with bond issuance and redemptions, and reduction for capitalized interest.
- <sup>12</sup> Receipts from KeySpan for Promissory Notes held by LIPA for repayment of certain assumed debt. LIPA’s Audited Financial Statements reflect these receipts as an offset to interest expense.
- <sup>13</sup> LIPA’s Fuel and Purchased Power Cost Adjustment mechanism will set recoveries of excess fuel costs so that LIPA achieves \$20 million of revenues in excess of expenses for each calendar year. The fuel recovery will not exceed the fuel cost recovery allowance calculated according to Fuel and Purchased Power Cost Adjustment rider to LIPA’s tariffs.
- <sup>14</sup> From Exhibit 2, Page 1.
- <sup>15</sup> Shoreham Property Tax Surcharge.
- <sup>16</sup> Annual carrying charges recorded on the Shoreham property tax settlement regulatory asset.
- <sup>17</sup> Recognition of deferred fuel costs as an expense in the year during which the corresponding fuel and purchased power costs are billed. The annual deferred fuel costs are the ten-year amortization of 2003 deferred fuel and purchased power costs.
- <sup>18</sup> The expensing of NMP2 nuclear fuel as it is consumed.
- <sup>19</sup> Incremental operating and maintenance costs attributable to the refueling outage, other than nuclear fuel and capital projects. Includes costs of specialty contractors, skilled craft outside labor, incremental onsite labor associated with the outage, materials and supplies, and benefits and taxes.
- <sup>20</sup> Amortization of operations and maintenance assets, including accretion of the asset retirement obligation.
- <sup>21</sup> Amortization of fuel hedging costs in the year of the contract’s settlement date.
- <sup>22</sup> See Note 8.

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

**FOOTNOTES:**

- <sup>23</sup> Includes true-ups and adjustments to reserve accounts.
- <sup>24</sup> See Notes 10 and 11.
- <sup>25</sup> Cash outlays for hedging contracts.
- <sup>26</sup> Cash outlays for NMP2 nuclear fuel
- <sup>27</sup> Deposits to the NMP2 decommissioning fund.
- <sup>28</sup> Bank fees, letter of credit fees, bond administration costs, and interest on customer deposits.
- <sup>29</sup> From Exhibit 2, Page 2.
- <sup>30</sup> Debt service on the Bonds (includes Series 7 floating-to-fixed rate swap).
- <sup>31</sup> Additional 20 percent coverage as required by the Bond Resolution until such time that LIPA retires 25 percent of the Acquisition Debt net of the then outstanding balance of KeySpan Promissory Notes. LIPA expects the 25 percent retirement level to be met in 2004. For 2005, the additional 20 percent coverage is not expected to be required.
- <sup>32</sup> Debt service on the Subordinated Indebtedness. Subordinated Indebtedness consists of variable rate debt and commercial paper.
- <sup>33</sup> Debt service on the Debentures and NYSERDA Financing Notes.
- <sup>34</sup> Transfers from the Rate Stabilization Fund to satisfy the deficiency of Revenues.
- <sup>35</sup> From Exhibit 2, Page 2.
- <sup>36</sup> From Exhibit 2, Page 1. See Notes 6 and 7.
- <sup>37</sup> Capacity payments for power supply agreements that satisfy the conditions for capital leases.
- <sup>38</sup> See Note 30.
- <sup>39</sup> See Notes 30 and 32.
- <sup>40</sup> See Notes 30, 32, and 33.
- <sup>41</sup> From Exhibit 2, Page 1.
- <sup>42</sup> See Note 15.
- <sup>43</sup> See Note 16.
- <sup>44</sup> See Note 17.
- <sup>45</sup> See Note 18.
- <sup>46</sup> See Note 19.
- <sup>47</sup> See Note 20.
- <sup>48</sup> See Note 21.
- <sup>49</sup> See Note 8.
- <sup>50</sup> See Note 23.
- <sup>51</sup> See Note 24.
- <sup>52</sup> Proceeds of Bonds and Notes for capital projects and upfront payments for swap transactions.
- <sup>53</sup> See Note 25.
- <sup>54</sup> See Note 27.
- <sup>55</sup> See Note 28.
- <sup>56</sup> See Note 40.
- <sup>57</sup> Transfer of proceeds from Bonds and Notes and internal funds to the Construction Fund.
- <sup>58</sup> See Note 26.
- <sup>59</sup> Changes in LIPA's cash position.
- <sup>60</sup> Beginning balance of cash available for optional defeased/tendered debt, working capital, capital improvements, and other purposes.
- <sup>61</sup> See Note 59.
- <sup>62</sup> See Note 34.
- <sup>63</sup> Deposits made to the Rate Stabilization Fund.
- <sup>64</sup> Ending balance of the cash account.

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

**FOOTNOTES:**

<sup>65</sup> Beginning Rate Stabilization Fund balance.

<sup>66</sup> See Note 34.

<sup>67</sup> Deposits made to the Rate Stabilization Fund.

<sup>68</sup> Ending Rate Stabilization Fund balance.

<sup>69</sup> Total beginning balance of the Cash Account and Rate Stabilization Fund.

<sup>70</sup> See Notes 61, 64, and 65

<sup>71</sup> Total ending balance of the Cash Account and Rate Stabilization Fund.

<sup>72</sup> Internal LIPA funds used for capital improvements.

<sup>73</sup> Bond and Note proceeds, net of financing costs.

<sup>74</sup> Total expenditures for capital improvements.

Note: Sums may not add due to rounding.

## Appendix A

### SUMMARY OF CERTAIN PROVISIONS OF THE MANAGEMENT SERVICES AGREEMENT

The following is a brief summary of certain provisions of the Management Services Agreement. The summary does not purport to be complete or definitive and is qualified in its entirety by reference to the Management Services Agreement, a copy of which is on file with the Trustee.

#### **General**

The Management Services Agreement establishes the terms and conditions under which the Authority has contracted with KeySpan and its subsidiaries (the “Manager”) for the purpose of providing the Operation and Maintenance Services and the Construction Work relating to the T&D System in a manner consistent with policies established by LIPA in order to assure the continued delivery of electric energy to the customers of the T&D System.

#### **Ownership of the T&D System**

The Agreement provides that the Manager will not have any ownership or leasehold interest in the T&D System. LIPA has engaged the Manager as an independent contractor to furnish the services described in the Agreement.

The Agreement provides that the Manager will not, without LIPA’s prior written consent, create or permit to be created or to remain, and will promptly discharge at its expense, any Encumbrance on the T&D System, other than (1) Encumbrances existing as of the date of the Agreement, or (2) any Lien affecting the T&D System (i) resulting solely from any action or failure to act by LIPA or anyone claiming by, through or under LIPA; or (ii) created by Subcontractors that are promptly discharged or bonded against by the Manager. The Agreement provides that nothing in the Agreement will be deemed to create any Lien or Encumbrance in favor of the Manager on any asset of LIPA as security for the obligations of LIPA under the Agreement.

#### **Operation of the T&D System**

*General.* The Agreement provides that the Manager will not transmit or distribute Power and Energy other than Power and Energy obtained by, on behalf of, or with the approval of LIPA, and will not use the T&D System for any purpose other than the purposes contemplated by the Agreement or to serve or benefit any person other than LIPA and its customers in the Service Area.

*Operation and Maintenance.* The Agreement provides that, commencing on the LIPA/LILCO Merger Closing Date, the Manager will provide Operation and Maintenance Services and Construction Work for the T&D System on behalf of LIPA in accordance with the Contract Standards. The Manager will be responsible for the safe and reliable operation and maintenance of the T&D System, management and/or performance of construction of improvements thereto and delivery of Power and Energy to LIPA’s customers and will be responsible for the following tasks and services, among others: (a) day-to-day operation and maintenance of the T&D System; (b) construction activities performed by the Manager’s work force; (c) supervision of routine and major capital improvements; (d) preparation of recommended and monitoring of approved annual capital and operating expenditure budgets, load and energy forecasts and long and short range system and strategic plans; (e) preparation of long and short range transmission and distribution planning analyses; (f) performance of accounting and tax and payment in lieu of tax reporting functions and

preparation of monthly reports concerning the T&D System; (g) operation of the T&D System in compliance with applicable provisions of the bond resolutions, and with other requirements pertaining to qualification of the bonds for tax-exemption under the Code; (h) other actions necessary to safely and reliably operate the T&D System in accordance with Prudent Utility Practice; (i) administration and management, at the direction of LIPA, of LIPA's interest in NMP2; and (j) billing and collection, in accordance with LIPA's direction, of all fees and charges in connection with the use or availability of the T&D System for wheeling services.

*Maintenance and Repair of T&D System.* The Agreement provides that the Manager will maintain the T&D System, the T&D System Site and the Common Facilities in good working order and repair and in a neat and orderly condition, and will conduct periodic, corrective, and preventive maintenance and repair of the T&D System consistent with the Contract Standards for the purpose of, among other things, mitigating and preventing abnormal wear, tear and usage.

The Agreement provides that all additions to the T&D System purchased in conjunction or for the use with any part of the T&D System during the term of the Agreement shall be the property of LIPA, except those which are leased or constitute part of the Common Facilities.

*Performance Guarantees.* The Agreement provides that, commencing on the LIPA/LILCO Merger Closing Date, the Manager will at all times comply with the Performance Guarantees, except to the extent excused by Uncontrollable Circumstances or LIPA Fault. If the Manager fails to comply with any Performance Guarantee, the Manager shall, without relief under any other Performance Guarantee under the Agreement, (1) promptly notify LIPA of any such noncompliance, (2) promptly provide LIPA with copies of any notices sent to or received from any Governmental Body having regulatory jurisdiction with respect to any violations of Applicable Law, (3) promptly make any applicable payments provided for in the Agreement, and (4) at its own cost and expense to the extent required under the Agreement, promptly take any action necessary in order to comply with such Performance Guarantee, continue or resume performance under the Agreement and eliminate the cause of, and avoid or prevent recurrence of noncompliance with such Performance Guarantee.

*Rights and Responsibilities of LIPA.* The Agreement provides that LIPA will retain the ultimate authority and control over the assets and operations of the T&D System and the right to direct the Manager in connection with the performance of the Manager's obligations under the Agreement. Without limiting the generality of the foregoing, LIPA's specific rights and responsibilities with respect to the T&D System include: (a) the right to determine all T&D System rates and charges, line extension policies and service rules and regulations applicable to the T&D System and System Power Supply; (b) the right to determine and to change from time to time, in its sole discretion, all policies and procedures for the T&D System consistent with Applicable Law and Prudent Utility Practice; (c) the right to review, amend as appropriate and approve annual capital and operating expenditure budgets pursuant to the procedures outlined in the Agreement and approve or in its discretion, develop, all long-range strategic plans for the T&D System and System Power Supply; and (d) to the extent the Manager acts as the representative of LIPA in connection with the North American Electric Reliability Council, Northeast Power Coordinating Council, the New York Power Pool, the ISO and any other similar institutions or organizations, the right to direct the Manager's actions with respect thereto.

*Customer Services, Rates and Rules of Service.* The Agreement provides that the Manager shall perform normal and customary customer services in a manner designed to achieve the highest level of customer service, including, but not limited to: customer account service and maintenance; service restorations account inquiry work; customer assistance, credit and collection services; cashiering; account connection and disconnection; and conservation advice.

The Agreement provides that the Manager shall, unless otherwise directed by LIPA, read the meters of electric commercial, industrial, residential heating and residential multiple rate period



customers on a monthly basis and all other electric customer meters on a bi-monthly basis. The Manager shall, according to the schedule of rates, tariffs and policies (the "Schedule of Rates") then in effect, render bills to all T&D System customers in the name of LIPA for electric service delivered on behalf of LIPA and in the format determined by LIPA. To the extent directed by LIPA, such bills will also reflect electric services provided to T&D System customers by other parties. LIPA may implement changes to such rates, rules of service, regulations and procedures by giving written notice to the Manager not later than sixty (60) days prior to the effective date of such change to the extent practicable given the nature of the change. The Manager will maintain customer bills and records as LIPA reasonably requests.

The Manager will use best efforts to collect on a timely basis (1) all amounts due LIPA for service provided to customers, and for other services, in accordance with the Schedule of Rates for the periods in which services were provided, and (2) other monies owed to LIPA pursuant to the operation of the T&D System. The Manager's responsibilities will also include the institution of legal proceedings in LIPA's name to collect utility billings and other monies owed LIPA related to the T&D System. All monies collected by the Manager or its Subcontractors will be the property of LIPA and will be deposited by the Manager daily in an account of LIPA specified pursuant to the Agreement. In collecting such monies, the Manager and any Subcontractor will act solely as an agent for LIPA and will have no right or claim to such moneys and, without limiting the generality of the foregoing, will have no right to assert a claim of set-off, recoupment, abatement, counterclaim or deduction for any amounts which may be owed to the Manager under the Agreement or with respect to any other matter in dispute thereunder.

It is expected that gas customers of Manager's Affiliate and the T&D System electric customers will be billed in a single statement. In the event any electric customer who is also a gas customer will pay less than the total amount due at any time under a single statement, the amounts collected will be applied pro rata between the amounts owed by such customer with respect to electric service and gas service. To the extent moneys are collected for any power supply services provided by any unrelated party, amounts collected will be allocated in accordance with the directions of LIPA. The Manager may elect to bill gas customers separately, provided that the Manager will bear all incremental costs arising by reason of any such election. (Note: Effective January 1, 2003, the Authority, at its expense, began the process of separating the electric and gas customer bills.)

*Licenses, Permits and Approvals.* The Manager will identify for LIPA, prepare, and with LIPA approval, make and prosecute all filings, applications and reports necessary to obtain and maintain all permits, licenses and approvals required to be made, obtained or maintained by each under Applicable Law in order to operate the T&D System.

*Operating Period Insurance.* During the term of the Agreement, the Manager will obtain and maintain, the Required Operating Period Insurance as specified in accordance with the Agreement and will comply with all applicable Insurance Requirements.

### **Manager's Reporting Requirements**

*Monthly Reports.* The Manager will provide LIPA and the Consulting Engineer with monthly reports no later than 15 Business Days after the end of each month, which include the following data: (1) on a monthly and year-to-date basis, the actual T&D System costs versus the Annual T&D Budget and the prior year's costs at such time, (2) a description and explanation of significant variations (at least \$1,000,000 and 3%) from the Annual T&D Budget or the prior year's results, (3) a description of partial or total shutdowns for maintenance and repairs during the prior month and anticipated during the current month, (4) any known or anticipated adverse conditions which may be expected to arise during the next 30 day period that may affect the ability of the Manager to transmit and distribute Power and Energy in accordance with the Performance Guarantees and the annual operating

plan established for the T&D System, (5) identification of those costs which are classified as capital versus operating in sufficient detail in order to allow LIPA to determine which costs qualify for bonding under the Resolution and which are to be recovered through T&D System rates, and (6) any other information or statement which is requested by LIPA and which may be reasonably produced from records maintained by the Manager in the normal course of business. The Manager will also provide a quarterly forecast of projected expenditures by line item through year-end.

*Semi-Annual Reports.* The Manager will, on a semi-annual basis within 60 days after the end of each half of the Contract Year, provide LIPA and the Consulting Engineer with a report of actual Direct Costs and Third Party Costs together with identification of any material Direct Costs projects or Third Party Costs projects which were included in the Direct Cost Budget or the Third Party Cost Budget from the previous Contract Year which were deferred to the current Contract Year or proposed to be deferred to a subsequent Contract Year, or such costs in the current Contract Year which the Manager proposes deferring beyond the current Contract Year.

*Other Costs Reports.* The Manager will promptly notify LIPA when an event occurs, or is anticipated to occur, that the Manager believes qualifies for treatment as an Other Cost.

*Annual Reports.* The Manager will furnish LIPA and the Consulting Engineer with the Annual Settlement Statement, an annual summary of the statistical data provided in the monthly reports, certified by the Manager and the Manager's independent public accountants.

*Operations Reports.* The Manager will prepare appropriate reports concerning matters reasonably related to the operation of or planning for the T&D System, including, but not limited to: source of Power and Energy supply; revenues and unit sales of Power and Energy supplied to customers in the aggregate and by customer class; environmental requirements and compliance; compliance with Applicable Law; safety requirements and compliance; and reports relating to any incentive and penalty provisions set forth in the Agreement.

*Fiscal Affairs, Accounting and Record Keeping.* The Manager will maintain possession of operating equipment, buildings, materials and supplies, maps, plans, specifications, and customer billing records during the term of the Agreement in accordance with the Manager's customary practices or in such manner as LIPA may reasonably require. The Manager also will maintain LIPA's fixed asset books and records for those activities performed by the Manager in general conformity with municipal electric utility accounting standards or such other standards as reasonably requested by LIPA.

All cash held by the Manager for the account of LIPA and all cash collected by the Manager for the account of LIPA after the LIPA/LILCO Merger Closing Date will be deposited on each business day in bank accounts in such bank as LIPA may direct and upon such terms and conditions as may be specified by LIPA.

*Purchase of Equipment, Materials and Services.* The Agreement provides that the Manager will arrange for the purchase or rental for the account of LIPA of equipment, materials, and supplies and services which are not purchased directly by LIPA or other items necessary to properly operate and maintain the T&D System and to maintain the records of LIPA, and to make such additions and extensions to the T&D System, all as may be required by LIPA. Subcontractors will be subject to approval by LIPA in accordance with the Agreement.

*Other Services.* The Manager will timely pay all bills related to the T&D System which are proper, appropriate and not otherwise disputed and which it has authority to pay and will assure that, to the extent within the Manager's control, no mechanic's or similar liens are filed against any portion of the T&D System.

## **Major Capital Improvements**

*Major Capital Improvements Generally.* The Major Capital Plan and Budget provided for in the Agreement is intended to provide for the implementation of major repairs and replacements not constituting routine maintenance of the T&D System. In addition, the Major Capital Plan and Budget is intended to recognize that it will be necessary or desirable from time to time during the term of the Agreement to modify, alter or improve the T&D System from its then-current condition. All such projects which constitute Major Capital Improvements will be made in accordance with the Agreement and will be owned by LIPA. The Manager will not make a Major Capital Improvement without notifying LIPA and receiving written consent from LIPA unless such Major Capital Improvement is included in the then current annual Major Capital Plan and Budget. LIPA will have the right, when the Manager has materially exceeded the Major Capital Plan and Budget as of an interim date, to require the Manager to defer specific Major Capital Improvements planned for the remainder of the year.

*Major Capital Plan and Budget.* Contemporaneously with the preparation of the Annual T&D Budget, the Manager is obligated to prepare a proposed annual and five year Major Capital Plan and Budget concerning planned Major Capital Improvement projects.

The annual Major Capital Plan and Budget will be approved by LIPA before or contemporaneously with the adoption of the Annual T&D Budget, provided that in the event the Major Capital Plan and Budget has not been adopted by LIPA as of the beginning of a Contract Year, the Manager may undertake such Major Capital Improvements as reasonably approved by LIPA on a project-by-project basis.

*Cost Determination.* Major Capital Improvements, except those awarded to the Manager as a result of the competitive procurement procedures established pursuant to the Agreement, will be performed at the cost of the service without any multiplier fee or mark-up.

The Manager will be entitled to incentive payments for cost savings and disincentive payments for cost overruns and delays in scheduled completion of approved Major Capital Improvements equal to 50% of all variances from the approved Major Capital Plan and Budget; provided, however, that no such incentive or disincentive will be payable for cost variances in excess of 15% of the approved Major Capital Plan and Budget. Incentives and disincentives will be trued-up upon the closing and acceptance by LIPA of approved capital projects.

*Public Works Improvements.* The Agreement provides that the budget for each Public Works Improvement will be subject to LIPA approval and the Manager will not undertake any Public Works Improvement until the budget therefor has been adopted.

Public Works Improvements will be performed at the cost of the service without any multiplier fee or mark-up; provided, however, that such costs will be reduced by all reimbursements or payments received from the applicable Governmental Body for the planning, engineering, procurement and completion of the Public Works Improvement. The Manager will be entitled to certain incentive payments for cost savings and disincentives for cost overruns and delays in scheduled completion that result in incremental costs for approved Public Works Improvement.

*Major Capital Improvements for which Manager is Responsible.* If the T&D System is damaged or destroyed by reason of circumstances for which the Manager is responsible described below under the heading "Allocation of Risks of Certain Costs and Liabilities", the Manager shall promptly proceed to make or cause to be made all Major Capital Improvements reasonably necessary to permit the Manager to perform its obligations under this Agreement. All such Major Capital Improvements for which the Manager is responsible as described under the heading "Allocation of Risks of Certain Costs and Liabilities" shall be made at the Manager's sole cost and expense, and the Manager shall not be entitled to any compensation from LIPA as a result thereof.

## Compensation and Budgets

*Service Fee Formula.* Commencing with the first Billing Period and for each Billing Period during the term of the Agreement, LIPA will pay the Manager a Service Fee for the services provided by the Manager under the terms of the Agreement in accordance with the following formula:

$$\text{SF} = \text{FDF} + \text{TPC} + \text{VP} + \text{CIF} + \text{NCPI}$$

Where

SF = Service Fee

FDF = Fixed Direct Fee

TPC = Third Party Costs

VP = Variable Payment

CIF = Cost Incentive Fee

NCPI = Non-cost Performance Incentives and Disincentives

Each component of the Service Fee will be computed in accordance with the Agreement and may be adjusted from time to time as provided in the Agreement. In addition to the Service Fee, Manager will be entitled to payment for cost overruns as and to the extent as discussed below.

*Fixed Direct Fee.* LIPA will make a monthly payment to the Manager equal to ninety percent (90%) of the approved annual Direct Cost Budget (the “Fixed Direct Fee”).

*Third Party Costs.* LIPA will make a monthly payment to the Manager for the monthly allocation of the approved annual Third Party Cost Budget.

*Variable Payment.* The Manager will be entitled to a Variable Payment equal to the lesser of (a) the difference between actual Total Costs (the sum of the actual Direct Costs and the actual Third Party Costs), less the sum of the Fixed Direct Fee and the lesser of actual or budgeted Third Party Costs or (b) the difference between the approved Total Cost Budget (the sum of the Direct Cost Budget and the Third Party Cost Budget) less the sum of the Fixed Direct Fee and the lesser of the actual or budgeted Third Party Costs. Monthly allocation of such payment will be determined by the parties based on historical monthly trends to minimize working capital costs.

*Management Fee, Cost Incentive Fee and Non-cost Performance Incentives and Disincentives.* To the extent actual Total Costs are less than the approved Total Cost Budget for the year, the Manager will be paid the portion of its Management Fee, described within the definition of Direct Costs as discussed below under the heading “Annual T&D Budget and Five Year Planning Budget” (relating to cost savings), in an amount equal to such cost savings up to a maximum of \$5 million. Beyond such \$5 million level, the Manager will be paid a Cost Incentive Fee equal to 50% of such additional savings, provided that no incentive will be paid for savings in excess of 15% of the Total Cost Budget. All savings above this cap will be for the benefit of LIPA.

*Cost Overruns.* To the extent actual Total Costs, excluding the Management Fee, are greater than the Total Cost Budget, excluding the net Management Fee, for the applicable Contract Year, the Manager will absorb the first dollars of such overruns, up to a maximum total of \$15 million in each Contract Year. For cost overruns in excess of this amount, the Manager will be entitled to a payment through the Annual Settlement Statement equal to the amount of such excess overruns (the “Overrun Payment”).

*Limitations.* The Agreement provides that the ratio of (1) the sum of the Variable Payment plus the Cost Incentive Fee plus the sum of the Non-cost Performance Incentives and Disincentives (as discussed below under the heading “Non-Cost Performance Incentives and Disincentives”) plus the

Overrun Payment divided by (2) the sum of (a) the amounts described in (1) above and (b) the Fixed Direct Fee, will not be greater than twenty percent (20%) in any Contract Year.

### **Annual T&D Budget and Five Year Planning Budget Process**

*General.* The Agreement provides that the Annual T&D Budget and the Five-Year Planning Budget will be established in the manner described below and will provide for the determination and payment of the Manager's costs of operating and maintaining the T&D System and performing its obligations under the Agreement, inclusive of fees paid to the Manager. The Annual T&D Budget and the Five-Year Planning Budget will be comprised of two broad categories: Direct Costs and Third Party Costs. These categories of costs will exclude Incremental Internal Costs and additional Third Party Costs relating to Major Capital Improvements, Public Works Improvements, and Other Costs.

In establishing the Direct Cost Budget for the initial Annual T&D Budget under the Agreement, the Direct Cost Budget will include (1) amounts to compensate the Manager for Operation and Maintenance Services costs anticipated to be reasonably predictable and incurred by the Manager through the utilization of either its work force, or its owned assets, in carrying out its responsibilities under the Agreement and (2) the Manager's fee.

The Third Party Cost Budget will include amounts for reimbursement of, on a dollar for dollar basis, all recurring capital or operating costs incurred by the Manager in carrying out its responsibilities under the Agreement and paid to parties other than the Manager, its parent or affiliates, and any of their employees.

The Manager will be entitled to receive Cost Incentive Fees, as discussed above under the heading "Service Fee", for costs savings from the amounts included for Direct Costs and Third Party Costs in the approved Annual T&D Budget.

*Annual T&D Budget Preparation.* The Agreement provides that no later than six months prior to the end of each Contract Year, the Manager will prepare a recommended annual budget for the operation and maintenance, including routine capital projects not constituting Major Capital Improvements or Public Works Improvements, of the T&D System and a recommended annual budget for total revenue requirements, inclusive of LIPA's own costs, with the costs that will be paid by LIPA to Manager under the Agreement specifically and separately identified (together, the "Annual T&D Budget"). The recommended Annual T&D Budget will be accompanied by the Five-Year Planning Budget. The Authority will hold at least one hearing to solicit public input on the initial budgets.

LIPA has established an initial Direct Cost Budget. Subsequent annual Direct Cost Budgets will be calculated based upon the initial Direct Cost Budget, subject to adjustments for the "Direct Cost Budget Indices" described in an appendix to the Agreement.

The Agreement provides that the Annual T&D Budget and Five-Year Planning Budget prepared by the Manager and submitted to LIPA for review and approval will be accompanied by any Manager-recommended rate adjustments for the upcoming year at least six months before the beginning of each subsequent Contract Year. The Agreement provides that LIPA will have 60 days to review the proposed Annual T&D Budget and Five-Year Planning Budget and any rate adjustments and to propose modifications as it deems appropriate, so as to have the Annual T&D Budget and the Five-Year Planning Budget adopted at least two months before the beginning of the next Contract Year. All rate proposals will be subject to public hearings prior to approval by LIPA.

*Other Costs.* The Agreement provides that "Other Costs" are those costs which cannot reasonably be anticipated and will include those costs the Manager and LIPA agree are not included in the Direct Cost Budget, Third Party Cost Budget or Major Capital Plan and Budget ("Other Costs"). Other Costs include the Incremental Internal Costs and additional Third Party Costs incurred

by the Manager as a result of events (including but not limited to major storms and extreme weather) that the Manager and LIPA agree have caused costs to be incurred by the Manager to respond to significant (i) damage to or adverse affects on the T&D System, (ii) changes in the level of required maintenance or operation of the T&D System, or (iii) tasks which are necessary for safety reasons.

Although Other Costs will not be budgeted, the Manager will recommend, and LIPA will adopt, an annual reserve level for Other Costs for each Annual T&D Budget and Five-Year Planning Budget to enable estimation of total “System Revenue Requirements,” consisting of the sum of the annual Service Fee, plus an estimate of other costs plus debt service requirements on the Authority’s Revenue Bonds plus the Authority’s costs as reported to the Manager pursuant to the Agreement. The Manager will be reimbursed for reasonably incurred Other Costs.

*Non-Cost Performance Incentives and Disincentives.* In addition to the cost saving incentives discussed above under the heading “Annual T&D Budget and Five Year Planning Budget Process,” the Manager will be eligible for incentives for performance above certain threshold target levels of performance standards (“Non-cost Performance Incentives”) and subject to disincentives for performance below certain other threshold minimum performance standard levels (“Non-cost Performance Disincentives”), with an intermediate band of performance in which neither incentives nor disincentives will apply, for reliability, worker safety, and customer service, all as provided in or established pursuant to the Agreement.

In any Contract Year in no event will the total of the Non-cost Performance Incentives, net of any applicable Non-cost Performance Disincentives, together with the System Power Supply Performance Incentive/Disincentive, be greater than \$7.5 million, nor will the total Non-cost Performance Disincentives, net of any applicable Non-cost Performance Incentives together with the System Power Supply Performance Incentive/Disincentive be greater than \$7.5 million.

*LIPA Non-Performance.* If caused by an event the costs of which LIPA is responsible for as discussed below under the heading “Allocation of Risk of Certain Costs and Liabilities,” there will be an increase in the Manager’s cost of Construction Work or Operation and Maintenance Services, the amount of any such incremental cost increase will be borne by LIPA to the extent it is responsible therefor and will not be considered for purposes of calculating any incentive or disincentive thereunder.

If at any time the T&D System is damaged or destroyed due to an event for which LIPA is responsible, LIPA will pay all Major Capital Improvement Costs and adjustments as are required to be made by LIPA pursuant to applicable provisions of the Agreement.

*Manager Non-Performance.* If due to an event for which the Manager is responsible as discussed below under the heading “Allocation of Risk of Certain Costs and Liabilities,” there will be an increase in the Manager’s cost of Construction Work or Operation and Maintenance Services, or in LIPA’s costs associated with performing obligations under the Agreement, the amount of any such incremental cost increase will be borne by the Manager to the extent it is responsible therefor.

*Annual Settlement.* The Agreement provides that the Manager will deliver to LIPA within 60 days after the end of each Contract Year, an Annual Settlement Statement, setting forth the actual aggregate Service Fee payable with respect to such Contract Year and a reconciliation of such amount with the amounts actually paid by LIPA pursuant to the billing statements. The Annual Settlement Statement will also include an accounting of any incentives or disincentives accrued during the applicable Contract Year which LIPA will have an opportunity to review prior to payment.

During the first quarter of the following Contract Year, the monthly payments made to the Manager by LIPA will be (i) reduced by any overpayment by LIPA or (ii) increased to reflect any Non-Cost Performance Incentive earned by the Manager during the previous year and/or any Overrun Payment due.

*LIPA's Payment Obligations.* The Agreement provides that amounts payable to the Manager under the Agreement will be paid from T&D System revenues and other funds of LIPA available for such purposes in accordance with the terms of the Resolution.

The Agreement contemplates that if any billing disputes cannot be resolved within 30 days, either party may refer such dispute for resolution as discussed below under the heading "Non-Binding Mediation; Arbitration."

*Allocation of Risks of Certain Costs and Liabilities.* The Agreement provides that except to the extent due to Subsidiary Fault (as determined by either a final non-appealable order or judgment of a court of competent jurisdiction (including administrative tribunals) or a final non-appealable binding arbitration decision), the Manager will be responsible and liable to LIPA for, and will not be entitled to reimbursement from LIPA for any Loss-and-Expense incurred by the Manager or LIPA,

(a) due to any gross negligence or willful misconduct by the Manager during the period commencing six months prior to the LIPA/LILCO Merger Closing Date to the extent LILCO knew or should have known of such gross negligence or willful misconduct and during the term of the Agreement in carrying out its obligations thereunder,

(b) due to any violation of or failure of compliance with Applicable Law by the Manager (except as provided below) during the period commencing six months prior to the LIPA/LILCO Merger Closing Date to the extent LILCO knew or should have known of such violation or failure of compliance and during the term of the Agreement which materially and adversely affects

(i) the condition or operations of the T&D System,

(ii) the financial condition of LIPA,

(iii) the performance or ability of the Manager to perform its obligations under the Agreement, or

(iv) the cost of providing electric service to the customers of the T&D System, provided, however, that Manager will not be responsible and liable to LIPA under the provisions of the Agreement described in this clause (b) with respect to any violation of, failure of compliance with, or liability under, Environmental Laws (as defined in the LIPA/LILCO Merger Agreement) for which LIPA or the Manager may be strictly liable provided that Manager (or for actions prior to the LIPA/LILCO Merger Closing Date, LILCO) acted in a manner consistent with Prudent Utility Practice. Notwithstanding the foregoing, Manager will in all events be liable for any fine or penalty arising by reason of any violation of or failure of compliance with Applicable Law for acts or omissions of the Manager not consistent with Prudent Utility Practice,

(c) due to any criminal violation of Applicable Law by the Manager (or for actions prior to the LIPA/LILCO Merger Closing Date, LILCO), or

(d) due to an event which gives rise to a cost not included in the Direct Cost Budget or Third Party Cost Budget or a cost incurred with respect to Major Capital Improvements or Public Works Improvements, that is incurred by reason of actions or omissions of the Manager not consistent with Prudent Utility Practice.

### **Default, Termination For Cause And Dispute Resolution**

*Remedies for Breach.* Subject to the provisions of the Agreement described below under the heading "Non-Binding Mediation; Arbitration," in the event that either party breaches any other obligation under the Agreement or any representation made by either party under the Agreement is untrue in any material respect, the other party will have the right to take any action at law or in equity

it may have to enforce the payment of any damages or the performance of such other obligation under the Agreement and such right to recover damages or to be reimbursed as provided therein will ordinarily constitute an adequate remedy for any breach of such other obligation or any material untruth in any such representation. Either party may enforce by an action for specific performance the other party's obligations under the Agreement in the event a material breach thereof has occurred and is continuing. Neither party will have the right to terminate the Agreement for cause except after an Event of Default determined in accordance with the provisions of the Agreement has occurred.

### **Events of Default by the Manager**

(1) *Events of Default Not Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of the Manager for which LIPA may terminate the Agreement without any requirement of cure opportunity:

(a) *Change of Control.* Change of Control of the Manager, the Parent or the Guarantor; provided, however, that the combination effectuated under the BUG/LILCO Agreement or the LIPA/LILCO Merger Agreement shall not constitute a Change of Control of the Manager for purposes of this provision.

(b) *Worker Safety/Customer Service.* Failure for two out of three consecutive years, for reasons other than major storms or extreme weather, to achieve the "Minimum Worker Safety Standard" or "Minimum Customer Service Standard," as such standards are established in accordance with appendices to the Agreement.

(c) *Bankruptcy.* Certain voluntary or involuntary events relating to bankruptcy affecting the Manager, the Parent or the Guarantor.

(d) *Credit Enhancement.* Failure of the Manager to supply, maintain, renew, extend or replace the credit enhancement required under the Agreement (see "General—Credit Enhancement in Certain Circumstances" below).

(e) *Letter of Credit Draw.* Failure of the Manager to supplement, replace or cause to be reinstated the letter of credit as described in the Agreement (see "General—Credit Enhancement in Certain Circumstances" below) within 30 days following draws equal to, in the aggregate, 50% of the face value thereof.

(2) *Events of Default Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of the Manager for which LIPA may terminate the Agreement upon compliance with the notice and cure provisions set forth below:

(a) *System Reliability.* Failure to achieve, for two out of three consecutive years, the "Minimum Reliability Standard" specified in the Agreement.

(b) *Failure to Pay or Credit.* Failure of the Manager to pay or credit undisputed amounts owed to LIPA under the Agreement within 90 days following the applicable due date.

(c) *Failure to Comply with Agreement or Guaranty.* The failure or refusal of the Manager to perform any material obligation under the Agreement, or the failure of the Guarantor to comply with any of its material obligations under the Guaranty unless such failure or refusal is excused by an Uncontrollable Circumstance or Subsidiary Fault; except that no such failure or refusal in clause (b) or (c) will constitute an Event of Default giving LIPA the right to terminate the Agreement for cause unless LIPA has given prior written notice to the Manager or the Guarantor and the Manager or the Guarantor, as applicable, has neither challenged in an appropriate forum LIPA's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from receipt of the notice (but if the Manager or the Guarantor shall have diligently



taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as the Manager or the Guarantor is continuing to take such steps to correct such default).

*Events of Default by LIPA.* Each of the following shall constitute an Event of Default on the part of LIPA for which the Manager may terminate the Agreement upon compliance with the notice and cure provisions set forth below:

(a) *Failure to Pay.* The failure of LIPA to pay undisputed amounts owed to the Manager under the Agreement within 90 days following the due date for such payment.

(b) *Failure to Comply with Agreement.* The failure or refusal by LIPA to perform any material obligation under the Agreement unless such failure or refusal is excused by an Uncontrollable Circumstance or Manager Fault; except that no such failure or refusal will constitute an Event of Default giving the Manager the right to terminate the Agreement for cause unless the Manager has given prior written notice to LIPA and LIPA has neither challenged in an appropriate forum the Manager's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from the date of the notice (but if LIPA shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as LIPA is continuing to take such steps to correct such default).

(c) *Change of Control of LIPA.* A change of control of LIPA which results in ownership control of LIPA by other than a state public benefit corporation, authority, political subdivision or other instrumentality of the State or any political subdivision thereof.

*Procedure for Termination for Cause.* If any party has a right of termination for cause, the right may be exercised by giving a notice of termination for cause to the party in default at least two years prior to (or, in the case of a bankruptcy or insolvency default or a Change of Control, simultaneously with, or, in the case of an Event of Default as discussed above under the heading "Events of Default by LIPA," six months) the date of termination specified in such notice (the "Termination Date").

### **Non-Binding Mediation; Arbitration**

The Agreement provides that any dispute arising out of or relating to the Agreement will be resolved in accordance with the mediation and arbitration procedures for the resolution of such disputes established by the Agreement, which shall constitute the sole and exclusive procedures for the resolution of such disputes.

Either party may, without prejudice to any negotiation, mediation, or arbitration procedures, proceed in any court to obtain provisional judicial relief if, in such party's sole discretion, such action is necessary to avoid imminent irreparable harm, to provide uninterrupted electrical and other services, or to preserve the status quo pending the conclusion of the dispute procedures specified in the Agreement.

### **Provisional Relief**

*LIPA Emergency Powers.* The Agreement provides that if the Manager, due to Uncontrollable Circumstances or any other reason whatsoever, fails to provide any Operation and Maintenance Services and Construction Work contemplated by the Agreement and LIPA or any Governmental Body finds that such failure endangers or menaces the public health, safety or welfare, then LIPA will have the right, upon notice to the Manager, during the period of such emergency, to take possession of and use any or all of the Operating Assets necessary to transmit and distribute Power and Energy which the Manager would otherwise be obligated to transmit and distribute. The Manager will fully cooperate with LIPA to effect such a temporary transfer of possession of the Operating Assets for LIPA's use of the same.

## **Term**

*Term of Agreement.* The Agreement commenced on June 26, 1997 and will continue in effect until May 28, 2006, unless earlier terminated in accordance with its terms.

*Mandatory Competitive Selection of Future Managers.* LIPA will conduct a competitive procurement for T&D System management services following May 28, 2003. The Manager will have the right or be ineligible to submit a bid in such procurement on the same basis as other bidders unless the Agreement is terminated due to an Event of Default of the Manager. The Manager is obligated to cooperate with LIPA during such procurement process.

## **Miscellaneous Provisions**

*Affiliate.* Pursuant to the Agreement, the Manager has agreed to remain an Affiliate of the Guarantor.

*Credit Enhancement in Certain Circumstances.* The Agreement provides that if the Guarantor's credit rating declines below investment grade, then the Manager shall provide credit enhancement of its obligations under the Agreement in the form of either (i) an unconditional guarantee of all of GENCO's obligations under the Power Supply Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, provided by a corporation or financial institution whose long-term senior debt is or would be rated investment grade, or (ii) an irrevocable letter of credit securing GENCO's obligations under the Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, in a face amount of \$60,000,000 provided by a financial institution whose long-term senior debt is rated investment grade. The amount of such letter of credit shall be reduced by \$30,000,000 if the Energy Management Agreement has theretofore been or is thereafter terminated and by \$4,000,000 if the Power Supply Agreement has theretofore been or is thereafter terminated, such obligation to continue until the expiration or termination of the Agreement, the Power Supply Agreement and the Energy Management Agreement.

*Uncontrollable Circumstances Generally.* Except as otherwise specifically provided in the Agreement, neither LIPA nor the Manager will be liable to the other for any failure or delay in performance of any obligation under the Agreement to the extent due to the occurrence of an Uncontrollable Circumstance.

*Indemnification.* The Agreement provides that the Manager, to the extent permitted by law, will protect, indemnify and hold harmless LIPA and its respective representatives, Trustees, officers, employees and subcontractors (as applicable in the circumstances), (the "LIPA Indemnified Parties") from and against (and pay the full amount of) any Loss-and-Expense and will defend LIPA Indemnified Parties in any suit, including appeals, for personal injury to, or death of, any person, or loss or damage to property arising out of any matter for which the Manager is responsible under the caption "Allocation of Risk of Certain Costs and Liabilities" in the Agreement and LIPA, to the extent permitted by law, will protect, indemnify and hold harmless the Manager Indemnified Parties from and against (and pay the full amount of) any Loss-and-Expense, and will defend the Manager Indemnified Parties in any suit, including appeals, for personal injury to, or death of, any person, or loss or damage to property arising out of any matter for which LIPA is responsible under the caption "Allocation of Risk of Certain Costs and Liabilities" in the Agreement. The foregoing indemnifications are subject to certain exceptions, including the negligence or other wrongful conduct of any indemnified party and any Uncontrollable Circumstance.

*Assignment and Transfer.* The Agreement may be assigned by either party only with the prior written consent of the other party, except that without the consent of the other party (1) LIPA may make such assignments, create such security interests in its rights thereunder and pledge such monies

receivable thereunder as may be required in connection with issuance of Revenue Bonds; (2) LIPA may assign its rights, obligations and interests thereunder, or transfer such rights and obligations by operation of law, to any other governmental entity or to a subsidiary of LIPA provided that the successor entity gives reasonable assurances to the Manager that it will be able to fulfill LIPA's obligations thereunder; and (3) the Manager may assign its rights, obligations and interests thereunder to the Parent or any Affiliate thereof except that the Manager may not, without the consent of LIPA, make any assignment or other transfer to any person of its rights and obligations under the Agreement unless the Guaranty is and remains in full force and effect and unless the Guarantor or a majority-owned direct or indirect subsidiary of the Guarantor will have control of and responsibility for the Operation and Maintenance Services and any Construction Work. The Authority may assign its rights, obligations and interests under the Agreement to LILCO (then a wholly-owned subsidiary of the Authority) and the Manager shall assign all of its rights, obligations and interests under the Agreement to the Parent or any Affiliate thereof.

## Appendix B

### SUMMARY OF CERTAIN PROVISIONS OF THE POWER SUPPLY AGREEMENT

The following is a brief summary of certain provisions of the Power Supply Agreement. The summary does not purport to be complete or definitive and is qualified in its entirety by reference to the Power Supply Agreement, a copy of which is on file with the Trustee.

#### General

The Power Supply Agreement sets forth the terms and conditions for the sale and delivery of electric capacity and energy by BL Holding Corp. and its subsidiaries (“GENCO”) to LIPA.

#### Power Supply

*Delivery of Power.* The Agreement provides that during the term of the Agreement GENCO shall sell and deliver to LIPA, and LIPA shall purchase and accept delivery from GENCO of, (i) all the capacity from the GENCO Generating Facilities, and (ii) all the energy that GENCO produces from the GENCO Generating Facilities, in accordance with the Agreement, that LIPA requests to meet the electricity requirements of its retail and wholesale electricity customers (regardless of whether located inside or outside the Service Area). The Agreement also provides that GENCO will provide the various Ancillary Services as required by LIPA, and LIPA shall pay for any associated costs not otherwise compensated by LIPA.

*Sale or Assignment of Generating Units.* The Agreement provides that GENCO shall not sell or otherwise assign any interest in any of its generating units (as set forth in an appendix to the Agreement) except for (i) liens securing bona fide debt or other encumbrances incurred in the ordinary course of business, (ii) capital leases, or (iii) sales or assignments made with LIPA’s prior written consent, which consent shall be deemed to have been given in respect of certain easements specified in the Agreement.

*Transmission Requirements.* The Agreement provides that LIPA is responsible for all transmission reinforcements required in conformance with Prudent Utility Practice for any new generation, including any new interconnections and other T&D System requirements regardless of their location, sufficient to maintain the delivery of electricity from the GENCO Generating Facilities onto the T&D System. The additional costs charged to GENCO for such transmission reinforcements will not be greater than if such costs were allocated to all of the LIPA Electricity Customers and transmission service customers on an average system basis.

#### Purchase Price and Payment

The Agreement provides that during the term of the Agreement LIPA will pay to GENCO monthly an amount equal to the aggregate of the following components:

- (i) a capacity charge to compensate GENCO for its fixed costs of generating electricity from the GENCO Generating Facilities,
- (ii) a variable charge based on the variable operation and maintenance costs as established by the Agreement, multiplied by the actual MWh of operation of the GENCO Generating Facilities,
- (iii) a charge for any costs incurred by GENCO in providing certain Ancillary Services to LIPA, if any such services are required by LIPA which are not otherwise compensated by the charges described in items (i) and (ii) above,
- (iv) a charge for non-variable related expenses net of insurance proceeds, that cannot be planned for with any certainty and are outside the control of GENCO, and

(v) certain other miscellaneous charges as specified in the Agreement.

## **Budgets**

Pursuant to the Agreement, GENCO and LIPA have agreed to an initial five-year plan which provides details on the fixed and variable costs of operating the GENCO Generating Facilities. The budget establishes the monthly capacity charge and the monthly variable charge for the first year of the five-year period, which forms the basis for adjustment for subsequent years in such period in accordance with the terms of the Agreement.

The Agreement provides that prior to the commencement of each successive five-year period during the term of the Agreement, GENCO shall prepare and submit to LIPA for review and approval a proposed five-year budget plan. If GENCO and LIPA are unable to reach agreement concerning the budget plan, those portions that are in dispute shall be resolved in a proceeding before the FERC.

The Agreement also provides that GENCO shall annually prepare and submit to LIPA a rolling Five Year Capital Improvement Budget for incremental capital expenditures and associated rate adjustments for LIPA's review and approval.

## **Capacity Ramp Down Option**

The Agreement provides that, commencing in the seventh year of the Agreement, LIPA may determine to reduce the amount of capacity purchased from GENCO. In any such an event, LIPA shall immediately reimburse GENCO for the capacity charges in the amount set forth in the Agreement that would have been recovered from LIPA over the remaining portion of the original term of the Agreement. The Agreement provides that such reduction may not be greater than 1500 MW.

## **Term and Termination**

*Term.* The Agreement commenced on May 28, 1998 for an initial term of fifteen (15) years. The Agreement provides that it shall terminate upon the purchase of the GENCO Generating Facilities by LIPA as provided for under the Generation Purchase Right Agreement attached to the LIPA/LILCO Merger Agreement.

*Termination for Cause by GENCO.* The Agreement provides that GENCO shall have the right to terminate the Agreement for cause if one of the following events shall have occurred:

(1) *Failure to Pay.* The failure of LIPA to pay undisputed amounts owed to GENCO under the Agreement within 90 days of such amounts having become due.

(2) *Failure to Comply with Agreement.* The failure or refusal by LIPA substantially to perform any material obligation under the Agreement unless such failure or refusal is excused by force majeure (as defined in the Agreement), except that the Agreement further provides that no such failure or refusal to pay or perform as referenced in these clauses (1) and (2) shall constitute an Event of Default giving GENCO the right to terminate the Agreement for cause unless GENCO has given prior written notice to LIPA stating that a specified failure or refusal to perform exists and LIPA has neither challenged in an appropriate forum GENCO's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from the date of the notice (but if LIPA shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as LIPA is continuing to take such steps to correct such default).

*Termination For Cause by LIPA.* The Agreement provides that LIPA shall have the right to terminate the Agreement for cause after one of the following Events of Default as determined in accordance with the provisions of the Agreement shall have occurred:

(1) *Events of Default Not Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of GENCO for which LIPA may terminate the Agreement without any requirement of cure opportunity:

(a) *Change of Control of GENCO.* Change of Control of GENCO or the Guarantor has occurred; provided, however, that the combination effectuated under the LIPA/LILCO Merger Agreement shall not constitute a Change of Control of GENCO for purposes of this provision.

(b) *Bankruptcy.* Certain voluntary or involuntary events relating to bankruptcy affecting GENCO or the Guarantor.

(c) *Credit Enhancement.* Failure of GENCO to supply, maintain, renew, extend or replace the credit enhancement required under the Agreement (see below, "Credit Enhancement in Certain Circumstances" below).

(d) *Letter of Credit Draw.* Failure of GENCO to supplement, replace or cause to be reinstated the letter of credit as described in the Agreement (see "Credit Enhancement in Certain Circumstances" below) within 30 days following draws equal to, in the aggregate, 50% of the face value thereof.

(2) *Events of Default Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of GENCO for which LIPA may terminate the Agreement upon compliance with the notice and cure provisions of the Agreement described below:

(a) *Failure to Comply with Agreement.* The failure or refusal by GENCO to substantially perform any material obligation under the Agreement, except that no such failure or refusal shall constitute an Event of Default giving LIPA the right to terminate the Agreement for cause unless LIPA has given prior written notice to GENCO or the Guarantor, as applicable, stating that a specified failure or refusal to perform exists and GENCO or the Guarantor, as applicable, has neither challenged in an appropriate forum LIPA's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from receipt of the notice (but if GENCO or the Guarantor shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as GENCO or the Guarantor is continuing to take such steps to correct such default).

*Procedure for Termination for Cause.* If either GENCO or LIPA shall have a right of termination for cause in accordance with the provisions of the Agreement outlined above, the same may be exercised by notice of termination given to the party in default at least two years prior to (or, in the case of a bankruptcy or insolvency default or a Change of Control, simultaneously with or, in the case of an event of default described in clauses (1)(c) or (1)(d) above, six months) the date of termination specified in such notice.

### **Non-binding Mediation; Arbitration**

The Agreement provides that any dispute arising out of or relating to the Agreement shall be resolved in accordance with the mediation and arbitration procedures for the resolution of such disputes established by the Agreement which shall constitute the sole and exclusive procedures for the resolution of such disputes.

**Affiliate**

Pursuant to the Agreement, GENCO has agreed to remain an Affiliate of the Guarantor.

**Credit Enhancement in Certain Circumstances**

The Agreement provides that if the Guarantor's credit rating declines below investment grade, then GENCO shall provide credit enhancement of its obligations under the Agreement at its sole cost and expense in the form of either (i) an unconditional guarantee of all of GENCO's obligations under the Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, provided by a corporation or financial institution whose long-term senior debt is or would be rated investment grade, or (ii) an irrevocable letter of credit securing GENCO's obligations under the Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, in a face amount of \$60,000,000 provided by a financial institution whose long-term senior debt is rated investment grade.

**Allocation of Risk of Certain Costs and Liabilities**

The Agreement contains provisions relating to the allocation of risks and liabilities that are substantially the same as the provisions of the Management Services Agreement described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Compensation and Budgets—Allocation of Risks of Certain Costs and Liabilities."

## Appendix C

### SUMMARY OF CERTAIN PROVISIONS OF THE ENERGY MANAGEMENT AGREEMENT

The following is a brief summary of the Energy Management Agreement. The summary does not purport to be complete or definitive and is qualified in its entirety by reference to the Energy Management Agreement, a copy of which is on file with the Trustee.

#### **General**

The Energy Management Agreement establishes the terms and conditions for the management by the KeySpan subsidiary party thereto (the “Energy Manager”) of fuel supplies used at the GENCO Generating Facilities to produce electric energy for delivery to LIPA, and for management and administration of the System Power Supply on behalf of LIPA in a manner consistent with policies established by LIPA.

#### **Scope of Energy Management Services**

As described in the Agreement, the Energy Manager is responsible for (a) fuel procurement, delivery, storage, and management for GENCO Generating Facilities to meet the energy generation requirements of the Electricity Customers, (b) the dispatch of all System Power Supply available to LIPA to meet total capacity and energy requirements of the Electricity Customers and Off-System Sales, (c) the purchase, on behalf of LIPA, of all capacity and energy to meet the needs of the Electricity Customers and (d) the sale, on behalf of LIPA, of Electricity owned by, or under contract to, LIPA which is not otherwise required to meet the needs of the Electricity Customers. The Agreement provides that all such responsibilities will be discharged in a manner consistent with Prudent Utility Practice, the System Policies and Procedures and New York State Public Service Commission policies and procedures pertaining to retail gas customer service. In discharging all such functions, the Energy Manager is obligated to use best efforts to obtain the least-cost fuel and least-cost capacity and energy for the benefit of the Electricity Customers.

The Energy Manager agrees to establish policies and procedures satisfactory to LIPA designed to assure that the Energy Manager’s responsibilities are performed without consideration of the ownership or economic return to the Energy Manager or its Affiliates, except for the incentive provisions of the Agreement (described below at “Fuel Management—Fuel Management Compensation—Fuel Purchase Performance Incentives/Disincentive Payments”), and comply with such policies and procedures.

The Agreement provides that in no event will the Energy Manager take title to Electricity being purchased or sold thereunder.

#### **Fuel Management**

*Fuel Management Services.* The Agreement provides that the Energy Manager will manage all aspects of the Fuel supply for the GENCO Generating Facilities, including determinations regarding the type of Fuel used for operating the GENCO Generating Facilities and the source of such Fuel supply taking into account the purchase of alternate sources of Electricity in lieu of Electricity from the GENCO Generating Facilities when economic. LIPA agrees to compensate the Energy Manager for such Fuel management services, including a Fuel Purchase Performance Incentive/ Disincentive Payment, in accordance with the terms of the Agreement (see “Fuel Management—Fuel Purchase Performance Incentives/Disincentive Payments” below). The Energy Manager will not contract for additional firm assets specifically for use in the GENCO Generating Facilities unless LIPA and the Energy Manager agree to the contract.



*Fuel Management Compensation.* During the term of the Agreement, LIPA will make monthly payments to the Energy Manager consisting of an amount equal to the sum of: (i) the Monthly Fuel Management Fee, plus (ii) the Monthly Fuel Payment, plus or minus (iii) the Fuel Purchase Performance Incentive/Disincentive.

*Fuel Management Fee.* The Energy Manager will be paid an annual Fuel Management Fee in consideration for the Energy Manager's performance of the Fuel Services contemplated in the Agreement. The Agreement provides that the cost-related component of the initial Fuel Management Fee, once established and approved by LIPA, will be indexed in the same manner as the Direct Cost Budget under the Management Services Agreement until the termination of the Management Services Agreement and thereafter will be subject to mutually agreeable adjustments. LIPA is obligated to pay the Fuel Management Fee to the Energy Manager in twelve equal monthly installments.

*Monthly Fuel Payment.* LIPA will, in accordance with the provisions discussed below at "Fuel Management—Payment," pay the total monthly cost of all Fuel for use in the GENCO Generating Facilities that are under contract to LIPA pursuant to the Power Supply Agreement, including but not limited to any current or future fuel related taxes or other fuel related fees or costs reasonably incurred by the Energy Manager. This cost will be based upon (a) the actual variable cost of gas delivered to the delivery points for such fuel plus (i) any incremental Firm Gas Supply costs which are incurred based on use of Firm Gas Supplies in the operation of the GENCO Generating Facilities, (ii) any costs the Energy Manager incurs based on non-use of gas it has otherwise contracted to purchase for use in the operation of the GENCO Generating Facilities, and (iii) the Local Transportation Charge and (b) the delivered cost of oil for use in GENCO's Generating Facilities.

*Fuel Purchase Performance Incentives/Disincentive Payments.* The Energy Manager will receive a Fuel Purchase Performance Incentive/Disincentive Payment, which will be calculated at the end of each month, with the results reflected in the following month's invoice. The total Fuel Purchase Performance Incentive/Disincentive Payment will not exceed \$5.0 million on an annual basis.

*Payment.* The Energy Manager will submit monthly invoices to LIPA for the Monthly Fuel Management Fee and the Fuel Purchase Performance Incentive/Disincentive Payment by the tenth (10th) Business Day following the month of service, consistent with the provisions in this description of "Fuel Management." Payment of all invoiced amounts will be due and payable by LIPA within fifteen (15) Business Days of LIPA receiving such invoices.

*Minimization of Costs.* In providing the Fuel, Energy Manager shall use best efforts to minimize Fuel costs for the GENCO Generating Facilities, such efforts being consistent with (i) all applicable insurance policies, (ii) all applicable prudent industry practices and standards, including Prudent Utility Practice, (iii) all applicable operating and contract constraints for Fuel delivery, (iv) Energy Manager's collective bargaining agreements and (v) Applicable Law.

## **Off-System Sales**

The Agreement provides that the Energy Manager will use best efforts to market to Off-System Sales customers, on LIPA's behalf, Electricity from the System Power Supply that is not otherwise needed by the Electricity Customers in a manner which will reduce the net cost of Electricity provided to the Electricity Customers. The Energy Manager will receive 33 percent of the revenue net of incremental costs from Off-System Sales of Electricity from the System Power Supply and LIPA will receive 67 percent of the revenue net of incremental costs from these Off-System Sales of Electricity from the System Power Supply. The incremental costs for such Off-System Sales will be based upon the incremental cost of energy for such Electricity sales including any other costs or charges (including applicable taxes) incurred to produce and deliver the Electricity and/or Ancillary Services for sale by the Energy Manager. The incremental costs associated with capacity sales will

include the cost of replacement capacity incurred as a result of the sale, if any, and any other costs or charges related to the sale, including startup, no-load operation, transmission, and applicable taxes.

Notwithstanding any of the above, the Energy Manager will only attempt to sell excess Electricity to the extent that, in GENCO's judgment, such Electricity sales do not jeopardize any of GENCO's tax-exempt debt and to the extent that, in LIPA's judgment, such Electricity sales do not jeopardize the tax-exempt status of any of the Authority's debt. Each party will furnish the other an appropriately detailed description of the constraints imposed on such sales and will update such description from time to time to reflect any applicable changes in law or regulation.

### **System Power Supply Management**

*Lowest Cost Electricity.* In connection with the purchase and management of the System Power Supply, on LIPA's behalf, the Energy Manager is obligated to use best efforts to provide the lowest cost Electricity to the T&D System and the Electricity Customers, given (i) the transmission and distribution limitations unique and/or external to the T&D System; (ii) the terms of the Existing Power Supply Agreements; (iii) availability of power through the New York Power Pool or its successor; (iv) regulatory and reliability council requirements, including, but not limited to system safety and reliability; and (v) System Policies and Procedures, including environmental policies contained therein.

*Specific Energy Manager Responsibilities.* In implementing its System Power Supply responsibilities, the Energy Manager will, subject to the transmission, contractual and reliability constraints referred to in the preceding paragraph:

- (i) schedule deliveries of and Dispatch energy from the System Power Supply;
- (ii) arrange for LIPA's purchase of Electricity to the extent the System Power Supply is insufficient to meet the requirements of the T&D System;
- (iii) continually monitor the market for LIPA's sale and purchase of wholesale Electricity and purchase Electricity, on LIPA's behalf, on the wholesale market to displace System Power Supply if such purchases, including the cost of transmission services to deliver such Electricity, will reduce total power supply costs;
- (iv) sell Electricity on LIPA's behalf from the System Power Supply that is surplus to the requirements of the T&D System whenever such sales, including consideration of any incremental cost of Transmission for delivery of such sales, are advantageous to LIPA;
- (v) arrange for such additional transmission services and capacity as will be necessary for the purchase or sale of Electricity by LIPA; and
- (vi) with the prior written consent of LIPA, subcontract with power marketers or brokers, or similar entities, to assist in the acquisition of Electricity and the marketing and sale of excess Electricity.

All contracts for the purchase or sale of Electricity will be entered into by LIPA or by the Energy Manager as agent for LIPA. The Agreement provides that no contract for the purchase or sale of Electricity for a term in excess of three months will be entered into without the prior written consent of LIPA.

*System Power Supply Management Compensation.* Except as otherwise provided in the Agreement, the payments LIPA will make to the Energy Manager pursuant to the Agreement with respect to System Power Supply Services other than Off-System Sales will be calculated as set forth in the Agreement and as summarized below. During the term of the Agreement, LIPA will make monthly payments to the Energy Manager consisting of an amount equal to the sum of: (i) the System

Power Supply Management Fee, plus or minus (ii) the System Power Supply Performance Incentive/Disincentive.

*System Power Supply Management Fee.* The Energy Manager will be paid an annual System Power Supply Management Fee, in consideration for the Energy Manager's performance of the System Power Supply management services contemplated in the Agreement. The amount of such System Power Supply Management Fee includes a fee of \$750,000 and an allowance for certain costs which, for 1998, has been established at \$868,000. Such allowance for costs will be indexed during the term of the Agreement in the same manner as the Direct Cost Budget under the Management Services Agreement. LIPA will pay the System Power Supply Management Fee to the Energy Manager in twelve equal monthly installments.

*System Power Supply Performance Incentives/Disincentive.* The Energy Manager will receive a System Power Supply Performance Incentive/Disincentive, calculated in accordance with the Agreement which will not exceed \$2 million on an annual basis.

*Payment.* The Energy Manager will submit monthly invoices to LIPA for the Monthly System Power Supply Management Fee and the System Power Supply Performance Incentive/Disincentive Payments and Off-System Sales compensation by the tenth (10th) Business Day following the month of service. Such invoices will show separately amounts payable with respect to Off System Sales and System Power Supply Management. Payment of all invoiced amounts will be due and payable by LIPA within fifteen (15) Business Days of LIPA receiving such invoices.

## **Records; Information**

### **Account Records; Collection of Monies; Availability of Energy Manager**

*Account Records.* The Energy Manager is obligated to maintain such records as LIPA reasonably requests setting forth in accurate and reasonable detail the information relating to the purchase and sale of Fuel and Electricity under the Agreement requested by LIPA.

*Collection of Monies.* The Energy Manager will use best efforts to collect on a timely basis (1) all amounts due LIPA for Off-System Sales, and (2) any other monies owed to LIPA in connection with System Power Supply and other matters within the purview of the Energy Manager. The Energy Manager will provide current and historical billing information concerning Fuel and System Power Supply to LIPA monthly in such form as reasonably requested by LIPA. All such monies collected by the Energy Manager or any Subcontractor thereto will be the property of LIPA and will be deposited by the Energy Manager daily into such accounts and in the manner as LIPA may from time to time designate. The Energy Manager is unconditionally and absolutely obligated to pay or deposit such moneys as directed by LIPA.

*Compliance with Applicable Law.* The Energy Manager is obligated to perform all of its obligations under the Agreement in accordance with Applicable Law.

*Information.* The Agreement requires the Energy Manager to establish and maintain an information system to provide storage and real time retrieval for LIPA review and copying of operating data relating to (i) cost and quantities of Fuel Supply and Power Purchases, (ii) revenues from and quantities of Off-System Sales and (iii) the performance by the Energy Manager of its obligations under the Agreement, including, but not limited to, all information necessary to verify calculations made pursuant to the Agreement.

*Books and Records.* The Energy Manager will prepare and maintain proper, accurate and complete books, records and accounts regarding Fuel and System Power Supply to the extent necessary (1) to enable LIPA to prepare LIPA's financial statements in accordance with generally accepted accounting principles, (2) to verify data with respect to any operations or transactions in which LIPA has a financial or other material interest under the Agreement, (3) to prepare periodic

performance reports and statements relating to purchase of Fuel and System Power Supply, which will be submitted by the Energy Manager to LIPA and (4) to enable LIPA to administer any fuel adjustment clause or similar provision applicable to Electricity sales. The Energy Manager will, upon notice and demand from LIPA, produce for examination and copying by representatives of LIPA, any documents showing all acts and transactions relating to the Agreement, any Subcontract or any transactions in which LIPA has or may have a financial or other material interest under the Agreement, and will produce such operation books and records for examination and copying in connection with the costs for which LIPA may be responsible under the Agreement.

### **Fiscal Affairs, Accounting and Record Keeping**

*General.* The Energy Manager will maintain possession of equipment, materials and supplies, maps, plans and specifications, and Fuel and System Power Supply billing records during the term of the Agreement and will duly account to LIPA for such items.

*Bank Deposits.* All cash held by the Energy Manager for the account of LIPA and all cash collected by the Energy Manager for the account of LIPA after the LIPA/LILCO Merger Closing Date will be deposited on each Business Day in bank accounts in such bank or banks as LIPA may direct and upon such terms and conditions as may be specified by LIPA.

*Bill Payments.* The Energy Manager will timely pay all bills related to Fuel which are proper and appropriate and which it has authority to pay and will assure that, to the extent within the Energy Manager's control, no liens are filed against any portion of the assets or revenues of LIPA.

### **Allocation of Risk of Certain Costs and Liabilities**

The Agreement contains provisions relating to the allocation of risks and liabilities that are substantially the same as the provisions of the Management Services Agreement described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Compensation and Budgets—Allocation of Risks of Certain Costs and Liabilities."

### **Term; Events of Default**

*Term.* The term of the Agreement commenced on May 28, 1998 and, except as otherwise provided, will remain in full force and effect for an initial term of (i) fifteen (15) years from such date with respect to the Fuel Services and (ii) eight (8) years from such date with respect to System Power Supply Services.

### **Events of Default; Procedures for Termination**

The Agreement contains provisions relating to Events of Default by the Energy Manager or LIPA and the procedures for termination that are substantially the same as the provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Compensation and Budget—Events of Default by the Manager—Events of Default by LIPA" and "—Procedure for Termination for Cause."

*LIPA Emergency Assumption of Fuel and System Power Supply Management Services.* Should the Energy Manager, due to Uncontrollable Circumstances or any other reason whatsoever, fail, refuse or be unable to provide any or all Fuel and System Power Supply Services contemplated hereby and LIPA or any Governmental Body finds that such failure endangers or menaces the public health, safety or welfare, then, in any of those events and to the extent of such failure, LIPA will have the right, upon notice to the Energy Manager, during the period of such emergency, to perform the services which the Energy Manager would otherwise be obligated to perform under the Agreement. The Energy Manager agrees that in such event it will fully cooperate with LIPA to effect such a temporary assumption. The Energy Manager agrees that, in such event, LIPA may take and use any or all of the operating assets of the Energy Manager necessary for the above-mentioned purposes

without paying the Energy Manager or any other person any additional charges or compensation whatsoever for such possession and use; provided, however, that if such emergency is due to Uncontrollable Circumstances, LIPA will reimburse the Energy Manager for its Cost-Substantiated costs incurred due to such a transfer of the operating assets.

### **Energy Manager's Reporting Requirements**

*Monthly Reports.* The Energy Manager is obligated to provide LIPA and the Consulting Engineer with monthly reports no later than 20 days after the end of each month, including such data relating to the Fuel Services and System Power Supply Services as may reasonably be requested to be furnished by LIPA.

*Annual Reports.* The Energy Manager will furnish LIPA and, the Consulting Engineer, within 60 days after the end of each Contract Year, an Annual Settlement Statement together with annual summary of the statistical data provided in the monthly reports, certified by the Energy Manager, as well as such other data relating to the services provided under the Agreement as may be reasonably requested to be furnished by LIPA.

*Fuel Consumption Reports.* Fifteen (15) Business Days following the end of each month, Energy Manager is obligated to submit to LIPA a report summarizing the Fuel burned during that month and such other information as the parties may mutually agree.

### **Indemnification**

The Agreement contains redemnification provisions that are substantially the same as the indemnification provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Miscellaneous Provisions—Indemnification."

### **Miscellaneous Provisions**

*Insurance.* The Agreement provides that Energy Manager shall maintain with financially responsible insurance companies insurance in such amounts and against such risks and losses as are customary for companies engaged in the business of providing services or undertaking activities similar to the Fuel Services and System Power Supply Services to be provided thereunder.

*Assignment and Transfer.* Agreement contains provisions relating to assignment and transfer that are substantially the same as the assignment and transfer provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Miscellaneous Provisions—Assignment and Transfer."

*Non-Binding Mediation; Arbitration.* The Agreement contains provisions relating to mediation and arbitration that are substantially the same as the mediation and arbitration provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Compensation and Budget—Non-Binding Mediation; Arbitration."

*Affiliate.* Pursuant to the Agreement, the Energy Manager has agreed to remain an Affiliate of the Guarantor.

*Credit Enhancement in Certain Circumstances.* The Agreement contains provisions relating to credit enhancement that are substantially the same as the credit enhancement provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Miscellaneous Provisions—Credit Enhancement in Certain Circumstances."

*Hedging Policies.* The Energy Manager agreed not engage in any hedging activities relating to the Fuel Services or System Power Supply Services without express approval from the Boards of Directors of the Energy Manager and its Parent and without notifying and consulting with LIPA at least 60 days prior to implementing such activities. The Agreement provides that in the event that approval for the use of hedging activities is implemented, the incentive/disincentive program will be reexamined by the parties to determine the appropriateness of the inclusion or exclusion of the related costs, gain or losses and appropriate mutually agreeable revisions thereto will be made.