

**MANAGEMENT'S DISCUSSION AND ANALYSIS  
OF THE CONSOLIDATED RESULTS OF OPERATIONS  
FOR THE SIX MONTHS ENDED JUNE 30, 2004**

*Consolidated Results of Operations*

The accompanying consolidated financial information reflects the operating results of the Authority and LIPA for the six months ended June 30, 2004 and 2003.

*Change in Net assets (deficit)*

For the six months ended June 30, 2004, the Authority generated a net deficit of approximately \$78 million compared with a net deficit of approximately \$86 million for the six months ended June 30, 2003. The variation of \$8 million resulted primarily from increased revenue and lower operating expenses partially offset by higher fuel and purchased power costs (as discussed below) and higher interest charges.

*Revenue*

Revenue for the six months ended June 30, 2004, increased approximately \$100 million when compared to the similar period in 2003. The increase is primarily attributable to system load growth totaling approximately \$23 million, higher recoveries of excess fuel costs totaling approximately \$66 million, the effects of weather totaling approximately \$13 million, and lower non-system revenue of \$2 million.

*Fuel and Purchased Power Costs*

Fuel and purchased power costs increased approximately \$79 million. This increase is due in part to higher excess fuel cost recoveries of approximately \$66 million, higher sales volumes of approximately \$10 million and higher currently recognized excess fuel costs totaling approximately \$9 million. These increase were partially offset by approximately \$6 million, due to the impact of the FPPCA modification whereby 2004 market-to-market unrealized gains or losses are deferred. In 2003, such unrealized amounts were included in net income.

LIPA's tariff includes a fuel recovery provision—the Fuel and Purchased Power Cost Adjustment (“FPPCA”). During 2003, the FPPCA was modified to allow LIPA to recover from customers amounts incurred for fuel and purchased power beyond those included in base rates (“Excess Fuel Costs”) in the period incurred, as opposed to a deferral method. This modification was fully implemented on January 1, 2004. From that date forward, LIPA will recover an amount of Excess Fuel Costs necessary to achieve revenue in excess of expenses of \$20 million annually.

Effective with the Board's adoption of the 2004 budget in mid-February, the FPPCA surcharge was increased by an annual rate of 4.5% and, as a result of the continuing increases in fuel and purchased power costs, the Authority increased the surcharge by an additional annual rate of 5.0% effective June 8, 2004. These increases were necessary to comply with the modified FPPCA mechanism to ensure the \$20 million of excess revenue over expenses by year-end. Due to the mid-February start date of the increased surcharge and the seasonal nature of LIPA's sales, Excess Fuel Costs incurred through June 7 have been temporarily deferred. These deferrals will be completely recovered by year-end as the surcharge factor incorporates such recovery.

During the six months ended June 30, 2004, approximately \$129 million of Excess Fuel Costs have been billed to customers through the FPPCA, and approximately \$58 million remains deferred for collection over the remainder of the year. Of the remaining excess fuel costs, LIPA applied \$36 million of previously deferred credits (amounts owed to customers) to mitigate the potential of future surcharges.

During the six months ended June 30, 2003, approximately \$22 million of Excess Fuel Costs had been billed to customers through the FPPCA, and approximately \$160 million was deferred for collection over the 10-year period to begin January 1, 2004

After eliminating the effects of the FPPCA and unrealized gains/losses, fuel and purchased power costs in 2004 increased by approximately \$63 million when compared to the six months period ended June 30, 2004. Approximately \$10 million is attributable to increased sales for the 2004 period compared to 2003, and the balance is attributable to increased fuel and purchased power prices.

#### Operations and maintenance ("O&M")

O&M increased approximately \$16 million for the six month period June 30, 2004, compared to the similar period in 2003 due primarily to increased MSA costs totaling approximately \$16 million, due to the timing of capital work being performed under the agreement. Also contributing to the increase is higher customer accounts expenses of approximately \$2 million, increased PSA costs totaling \$5 million, \$2 million related to the settlement of the Cross Sound Cable dispute, increased costs associated with renting temporary emergency stand-by generators totaling approximately \$2 million (due primarily to timing of rental period) and increased NMP2 costs totaling approximately \$2 million as a result of the refueling outage. Partially offsetting this increase was the one-time recognition, in 2003, of LIPA's \$5 million contribution to the Shoreham bill credits as required by the Shoreham Settlement Agreement (LIPA had no such funding in 2004), lower clean energy expenses totaling approximately \$6 million, and lower storm cost accruals totaling approximately \$2 million.

#### General and Administrative ("G&A")

General and administrative expenses decreased approximately \$3 million due primarily to the timing of costs incurred for professional services.

#### Depreciation and amortization

Depreciation and amortization decreased approximately \$2 million. During 2003, an adjustment totaling approximately \$6 million was recognized in conjunction with the adoption of the accounting for asset retirement obligations. Partially offsetting that decrease of \$6 million is higher utility plant balances in 2004 when compared to 2003 resulting in approximately \$4 million higher depreciation expense.

#### Other Income

Other income remained consistent with the prior year as investment income decreased approximately \$3 million due to lower investment balances in 2004 when compared to 2003, offset by increased other income primarily due to interest received on New York Independent System Operator (NYISO) prior months re-bills that resulted in LIPA's favor.

Interest Charges and Credits

Interest charges on long term debt increased slightly when compared to 2003 as a result of the unwinding of the variable rate swap on Series L debt, the issuance of Series 2003C bonds partially offset by savings resulting from 2003 refinancings.

Allowance for borrowed funds used during construction decreased approximately \$1 million due to lower construction work in process balances in 2004 compared to 2003.

Other Significant Items

During the six month period ended June 30, 2004:

- the Authority issued \$100 million of commercial paper to reimburse the Authority's treasury for capital projects that had been funded with cash from operations. As a result of this issuance, total commercial paper outstanding is \$200 million;
- The Authority entered into a basis swap with three counterparties for a notional amount of approximately \$1 billion the terms of which require LIPA to pay the counter parties the Bond Market Association (BMA) Index, and receive a fixed percent of LIBOR. This agreement became effective July 1, 2004, and will continue through August 15, 2033. Under the terms of the agreement, LIPA received on June 28, 2004, an up front premium of \$35 million, which will be amortized as a reduction to interest expense over the life of the agreement;
- The Authority entered into two fixed-to-floating rate swap agreements, each with a notional amount of approximately \$101 million. Under the terms of these identical agreements, LIPA will pay a floating rate equal to the BMA index, and receive a fixed rate of interest. The agreements became effective July 1, 2004, and are co-terminus with the underlying securities, the last of which matures September 1, 2016. These agreements are cancelable by the counterparties on July 1, 2007;
- an agreement (the "Settlement Agreement") was reached between the Authority, the Connecticut Department of Environmental Protection ("CTDEP"), the Connecticut Department of Public Utility Control, the Connecticut Light and Power Company ("CLP") and Cross Sound Cable LLC ("CSC LLC") that provided for the immediate energization and regular, full-time commercial operation of the cross sound cable while CSC LLC seeks to come in to compliance with the CTDEP permits. The Settlement Agreement also calls for the Authority and CLP to work on a plan to replace the existing Norwalk-to-Norhport cable. In addition, the Settlement Agreement requires that the Authority, CLP and CSC LLC each contribute \$2 million to a fund for the study and preservation of the Long Island Sound. As a result of this Settlement Agreement, LIPA will be obligated to make monthly payments for the use of the cable to CSC LLC at rates which are currently being negotiated.
- The Authority began marketing its \$200 million Electric System General Revenue Bonds, Series2004A. The purpose of these bonds is to reimburse LIPA's treasury for

capital projects funded previously with cash from operations, and to provide funding for future capital spending. These bonds will be fixed rate serial and term bonds.

**Consolidated Statement of Revenues, Expenses and  
Changes in Net Assets (Deficit)  
(Thousands of Dollars)**

	<b>Six Months Ended June 30,</b>	
	<b>2004 (unaudited)</b>	<b>2003 (unaudited)</b>
<b>Operating revenues - electric sales</b>	\$ 1,230,622	\$ 1,130,407
<b>Operating expenses:</b>		
Operations - fuel and purchased power		
Fuel and purchased power costs	616,431	597,126
Recovery of Prior Year Excess Fuel Costs	17,768	59,981
Fuel and purchased power expenses - deferral, net	<u>(58,046)</u>	<u>(160,230)</u>
	576,153	496,877
Operations and maintenance	366,382	350,224
General and administrative	17,336	20,907
Depreciation and amortization	114,285	116,288
Payments in lieu of taxes	<u>101,394</u>	<u>101,819</u>
<b>Total Operating Expenses</b>	<u>1,175,550</u>	<u>1,086,115</u>
<b>Operating Income</b>	<u>55,072</u>	<u>44,292</u>
<b>Nonoperating revenues and expenses:</b>		
<b>Other income, net</b>		
Investment income	3,228	6,205
Carrying charges on regulatory asset	15,601	15,061
Other	<u>7,344</u>	<u>4,802</u>
<b>Total other income, net</b>	<u>26,173</u>	<u>26,068</u>
<b>Change in net assets before interest charges and (credits)</b>	<u>81,245</u>	<u>70,360</u>
<b>Interest charges and (credits):</b>		
Interest on long-term debt, net	148,264	146,671
Other interest	11,466	12,773
Allowance for borrowed funds used during construction	<u>(911)</u>	<u>(2,776)</u>
<b>Total interest charges</b>	<u>158,819</u>	<u>156,668</u>
<b>Change in net deficit</b>	(77,574)	(86,308)
<b>Net assets (deficit)</b>		
Total net assets (deficit), beginning of year	11,620	(11,253)
Cumulative effect of change in accounting principle	<u>-</u>	<u>2,873</u>
<b>Total net deficit, end of period</b>	<u>\$ (65,954)</u>	<u>\$ (94,688)</u>

**Consolidated Balance Sheet**  
**(Thousands of Dollars)**

	<b>June 30, 2004 (unaudited)</b>	<b>December 31, 2003 (audited)</b>
<b>Current assets:</b>		
Cash and cash equivalents	\$ 92,523	\$ 219,095
Investments	141,944	198,892
Accounts receivable (less allowance for doubtful accounts of \$19,485)	250,592	235,732
Other accounts receivable	22,623	24,978
Fuel inventory	65,655	54,651
2004 Fuel and purchased power costs recoverable	58,046	-
Material and supplies inventory	6,985	7,130
Interest receivable	356	602
Prepayments and other current assets	14,504	5,836
Total Current Assets	653,228	746,916
<b>Noncurrent assets:</b>		
Utility plant and property and equipment, net	3,415,160	3,390,387
Promissory Notes Receivable-KeySpan Energy	155,425	155,425
Nonutility Property and Other Investments	107,067	63,652
Deferred Loss related to Non Fuel Derivatives	14,397	39,139
Deferred Charges	92,564	80,431
Regulatory Assets		
Shoreham settlement	575,214	575,660
Fuel and purchased power costs	321,723	381,880
Total Regulatory Assets	896,937	957,540
Acquisition Adjustment (net of accumulated amortization of \$846,551 and \$790,211, respectively)	3,248,960	3,305,300
Total assets	\$ 8,583,738	\$ 8,738,790
<b>Current liabilities:</b>		
Short-term debt	\$ 200,000	\$ 100,000
Current maturities of long-term debt	172,265	186,380
Current portion of capital lease obligation	79,391	80,073
Accounts payable and accrued expenses	305,822	329,971
Accrued payments in lieu of taxes	18,127	38,552
Accrued interest	41,463	42,000
Customer deposits	25,265	25,252
Total current liabilities	842,333	802,228
<b>Noncurrent liabilities:</b>		
Long-term debt	6,765,399	6,835,943
Capital Lease Obligation	704,140	721,630
Asset Retirement Obligation	66,386	64,452
Deferred Credits	102,374	147,679
Swaption	147,648	133,757
Claims, Damages and Storm Reserves	21,412	21,481
Total noncurrent liabilities	7,807,359	7,924,942
<b>Net assets (deficit)</b>		
Invested in capital assets net of related debt	(602,796)	(566,082)
Unrestricted	536,842	577,702
Total net (deficit) assets	(65,954)	11,620
Total liabilities and net (deficit) assets	\$ 8,583,738	\$ 8,738,790

**Statement of Cash Flows**  
**(Thousands of Dollars)**

	<b>Six Months</b>	
	<b>Ended</b>	
	<b>June 30,</b>	
	<b>2004</b>	<b>2003</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
<b>Cash flows from operating activities:</b>		
Received from customers for the system sales, net of refunds	\$ 1,259,391	\$ 1,167,525
Paid to suppliers and employees		
Operations and maintenance	(414,323)	(407,326)
Fuel and purchased power	(659,723)	(594,841)
Payments in lieu of taxes	(167,789)	(151,562)
Net cash used in operating activities	<u>17,556</u>	<u>13,796</u>
<b>Investing activities:</b>		
Net purchases (sales) of investment securities	56,946	946
Earnings received on investments	2,453	5,201
Other	6,452	307
Net cash provided by investing activities	<u>65,851</u>	<u>6,454</u>
<b>Cash flows from capital and related financing activities:</b>		
Capital and nuclear fuel expenditures	(102,517)	(109,318)
Bond issuance costs	-	(23,455)
Swaption proceeds	35,000	29,892
Proceeds of promissory note redemption	-	447,000
Interest paid, net	(144,547)	(138,385)
Proceeds from the issuance of commercial paper notes and bonds	100,000	1,605,552
Redemption of long-term debt	(97,915)	(1,970,157)
Net cash provided by (used in) capital and related financing activities	<u>(209,979)</u>	<u>(158,871)</u>
Net increase (decrease) in cash and cash equivalents	(126,572)	(138,621)
Cash and cash equivalents at beginning of period	219,095	491,986
Cash and cash equivalents at end of period	<u>\$ 92,523</u>	<u>\$ 353,365</u>
<b>Reconciliation to net cash provided by operating activities:</b>		
Operating income	\$ 55,072	\$ 44,292
<b>Adjustments to reconcile operating income to net cash provided by operating activities:</b>		
Depreciation and amortization	114,285	116,288
Nuclear fuel burned	2,538	3,067
Shoreham surcharge recovery	16,047	(24,922)
Provision for claims and damages	3,500	5,250
Change in the fair market value of fuel related derivatives	-	5,980
Accretion of asset retirement obligation	1,934	1,824
Other	(39,275)	(3,932)
<b>Changes in operating assets and liabilities:</b>		
Accounts receivable, net	(12,505)	26,171
Fuel and Material & supplies inventory	(10,859)	(6,924)
Fuel and purchased power costs recovered related to prior periods	17,768	59,921
Excess fuel and purchased power costs deferred	(58,046)	(160,170)
Prepaid assets	(8,668)	(9,510)
Accounts payable and accrued expenses	(24,149)	(28,920)
Accrued taxes	(20,425)	(19,812)
Other, net	(19,661)	5,193
Net cash used in operating activities	<u>\$ 17,556</u>	<u>\$ 13,796</u>