

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

Consolidated Results of Operations

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

Change in Net assets (deficit)

For the nine months ended September 30, 2004, the Authority generated net income of approximately \$17 million compared with approximately \$30 million for the nine months ended September 30, 2003. The variation of \$13 million resulted primarily from higher fuel and purchased power costs (as discussed below) partially offset by increased revenue.

Revenue

Revenue for the nine months ended September 30, 2004, increased approximately \$176 million when compared to the similar period in 2003. The increase is primarily attributable to system load growth totaling approximately \$28 million, higher recoveries of excess fuel costs totaling approximately \$143 million, and the impact of the blackout that occurred in August of 2003 which caused the loss of revenue in 2003 estimated at \$8 million. These increases were partially offset by the negative effects of weather estimated at \$1 million, and lower non-system revenue of approximately \$2 million.

Fuel and Purchased Power Costs

Fuel and purchased power costs increased approximately \$185 million. This increase is due in part to higher recoveries of current year excess fuel costs of approximately \$143 million, higher sales volumes of approximately \$8 million and higher currently recognized excess fuel costs totaling approximately \$58 million. These increases were partially offset by approximately \$24 million, due to the impact of the FPPCA modification whereby 2004 mark-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 nine months ended September 30, 2004, approximately \$281 million of Excess Fuel Costs have been billed to customers through the FPPCA, and approximately \$26 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 nine months ended September 30, 2003, approximately \$53 million of Excess Fuel Costs had been billed to customers through the FPPCA, and approximately \$274 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 \$83 million when compared to the nine months period ended September 30, 2003. Approximately \$9 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 \$7 million for the nine month period September 30, 2004, compared to the similar period in 2003 due primarily to increased MSA costs totaling approximately \$13 million, due primarily to the timing of capital work being performed under the agreement. Also contributing to the increase is higher customer accounts expenses of approximately \$1 million, increased PSA costs totaling \$8 million, \$2 million related to the settlement of the Cross Sound Cable dispute, 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 \$10 million, lower storm cost accruals totaling approximately \$3 million and lower costs associated with renting temporary emergency stand-by generators totaling approximately \$1 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 \$1 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 \$5 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

Allowance for borrowed funds used during construction decreased approximately \$2 million due to lower construction work in progress balances in 2004 compared to 2003.

Other Significant Items

During the nine month period ended September 30, 2004:

- In March 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 of September 30, 2004, the Authority redeemed \$49 million and plans to redeem the remaining \$51 million by year end;
- 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-Northport 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;
- In August, the Authority issued \$200 million Electric System General Revenue Bonds, Series 2004A. The issuance consists of \$33.9 million of Serial bonds and \$166.1 million of Term bonds. The Serial bonds have maturities that begin in 2013 and continue each year through 2025. Interest rates on the Serial bonds range from 3.8% to 4.875%. The Term bonds have maturities of \$64.885 million in 2029, \$12.41 million in 2032, and \$88.805 million in 2034. Interest rates on the Term bonds are 5.0% and 5.1%. The purpose of these bonds was to reimburse LIPA's treasury for capital projects funded previously with cash from operations, and to provide funding for future capital spending.

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

	Nine Months Ended September 30,	
	2004 (unaudited)	2003 (unaudited)
Operating revenues - electric sales	\$ 2,166,510	\$ 1,990,627
Operating expenses:		
Operations - fuel and purchased power		
Fuel and purchased power costs	1,037,287	1,014,397
Recovery of Prior Year Excess Fuel Costs	28,142	113,764
Fuel and purchased power expenses - deferral, net	<u>(25,601)</u>	<u>(273,697)</u>
	1,039,828	854,464
Operations and maintenance	548,479	540,981
General and administrative	28,527	31,539
Depreciation and amortization	171,813	172,422
Payments in lieu of taxes	160,040	160,080
	<u>1,948,687</u>	<u>1,759,486</u>
Total Operating Expenses		
Operating Income (Loss)	<u>217,823</u>	<u>231,141</u>
Nonoperating revenues and expenses:		
Other income, net		
Investment income	4,812	7,559
Carrying charges on regulatory asset	23,577	22,760
Other	<u>7,971</u>	<u>5,531</u>
Total other income, net	<u>36,360</u>	<u>35,850</u>
Change in net assets before interest charges and (credits)	<u>254,183</u>	<u>266,991</u>
Interest charges and (credits):		
Interest on long-term debt, net	222,065	220,977
Other interest	16,848	20,741
Allowance for borrowed funds used during construction	<u>(1,553)</u>	<u>(3,838)</u>
Total interest charges	<u>237,360</u>	<u>237,880</u>
Change in net assets	16,823	29,111
Net assets		
Total net assets (deficit), beginning of year	11,620	(11,253)
Cumulative effect of change in accounting principle	<u>-</u>	<u>2,873</u>
Total net assets, end of period	<u>\$ 28,443</u>	<u>\$ 20,731</u>

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

	September 30, 2004 (unaudited)	December 31, 2003 (audited)
Current assets:		
Cash and cash equivalents	\$ 324,936	\$ 219,095
Investments	140,910	198,892
Accounts receivable (less allowance for doubtful accounts of \$19,485)	367,596	235,732
Other accounts receivable	13,927	24,978
Fuel inventory	67,449	54,651
2004 Fuel and purchased power costs recoverable	25,601	-
Material and supplies inventory	7,052	7,130
Interest receivable	400	602
Prepayments and other current assets	6,400	5,836
Total Current Assets	954,271	746,916
Noncurrent assets:		
Utility plant and property and equipment, net	3,417,249	3,390,387
Promissory Notes Receivable-KeySpan Energy	155,425	155,425
Nonutility Property and Other Investments	144,379	63,652
Deferred loss financial derivatives	85,755	39,139
Deferred Charges	97,085	80,431
Regulatory Assets		
Shoreham settlement	572,322	575,660
Fuel and purchased power costs	287,673	381,880
Total Regulatory Assets	859,995	957,540
Acquisition Adjustment (net of accumulated amortization of \$874,721 and \$790,211, respectively)	3,220,790	3,305,300
Total assets	\$ 8,934,949	\$ 8,738,790
Current liabilities:		
Short-term debt	\$ 151,000	\$ 100,000
Current maturities of long-term debt	172,265	186,380
Current portion of capital lease obligation	79,062	80,073
Accounts payable and accrued expenses	282,541	329,971
Accrued payments in lieu of taxes	26,513	38,552
Accrued interest	80,290	42,000
Customer deposits	25,516	25,252
Total current liabilities	817,187	802,228
Noncurrent liabilities:		
Long-term debt	6,968,977	6,835,943
Capital lease obligation	695,275	721,630
Asset retirement obligation	67,353	64,452
Deferred gain financial derivatives	13,267	-
Deferred credits	91,386	147,679
Deferred credits financial derivatives	229,207	133,757
Claims, damages and storm reserves	23,854	21,481
Total noncurrent liabilities	8,089,319	7,924,942
Net assets		
Invested in capital assets net of related debt	(769,058)	(566,082)
Unrestricted	797,501	577,702
Total net assets	28,443	11,620
Total liabilities and net assets	\$ 8,934,949	\$ 8,738,790

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

	Nine Months Ended September 30,	
	2004 (unaudited)	2003 (unaudited)
Cash flows from operating activities:		
Received from customers for the system sales, net of refunds	\$ 2,120,204	\$ 1,943,303
Paid to suppliers and employees		
Operations and maintenance	(636,200)	(617,120)
Fuel and purchased power	(1,066,075)	(975,348)
Payments in lieu of taxes	(239,135)	(229,422)
Net cash provided by operating activities	<u>178,794</u>	<u>121,413</u>
Investing activities:		
Net purchases (sales) of investment securities	57,982	(139,621)
Earnings received on investments	3,629	6,610
Other	6,669	4,998
Net cash provided by (used in) investing activities	<u>68,280</u>	<u>(128,013)</u>
Cash flows from capital and related financing activities:		
Capital and nuclear fuel expenditures	(144,694)	(150,164)
Bond issuance costs	(4,586)	(25,470)
Swaption proceeds	35,000	29,892
Proceeds of promissory note redemption	-	447,000
Interest paid, net	(177,550)	(164,690)
Proceeds from the issuance of commercial paper notes and bonds	248,512	1,605,552
Redemption of long-term debt	(97,915)	(1,970,157)
Net cash used in capital and related financing activities	<u>(141,233)</u>	<u>(228,037)</u>
Net increase (decrease) in cash and cash equivalents	105,841	(234,637)
Cash and cash equivalents at beginning of period	219,095	491,986
Cash and cash equivalents at end of period	<u>\$ 324,936</u>	<u>\$ 257,349</u>
Reconciliation to net cash provided by operating activities:		
Operating income	\$ 217,823	\$ 231,141
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation and amortization	171,813	172,422
Nuclear fuel burned	4,717	4,393
Shoreham surcharge recovery	26,915	(14,100)
Provision for claims and damages	5,252	7,875
Change in the fair market value of fuel related derivatives	-	23,855
Accretion of asset retirement obligation	2,901	2,736
Other	(38,113)	(3,091)
Changes in operating assets and liabilities:		
Accounts receivable, net	(120,813)	(111,062)
Fuel and Material & supplies inventory	(12,720)	(15,313)
Fuel and purchased power costs recovered related to prior periods	28,142	113,764
Excess fuel and purchased power costs deferred	(25,601)	(273,697)
Prepaid assets	(564)	(8,410)
Accounts payable and accrued expenses	(47,430)	1,250
Accrued taxes	(12,039)	(10,363)
Other, net	(21,489)	13
Net cash provided by operating activities	<u>\$ 178,794</u>	<u>\$ 121,413</u>