KPMG

LONG ISLAND POWER AUTHORITY

(A Component Unit of The State of New York)

Basic Financial Statements

December 31, 2008 and 2007

(With Independent Auditors' Report Thereon)

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Basic Financial Statements

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Table of Contents

KPMG LLP
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1305 Walt Whitman Road
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Independent Auditors' Report

The Board of Trustees
Long Island Power Authority:

We have audited the balance sheets, statements of revenues, expenses, and changes in net assets, and statements of cash flows of the Long Island Power Authority (Authority), a component unit of the State of New York, as of and for the years then ended December 31, 2008 and 2007, which collectively comprise the Authority's basic financial statements. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Authority as of December 31, 2008 and 2007, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 30, 2009 on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope and of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis on pages 3 through 12 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

March 30, 2009

Overview of the Financial Statements

This report consists of three parts: management's discussion and analysis, the basic financial statements, and the notes to the financial statements.

The financial statements provide summary information about the Authority's overall financial condition. The notes provide explanation and more details about the contents of the financial statements.

The Authority is considered a special-purpose government entity engaged in business-type activities and follows financial reporting for enterprise funds. The Authority's financial statements are prepared in accordance with generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB). In accordance with GASB standards, the Authority has elected to comply with all authoritative pronouncements applicable to nongovernmental entities (i.e., pronouncements of the Financial Accounting Standards Board) that do not conflict with GASB pronouncements.

The following is a summary of the Authority's financial information for 2008, 2007, and 2006 (amounts in thousands):

Balance Sheet Summary

	December 31, 2008	December 31, 2007	December 31, 2006
Assets:			
Current assets:			
Cash, cash equivalents and investments	$ 257,720	814,412	709,999
Other current assets	725,269	705,216	451,998
Noncurrent assets:			
Utility plant, net	5,725,010	5,320,740	4,118,775
Promissory notes receivable	155,425	155,425	155,425
Nonutility property and other investments	71,753	70,979	63,594
Deferred charges and long-term receivables	584,360	235,657	123,492
Regulatory assets	1,097,230	780,867	861,320
Acquisition adjustment, net	2,741,897	2,854,578	2,967,258
Total assets	$ 11,358,664	10,937,874	9,451,861
Liabilities and net assets:			
Regulatory liability	$ 2,483	269,476	197,918
Other current liabilities	1,196,538	1,215,244	878,766
Noncurrent liabilities:			
Long-term debt	6,394,364	6,402,713	6,806,290
Capital lease obligation	2,369,168	2,130,236	1,044,240
Other noncurrent liabilities	310,187	130,794	116,725
Deferred credits	796,746	526,575	238,132
Total liabilities	11,069,486	10,675,038	9,282,071
Net assets (deficit):			
Capital assets net of related debt	(56,269)	(190,510)	(417,837)
Restricted	229,285	—	—
Unrestricted	116,162	453,346	587,627
Total net assets	289,178	262,836	169,790
Total liabilities and net assets	$ 11,358,664	10,937,874	9,451,861

Summary of Revenues, Expenses, and Changes in Net Assets

		Year ended December 31,		
		2008	**2007**	**2006**
Electric revenue	$	3,639,684	3,542,555	3,664,976
Operating expenses:				
Operations – fuel and purchased power		2,052,732	1,838,495	2,024,811
Operations and maintenance		785,342	847,963	765,569
General and administrative		31,347	37,978	43,082
Depreciation and amortization		246,919	245,632	242,206
Payments in lieu of taxes		239,659	231,490	225,077
Prior service cost-OPEB's		—	10,912	—
Total operating expenses		3,355,999	3,212,470	3,300,745
Operating income		283,685	330,085	364,231
Other income, net		69,862	82,374	85,853
Interest charges		(323,365)	(319,413)	(331,914)
Change in net assets before extraordinary loss		30,182	93,046	118,170
Extraordinary loss on early extinguishment of debt		(3,840)	—	—
Change in net assets		26,342	93,046	118,170
Net assets – beginning of year		262,836	169,790	51,620
Net assets – end of year	$	289,178	262,836	169,790

Excess of Revenues over Expenses

The revenues in excess of expenses for the years ended December 31, 2008, 2007 and 2006 totaled approximately $26 million, $93 million and $118 million, respectively.

Revenues

Revenue for the twelve months ended December 31, 2008 increased approximately $97 million (which includes an approximate $14 million settlement with a commercial customer) when compared to the similar period of 2007. This increase is primarily attributable to the higher recoveries of power supply costs revenues totaling approximately $122 million partially offset by the sales mix and lower average customer usage, (primarily in the Commercial & Industrial segment), totaling approximately $12 million and the negative effects of weather totaling approximately $13 million.

(Continued)

Revenue for the year ended December 31, 2007, decreased approximately $122 million when compared to 2006. The decrease is primarily attributable to lower recoveries of power supply costs revenues totaling approximately $170 million. This decrease was partially offset by load growth and sales mix estimated to be approximately $31 million, and the positive effects of weather estimated to be approximately $17 million.

Fuel and Purchased Power Costs

The Authority's tariff includes a power supply costs recovery provision—the Fuel and Purchased Power Cost Adjustment (FPPCA) that provides for the amount and timing of fuel and purchased power cost recoveries. During 2003, the Board approved a modification to the FPPCA which provided for the recovery of fuel and purchased power costs in the period incurred, up to amounts sufficient to allow the Authority to earn a financial target of $20 million of excess revenue over expenses as a reserve but in no event greater than incurred fuel and purchased power costs. In April 2006, the Board approved a modification to the FPPCA increasing the financial target from $20 million to $75 million with a variance of $50 million above or below such financial target in each year. Should fuel and purchased power prices change such that the Authority would exceed or fail to meet its financial target, the FPPCA would be reduced or increased accordingly. In no event, however, can the Authority recover an amount that exceeds its fuel and purchased power costs incurred.

For the year ended December 31, 2008, fuel and purchased power expense increased approximately $214 million. Commodity costs totaled approximately $2.165 billion, including derivative settlements gains of approximately $204 million, which represents an increase in the net commodity costs due to price of approximately $307 million offset by the impact of lower sales volumes of approximately $28 million, and the amortization of various fuel related regulatory items that reduced expense by approximately $65 million.

For the year ended December 31, 2007, fuel and purchased power expense decreased approximately $186 million. Commodity costs totaled approximately $1.886 billion, including derivative settlements gains of approximately $23 million, representing an increase in the net commodity costs due to price of approximately $52 million over 2006, combined with higher sales volumes that added to overall costs by an additional $43 million. These increases were offset by the deferral and/or amortization of various regulatory items totaling approximately $281 million.

Operations and Maintenance Expense (O&M)

Operations and maintenance (O&M) expense for the year ended December 31, 2008, decreased approximately $63 million primarily attributable to a $34 million decrease in costs associated with the ongoing funding of certain KeySpan electric service employee benefit programs, approximately $9 million of synergy savings received from National Grid, lower Management Services Agreement (MSA) costs totaling approximately $8 million, lower clean energy costs totaling approximately $9 million, lower storm restoration costs totaling approximately $3 million, lower Nine Mile Point 2 operating costs totaling approximately $3 million and other various items totaling approximately $1 million. These decreases were partially offset by higher Power Supply Agreement (PSA) costs totaling approximately $4 million.

Operations and maintenance (O&M) expense for the year ended December 31, 2007, increased approximately $82 million primarily due to the recognition of approximately $54 million of costs associated with a settlement with National Grid for the funding of certain KeySpan electric service employee benefit programs dating back to 1998. The remaining O&M increase is due to higher PSA costs totaling approximately $13 million as a result of increased capacity charges (driven by higher property taxes), higher MSA costs of $10 million (due to higher transmission rents of $5 million and higher storm hardening activities of $4 million), and higher clean energy costs totaling approximately $8 million. These increases were partially offset by lower storm restoration costs totaling approximately $3 million.

General and Administrative Expenses (G&A)

General and administrative expenses for the year ended December 31, 2008 decreased approximately $7 million as a result of reducing the reserve for injuries and damages by approximately $3 million, lower employee benefit costs totaling approximately $2 million and the use of deferred settlement amounts to offset consulting fees totaling approximately $2 million.

For the year ended December 31, 2007, G&A expenses decreased approximately $5 million due to an insurance reimbursement totaling approximately $1 million, lower legal and consulting fee totaling approximately $3 million, and lower advertising costs of approximately $1 million. These reductions were partially offset by the adoption of Governmental Accounting Standard No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (GASB No. 45) whereby the Authority recorded a $1 million expense in that period related to the costs of providing health benefits to employees upon retirement. Prior to adoption of this pronouncement, the Authority recorded such expenses when paid.

Depreciation and Amortization

For the years ended December 31, 2008 and 2007, depreciation and amortization increased approximately $1 million and $3 million, respectively, due to higher utility plant balances.

Payments in Lieu of Taxes

For the years ended December 31, 2008 and 2007, payments in lieu of taxes (PILOTs) increased approximately $8 million and $6 million due to higher property taxes.

Prior Service Cost – OPEBs

In 2007, the Authority adopted the provisions of GASB No. 45, which, in addition to requiring the recognition of a current period expense for providing health benefits to employees upon their retirement, also required the recognition of amounts incurred in the periods prior to the adoption of this pronouncement. The prior years' service costs related to this adoption totaled approximately $11 million.

For 2008, the current period expense related to providing health benefits to employees upon their retirement is included in G&A as discussed above.

Other Income, Net

Other income decreased approximately $13 million for the year ended December 31, 2008, when compared to the year ended December 31, 2007, as a result of lower investment earnings totaling approximately $15 million and lower gains on the sale of unneeded emissions allowance credits totaling approximately $11 million. Partially offsetting these lower income items was approximately $7 million of income related to an interest rate swap that was terminated in 2008 and an approximate $6 million decrease related to the community benefits package associated with the Caithness generating station incurred in 2007.

Other income decreased approximately $3 million for the year ended December 31, 2007, when compared to the year ended December 31, 2006. This decrease was due to a $6 million charge for the cost of a community benefits package associated with the Caithness generating station and lower gains on the sale of emissions allowance credits of approximately $5 million. These costs were offset by higher investment earnings totaling approximately $8 million resulting from higher investment balances coupled with higher interest rates.

Interest Charges and Credits

Total interest charges increased approximately $4 million for the year ended December 31, 2008, due primarily to higher interest rates on variable rate debt, the restructuring in the fourth quarter of a portion of the insured variable rate debt to higher interest fixed rate debt and increased interest costs associated with holding counterparty collateral.

For the year ended December 31, 2007, total interest charges decreased approximately $13 million due to lower counterparty collateral being held by the Authority when compared to 2006, and higher allowance for borrowed funds used during construction totaling approximately $3 million. The remaining decrease is due to the lower debt outstanding in 2007 compared to 2006 partially offset by increased interest rates on variable rate debt.

Extraordinary Loss on Early Extinguishment of Debt

In March 2008, the Authority redeemed $200 million of its insured variable rate Electric System General Revenue Bonds to lower the risks associated with their marketability. The Authority used cash on hand to redeem these securities. The Authority had deferred charges totaling approximately $4 million associated with these bonds that were recognized as an extraordinary loss on early extinguishment of debt.

Cash, Cash Equivalents, and Investments

The Authority’s cash, cash equivalents, and investments totaled approximately $258 million, $814 million, and $710 million at December 31, 2008, 2007, and 2006, respectively. The decrease from 2007 to 2008 is due to increased fuel and purchased power costs, required collateral postings with various counterparties, the return of prior year excess power supply costs to the ratepayer and the redemption of debt with cash on hand. The increase from 2006 to 2007 is primarily the result of approximately $81 million received from KeySpan/National Grid in 2007 related to the Amended and Restated MSA and the Settlement Agreement (for a further discussion on the Settlement Agreement, see note 2 to the basic financial statements). The Authority also has the authorization to issue up to $300 million of commercial paper notes, $200 million of which was outstanding at December 31, 2008 and $100 million of which was outstanding as of December 31, 2007 and 2006.

(Continued)

Capital Assets

The Authority continued its investment in transmission and distribution (T&D) upgrades to manage reliability and to enhance capacity needed to meet growing customer demands. For the years ended December 31, 2008 and 2007, capital improvements to the T&D system totaled approximately $267 million and approximately $295 million, respectively. These improvements included interconnection equipment necessary to connect newly installed capacity to the system, the replacement or upgrade of transformer banks and circuit breakers, new substations, enhanced transmission lines and upgraded command and control equipment.

Regulatory Assets

Regulatory assets increased approximately $316 million from December 31, 2007 to December 31, 2008. The increase is the result of: (i) the negative mark-to-market valuation on the Authority's fuel and purchased power derivatives totaling approximately $357 million, and (ii) carrying charges on the Shoreham Property Tax Settlement Agreement related credits totaling approximately $32 million. These increases were partially offset by: (i) the recovery of the 2003 deferred excess fuel and purchased power costs totaling approximately $36 million, scheduled to be recovered over a ten-year period which began January 1, 2004, in accordance with the Authority's tariff, and (ii) the scheduled recovery of approximately $37 million related to the Shoreham Property Tax Settlement Agreement through a surcharge on billings for electric service to customers residing in Suffolk County (the Shoreham surcharge), which began in 2003 (as discussed in greater detail in note 3 to the basic financial statements).

Regulatory assets decreased approximately $80 million from December 31, 2006 to December 31, 2007. The decrease is the result of: (i) the change in the mark-to-market valuation on the Authority's fuel and purchased power derivatives totaling approximately $41 million, and (ii) the recovery of the 2003 deferred excess fuel and purchased power costs totaling approximately $36 million scheduled to be recovered over a ten-year period which began January 1, 2004, in accordance with the Authority's tariff, and (iii) the scheduled recovery of approximately $35 million related to the Shoreham Property Tax Settlement Agreement through a surcharge on billings for electric service to customers residing in Suffolk County (the Shoreham surcharge), which began in 2003. These decreases were partially offset by approximately $32 million of carrying charges on the Shoreham Property Tax Settlement Agreement related credits.

Regulatory Liabilities

For the year ended December 31, 2008, the regulatory liabilities decreased by approximately $267 million resulting from: (i) the return of 2007 excess recovery of fuel and purchased power supply costs which totaled approximately $112 million and; (ii) the net change in the mark-to-market on the Authority's fuel and purchased power derivatives which totaled approximately $155 million at December 31, 2007. At December 31, 2008, the Authority had a mark-to-market loss on its fuel derivatives which is recorded in regulatory assets.

For the year ended December 31, 2007, the Authority recorded a regulatory liability of approximately $269 million which is comprised of: (i) approximately $114 million of fuel and purchased power costs recovered in excess of that incurred that was returned to the customers through reductions in the FPPCA in 2008, and; (ii) the mark-to-market gains on the Authority's fuel and purchased power derivatives totaling approximately $155 million.

Debt

The Authority's debt, including current maturities, is comprised of the following instruments (amounts in thousands):

		Debt Balance at December 31,		
		2008	2007	2006
General Revenue Bonds	$	5,722,633	5,791,239	5,982,213
Subordinated Revenue Bonds		785,825	879,725	879,725
Commercial Paper Notes		200,000	100,000	100,000
NYSERDA Notes		155,420	155,420	155,420
	$	6,863,878	6,926,384	7,117,358

During 2008, debt decreased approximately $63 million resulting from scheduled maturities of approximately $227 million and debt refunding totaling approximately $719 million. This decrease was partially offset by the issuance of Electric System General Revenue Bonds Series 2008A and Series 2008B totaling approximately $754 million for the purpose of refunding certain outstanding insured variable rate debt and financing the Authority's on going capital improvements program, the issuance of additional Commercial Paper Notes totaling $100 million and the accretion of the capital appreciation bonds totaling approximately $29 million.

For a full discussion on the Authority's refunding activities during 2008, see note 9 to the basic financial statements.

During 2007, debt decreased as a result of scheduled maturities of approximately $219 million partially offset by the accretion of the capital appreciation bonds totaling approximately $28 million.

Risk Management

The Authority is routinely exposed to commodity and interest rate risk. In order to mitigate such exposure, the Authority formed an Executive Risk Management Committee to strengthen executive management oversight for the risk mitigation activities of the Authority. In addition, the Authority retains an external consultant specializing in risk management, energy markets and energy trading to enhance its understanding of these areas.

The risk management program is intended to identify exposures to movements in fuel and purchased power prices, quantify the impact of these exposures on the Authority's financial position, liquidity and the FPPCA and mitigate the exposures in line with the Authority's identified level of risk tolerance. The Authority actively manages the program in both upward and downward trending markets and adjusts its positions as necessary to mitigate the impact of potentially unfavorable market movements. The significant volatility in energy commodity costs that occurred in 2008 had a substantial impact on the Authority's cash position throughout the year. At December 31, 2007, the Authority was holding approximately $3 million in counterparty collateral in connection with its energy commodity hedges, while at June 30, 2008, the Authority was holding approximately $929 million in counterparty collateral. At December 31, 2008, the Authority had posted approximately

$229 million of collateral to its counterparties in connection with its energy commodity hedge positions. No collateral was held by or posted by the Authority with respect to its interest rate derivatives.

In accordance with SFAS No. 133, *Accounting for Derivatives and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, the Authority records its derivatives at fair value and records unrealized gains and losses. For a further discussion on these matters, see note 3 of the basic financial statements.

Fuel and purchased power transactions – For the year ended December 31, 2008, the Authority had realized gains totaling approximately $204 million which reduced fuel and purchased power costs and recorded an unrealized loss on commodity derivatives of approximately $357 million. For the year ended December 31, 2007, the Authority had realized gains totaling approximately $23 million and recorded an unrealized gain on commodity derivatives totaling approximately $155 million.

Interest rate transactions – At December 31, 2008 and 2007, the Authority recorded net unrealized fair value losses of approximately $498 million and $196 million, respectively, which includes unamortized upfront premiums totaling approximately $111 million and $124 million, respectively, related to certain of these derivative transactions. The upfront premiums are being amortized over the life of the underlying derivative as interest rate modifiers. Any gains or losses resulting from these fair values are deferred, and will be recognized when realized consistent with the Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS No. 71).

Power Supply

The Authority has entered into numerous agreements for capacity and energy necessary to continue to satisfy the increasing energy demand of Long Island, while increasing the diversity of its fuel mix alternatives. The Authority has entered into an agreement to purchase 660 MW of transmission capacity via an undersea high voltage cable between New Jersey and New York. Since 2007, the cable has enabled the Authority to import 660 MW of power from the Pennsylvania, New Jersey and Maryland markets (PJM-ISO or PJM). The Authority has also entered into an agreement with the owners of a facility located in PJM to secure long-term power capacity supply. This agreement will commence on June 1, 2010.

The Authority also entered into an agreement to acquire 286 MW from a 326 MW plant being constructed on Long Island that is expected to be in operation for the summer of 2009.

In April 2007, the Authority began purchasing up to 345 MW of additional capacity and varying amounts of energy from a portfolio of facilities located in New England. This power is transmitted via an undersea high voltage cable running between Connecticut and Long Island pursuant to a long-term firm transmission capacity purchase agreement.

During 2008, the Authority entered into an agreement to purchase renewable energy which will be delivered from off-island sources. The Authority expects these purchases to begin in 2009.

For additional information on power purchase agreements and its related accounting treatments, see notes 3 and 12 to the basic financial statements.

Investment Ratings

Below are the Authority's securities as rated by Moody's Investors Service (Moody's), Standard and Poor's Ratings Services (S&P), and Fitch Ratings (Fitch):

	Investment ratings		
	Moody's	**S&P**	**Fitch**
Senior Lien debt	A3	A-	A-

Certain Senior and all Subordinated Lien debt and the Commercial Paper notes are supported by either a Letter of Credit (LOC) or are insured against default. Such debt carries the higher of the ratings of the credit support provider (LOC bank or insurance company), or that of the Authority.

Subsequent Event

In January 2009, the Authority issued approximately $436 million of its Electric System General Revenue Bonds, Series 2009A. The proceeds of these fixed rate bonds, net of discount and cost of issuance, will be used to finance the Authority's on-going capital program and the remainder was used to redeem approximately $231 million of the Authority's variable rate securities in a current refunding. This current refunding produced an approximate $45 million net present value savings. The 2009A bonds have an average life of 20 years and an all-in cost of 5.50%.

Contacting the Long Island Power Authority

This financial report is designed to provide our bondholders, customers, and other interested parties with a general overview of the Authority's finances and to demonstrate its accountability for the funds it receives. If you have any questions about this report or need additional information, contact the Authority at 333 Earle Ovington Blvd., Suite 403, Uniondale, New York 11553, or visit our website at www.lipower.org.

LONG ISLAND POWER AUTHORITY
(A Component Unit of the State of New York)

Balance Sheets

December 31, 2008 and 2007

(Dollars in thousands)

Assets		**2008**	**2007**
Current assets:			
Cash and cash equivalents	$	225,158	526,531
Investments		32,562	287,881
Counterparty collateral – posted by the Authority		229,285	—
Accounts receivable (net of allowance for doubtful accounts of $19,485)		275,755	272,666
Other accounts receivable		49,503	110,249
Fuel inventory		131,286	143,206
Fuel derivatives		—	155,153
Material and supplies inventory		7,282	6,720
Interest receivable		275	690
Prepayments and other current assets		31,883	16,532
Total current assets		982,989	1,519,628
Noncurrent assets:			
Utility plant and property and equipment, net		5,725,010	5,320,740
Promissory notes receivable – KeySpan Energy		155,425	155,425
Nonutility property and other investments		71,753	70,979
Other long-term receivables		80,276	81,850
Deferred unrealized loss – financial derivatives		386,462	71,599
Deferred charges		117,622	82,208
Regulatory assets:			
Shoreham property tax settlement		557,470	562,212
Fuel and purchased power costs recoverable		539,760	218,655
Acquisition adjustment (net of accumulated amortization of $1,353,615 and $1,240,933, respectively)		2,741,897	2,854,578
Total noncurrent assets		10,375,675	9,418,246
Total assets	$	11,358,664	10,937,874

See accompanying notes to basic financial statements.

Liabilities and Net Assets	2008	2007
Current liabilities:		
Short-term debt	$ 200,000	100,000
Current maturities of long-term debt	241,370	426,570
Current portion of capital lease obligation	102,844	90,761
Accounts payable and accrued expenses	366,897	486,469
Regulatory liability – fuel and purchased power costs	2,483	269,476
Fuel derivatives	167,532	—
Accrued payments in lieu of taxes	37,708	38,237
Accrued interest	52,138	43,330
Counterparty collateral	—	2,900
Customer deposits	28,049	26,977
Total current liabilities	1,199,021	1,484,720
Noncurrent liabilities:		
Long-term debt	6,394,364	6,402,713
Capital lease obligation	2,369,168	2,130,236
Fuel derivatives	189,599	—
Asset retirement obligation	92,558	91,541
Total noncurrent liabilities	9,045,689	8,624,490
Deferred credits – financial derivatives	497,674	195,500
Deferred credits – other	299,072	331,075
Claims and damages	28,030	39,253
Commitments and contingencies (notes 12 and 13)		
Total liabilities	11,069,486	10,675,038
Net assets (deficit):		
Invested in capital assets net of related debt	(56,269)	(190,510)
Restricted	229,285	—
Unrestricted	116,162	453,346
Total net assets	289,178	262,836
Total liabilities and net assets	$ 11,358,664	10,937,874

LONG ISLAND POWER AUTHORITY
(A Component Unit of the State of New York)

Statements of Revenues, Expenses, and Changes in Net Assets

Years ended December 31, 2008 and 2007

(Dollars in thousands)

		2008	2007
Operating revenues – electric sales	$	3,639,684	3,542,555
Operating expenses:			
Operations – fuel and purchased power		2,052,732	1,838,495
Operations and maintenance		785,342	847,963
General and administrative		31,347	37,978
Depreciation and amortization		246,919	245,632
Payments in lieu of taxes		239,659	231,490
Prior service cost-OPEB's		—	10,912
Total operating expenses		3,355,999	3,212,470
Operating income		283,685	330,085
Nonoperating revenues and expenses:			
Other income, net:			
Investing income		24,443	39,628
Carrying charges on regulatory asset		31,829	32,178
Other		13,590	10,568
Total other income, net		69,862	82,374
Interest charges and (credits):			
Interest on long-term debt, net		316,424	314,725
Other interest		15,291	12,871
Allowance for borrowed funds used during construction		(8,350)	(8,183)
Total interest charges		323,365	319,413
Total nonoperating revenues and expenses		(253,503)	(237,039)
Change in net assets before extraordinary loss		30,182	93,046
Extraordinary loss on early extinguishment of debt		(3,840)	—
Change in net assets		26,342	93,046
Total net assets, beginning of year		262,836	169,790
Total net assets, end of year	$	289,178	262,836

See accompanying notes to basic financial statements.

LONG ISLAND POWER AUTHORITY
(A Component Unit of the State of New York)

Statements of Cash Flows

Years ended December 31, 2008 and 2007

(Dollars in thousands)

		2008	2007
Cash flows from operating activities:			
Received from customers for system sales, net of refunds	$	3,652,883	3,587,244
KeySpan/National Grid Settlement		1,587	81,348
Other operating revenues received		34,265	37,903
Paid to suppliers and employees:			
Operations and maintenance		(850,003)	(732,899)
Fuel and purchased power		(2,122,236)	(1,758,301)
Payments in lieu of taxes		(341,260)	(338,204)
Collateral on fuel derivative transactions, net		(232,185)	2,900
Net cash provided by operating activities		143,051	879,991
Investing activities:			
Net sales (purchases) of investment securities		255,319	(79,126)
Earnings received on investments		20,341	36,821
Other		4,714	7,730
Net cash provided by (used in) investing activities		280,374	(34,575)
Cash flows from capital and related financing activities:			
Capital and nuclear fuel expenditures		(297,312)	(300,376)
Proceeds from KeySpan/National Grid for promissory note		8,075	8,075
Proceeds from the issuance of bonds, net of discount		831,037	—
Bond issuance costs		(14,899)	—
Interest paid, net		(306,229)	(309,223)
Redemption of long-term debt		(945,470)	(218,605)
Net cash used in capital and related financing activities		(724,798)	(820,129)
Net (decrease) increase in cash and cash equivalents		(301,373)	25,287
Cash and cash equivalents at beginning of year		526,531	501,244
Cash and cash equivalents at end of year	$	225,158	526,531
Reconciliation to net cash provided by operating activities:			
Operating income	$	283,685	330,085
Adjustments to reconcile operating income to net cash provided by operating activities:			
Depreciation and amortization		246,919	245,632
Nuclear fuel burned		5,906	5,456
Shoreham surcharges (credits), net		36,570	35,358
Provision for claims and damages		37,584	40,552
Accretion of asset retirement obligation		5,468	6,455
Amortization of settlement benefits to ratepayers		(36,000)	—
Other, net		(1,581)	3,157
Changes in operating assets and liabilities:			
Accounts receivable, net		59,231	(31,797)
Fuel and material and supplies inventory		11,358	(4,880)
Deferred fuel and purchased power costs		(75,814)	(46,994)
Counterparty collateral		(232,185)	2,900
Claims, damages and storm restoration		(48,807)	(32,244)
Accounts payable, accrued expenses and other		(149,283)	326,311
Net cash provided by operating activities	$	143,051	879,991

See accompanying notes to basic financial statements.

(1) Basis of Presentation

The Long Island Power Authority (Authority) was established as a corporate municipal instrumentality of the State of New York (State), constituting a political subdivision of the State, created by Chapter 517 of the Laws of 1986 (the LIPA Act). As such, it is a component unit of the State and is included in the State's annual financial statements.

The Authority's reporting entity is comprised of itself and its operating subsidiary the Long Island Lighting Company (LILCO), a wholly owned subsidiary of the Authority doing business as LIPA. LIPA has one share of $1 par value common stock authorized, issued and outstanding, which is held by the Authority.

As the Authority holds 100% of the common stock of LIPA and controls the operations of LIPA, under Governmental Accounting Standard Board Statement No. 14, *The Financial Reporting Entity*, LIPA is considered a blended component unit of the Authority and the assets, liabilities and results of operations are consolidated with the operation of the Authority for financial reporting purposes.

The Authority and its blended component unit, LIPA, are referred to collectively, as the "Authority" in the financial statements. All significant transactions between the Authority and LIPA have been eliminated.

(2) Nature of Operations

The Authority, as owner of the transmission and distribution system located in the New York State Counties of Nassau and Suffolk (with certain limited exceptions) and a small portion of Queens County known as the Rockaways (Service Area), is responsible for supplying electricity to customers within the Service Area. To assist the Authority in meeting these responsibilities, the Authority contracted with KeySpan Energy Corporation (KeySpan), a wholly owned subsidiary of National Grid plc, to provide: operations and management services related to the transmission and distribution system through a Management Services Agreement (MSA); capacity and energy from the fossil fired generating plants of KeySpan, formerly owned by LILCO, through a Power Supply Agreement (PSA); and, energy and fuel management services through an Energy Management Agreement (EMA) (collectively; the Operating Agreements). Through these contracts, the Authority pays KeySpan directly for these services and KeySpan, in turn, pays the salaries of its employees and fees of its contractors and suppliers. In 2008 and 2007, the Authority paid to KeySpan approximately $2 billion each year under the operating agreements, which includes all fees under such agreements, reimbursement for various taxes and PILOTS, certain fuel and purchased power costs, capital projects, conservation services, research and development and various other expenditures authorized by the Authority. In 2006, the Authority entered into agreements with certain of the KeySpan subsidiary companies to amend the MSA and certain other Operating Agreements. The Amended and Restated MSA (i) provides a simpler "fee for service" contract, (ii) establishes 18 service level metrics which KeySpan must achieve or be subject to monetary penalties and (iii) has a term that expires on December 31, 2013.

Certain services provided for under the EMA are set to expire on December 31, 2009. Through a competitive procurement process, the Authority has selected two new providers of those services. Both contracts are planned to commence on January 1, 2010 for an initial five-year period and are subject to an extension for a period of five years at the Authority's option. Both contracts have been approved by the New York State Comptroller and the Attorney General.

The Authority also entered into option agreements with KeySpan Generation LLC (GENCO) which provides the Authority with an option to acquire the E.F. Barrett and/or the Far Rockaway plants for book value at the time of sale (the Purchase Option Agreement). The Purchase Option Agreement was set to expire on May 31, 2008; however, the expiration date was extended to December 31, 2008 and further extended to March 31, 2009. National Grid also granted the Authority options to purchase, at 1.25 times book value at the time of sale, the combustion turbines at the Shoreham and Wading River sites. The purchase option for the Shoreham and Wading River sites expired on December 31, 2008. The Authority also obtained a right of first refusal to purchase, on substantially the same terms as offered, all (but not less than all) GENCO generating facilities which GENCO may decide to sell to a foreign or foreign-controlled entity during the term of the PSA (Right of First Refusal). In the event that the Authority acquires either or both the Barrett and Far Rockaway plants, the Authority and KeySpan have agreed that KeySpan, acting through a subsidiary to be designated, will operate and maintain such plant(s) until it is retired or repowered.

In consideration for the Authority's waiver of its rights under the change of control provisions in the Operating Agreements as a result of the National Grid acquisition of KeySpan in 2007, the Authority and National Grid reached an agreement (the Agreement and Waiver). Under the Agreement and Waiver, National Grid agreed to pay the Authority approximately $91 million over a period of seven years representing the Authority's guaranteed share of the synergy savings resulting from the National Grid acquisition of KeySpan. The Authority recorded the net present value (discounted at 7.8%) totaling approximately $69 million. As December 31, 2008, the Authority has a current receivable of approximately $12 million and a noncurrent other receivable of approximately $51 million remaining outstanding.

The Authority and LIPA are also parties to an Administrative Services Agreement, which describes the terms and conditions under which the Authority provides personnel, personnel-related services, and other services necessary for LIPA to provide service to its customers. As compensation to the Authority for the services described above, the Authority charges LIPA a monthly management fee equal to the costs incurred by the Authority in order to perform its obligations under the Administrative Services Agreement.

(3) Summary of Significant Accounting Policies

General

The Authority complies with all applicable pronouncements of the Governmental Accounting Standards Board (GASB). In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Authority complies with all authoritative pronouncements applicable to nongovernmental entities (i.e., pronouncements of the Financial Accounting Standards Board) that do not conflict with GASB pronouncements.

The operations of the Authority are presented as an enterprise fund following the accrual basis of accounting in order to recognize the flow of economic resources. Under this basis, revenues are recognized in the period in which they are earned and expenses are recognized in the period in which they are incurred.

Accounting for the Effects of Rate Regulation

The Authority is subject to the provisions of Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS No. 71). This statement recognizes the economic ability of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies. Accordingly, the Authority records these future economic benefits and obligations as regulatory assets and regulatory liabilities, respectively.

Regulatory assets represent probable future revenues associated with previously incurred costs that are expected to be recovered from customers. Regulatory liabilities represent probable future reductions in revenues associated with amounts that are expected to be refunded to customers through the ratemaking process.

In order for a rate-regulated entity to continue to apply the provisions of SFAS No. 71, it must continue to meet the following three criteria: (1) the enterprise's rates for regulated services provided to its customers must be established by an independent third-party regulator or its own governing board empowered by a statute to establish rates that bind customers; (2) the regulated rates must be designed to recover the specific enterprise's costs of providing the regulated services; and (3) in view of the demand for the regulated services and the level of competition, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers.

Based upon the Authority's evaluation of the three criteria discussed above in relation to its operations, and the effect of competition on its ability to recover its costs, the Authority believes that SFAS No. 71 continues to apply.

If the Authority had been unable to continue to apply the provisions of SFAS No. 71, as of December 31, 2008, the Authority estimates that approximately $537 million of net recoverable fuel and purchased power costs, approximately $386 million of net unrealized deferred losses on the Authority's financial derivative transactions, and the acquisition adjustment totaling approximately $2.7 billion would be considered for impairment.

Cash and Cash Equivalents and Investments

Funds held by the Authority are administered in accordance with the Authority's investment guidelines pursuant to Section 2925 of the New York State Public Authorities Law. These guidelines comply with the New York State Comptroller's investment guidelines for public authorities. Certain investments and cash and cash equivalents have been designated by the Authority's Board of Trustees to be used for specific purposes, including rate stabilization, debt service, capital expenditures, and clean energy initiatives. Investments' carrying values are reported at fair market value. See note 8 for a further discussion.

Counterparty Collateral

Whenever the Authority enters into a transaction to mitigate risk, it becomes exposed to an event of nonperformance by the counterparty; however, to limit its exposure to such risk, the Authority will only enter into derivative transactions with counterparties that have a credit rating of "investment grade" or better. The Authority and its counterparties require collateral posting for mark-to-market valuations that exceed established credit limits. At December 31, 2008, the Authority was required to post approximately

$229 million of counterparty collateral which is reflected as an asset and a corresponding restricted net asset. At December 31, 2007, the Authority held approximately $3 million of counterparty collateral.

Utility Plant and Property and Equipment

Additions to and replacements of utility plant are capitalized at original cost, which includes material, labor, indirect costs associated with an addition or replacement, plus an allowance for borrowed funds used during construction. The cost of renewals and betterments relating to units of property is added to utility plant. The cost of property replaced, retired or otherwise disposed of is deducted from utility plant and, generally, together with dismantling costs less any salvage, is charged to accumulated depreciation. The cost of repairs and minor renewals is charged to maintenance expense. Mass properties (such as poles, wire and meters) are accounted for on an average unit cost basis by year of installation. See note 6 for further discussion.

Property and equipment represents leasehold improvements, office equipment and furniture and fixtures of the Authority.

Fuel Inventory

Under the terms of the EMA and various Power Purchase Agreements, the Authority owns the fuel oil used in the generation of electricity at the facilities under contract to the Authority. Fuel inventory represents the value of low sulfur and internal combustion fuels that the Authority had on hand at each year-end in order to meet the demand requirements of these generating stations. Fuel inventory is valued using the weighted average cost method.

Fuel Derivatives

The Authority uses derivative instruments through its risk management program to protect its customers from market price fluctuations for the purchase of fuel oil, natural gas and electricity. The program is intended to identify exposures to movements in fuel and purchased power prices, quantify the impact of these exposures on the Authority's financial position, liquidity and the FPPCA and mitigate the exposures in line with the Authority's identified level of risk tolerance. The Authority actively manages the program in both upward and downward trending markets and adjusts its positions as necessary to mitigate the impact of changing market trends.

These instruments are recorded at fair value, see note 4 for further discussion. Any unrealized gains or losses are deferred until realized, in accordance with the provisions of the fuel and purchased power cost adjustment (FPPCA).

Material and Supplies Inventory

This represents Authority's share of material and supplies inventory needed to support the operation of the Nine Mile Point 2 (NMP2) nuclear power station.

Promissory Note Receivable

As part of the 1998 Merger, KeySpan issued promissory notes to the Authority of approximately $1.048 billion. As of December 31, 2008 and 2007, approximately $155 million remained outstanding, respectively. The fair market value of the note at December 31, 2008 and 2007 is approximately $153 million and $156 million, respectively. The interest rates and timing of principal and interest payments on the promissory notes from KeySpan are identical to the terms of certain LILCO indebtedness assumed by the Authority in the merger. KeySpan is required to make principal and interest payments to the Authority thirty days prior to the corresponding payment due dates.

Nonutility Property and Other Investments

The Authority's nonutility property and other investments consist primarily of the Nine Mile Point 2 decommissioning Trust Fund (the Trusts). At December 31, 2008 and 2007, the value of the Trusts was approximately $72 million and $71 million, respectively.

Other Long-Term Receivables

This represents the net present value of synergy savings due from National Grid resulting from their purchase of KeySpan as discussed in note 2. The Authority also recorded the net present value of a receivable related to the partial reimbursement of costs to construct the interconnection facilities related to the Neptune cable, which is to be paid to the Authority over a period of 20 years.

Deferred Unrealized Gains (Losses) – Financial Derivatives

The Authority uses derivative instruments to manage the cash flow impact of interest rate changes on its customer's, net assets and cash flows. Under the provisions of SFAS No. 133, *Accounting for Derivatives and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities,* and SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, the Authority is required to recognize the fair value of all derivative instruments as either an asset or liability on the balance sheet with an offsetting gain or loss also recognized on the balance sheet. In accordance with SFAS No. 157, *Fair Value Measurements*, the fair market values of the derivatives are provided by an independent third party. These standards permit the deferral of hedge gains and losses to Other Comprehensive Income, under specific hedge accounting provisions, until the hedged transaction is realized. However, the Authority is a governmental agency and, therefore, its financial statements are prepared in accordance with the provisions of the Governmental Accounting Standards Board, which do not provide for Other Comprehensive Income.

As the Authority is subject to the provisions of SFAS No. 71, all such gains and losses are deferred until realized which corresponds to the period they are recovered in rates.

The Authority has entered into several interest rate swap agreements with several counterparties to modify the effective interest rates on outstanding debt as detailed below (amounts in thousands):

					December 31, 2008	
	Notional amount	**Termination date**	**Type of swap**		**Fair value**	**Deferred unrealized loss**
$	150,000	4/1/2025	Floating to fixed		$ (32,907)	(32,907)
	100,000	4/1/2025	Floating to fixed		(21,938)	(21,938)
	587,225	12/1/2029	Floating to fixed	(a)	(305,389)	(221,409)
	110,715	9/1/2015	Floating to fixed		(17,072)	(17,072)
	502,090	8/15/2033	Basis swap	(b)	(60,184)	(46,568)
	251,045	8/15/2033	Basis swap	(c)	(30,092)	(23,284)
	251,045	8/15/2033	Basis swap	(c)	(30,092)	(23,284)
			Total		$ (497,674)	(386,462)

(a) The Authority received an upfront premium totaling approximately $106 million, of which $24.4 million represented reimbursement of administrative costs.

(b) The Authority received an upfront premium totaling approximately $17.5 million.

(c) The Authority received an upfront premium totaling approximately $8.75 million per swap.

Deferred Charges

Deferred charges consists of the unamortized balance of costs incurred to issue long-term debt which are amortized to interest expense over the life of the debt issuance to which they relate, and certain amounts incurred related to various energy projects, whose amortization is charged to fuel and purchased power costs over the period of benefit (the life of the related Power Purchase Agreement).

Regulatory Assets

Shoreham Property Tax Settlement (Settlement)

In January 2000, the Authority reached an agreement with Suffolk County, Town of Brookhaven, Shoreham-Wading River Central School District, Wading River Fire District and Shoreham-Wading River Library District (which was succeeded by the North Shore Library District) (collectively, the Suffolk Taxing Jurisdictions) and Nassau County regarding the over assessment of the Shoreham Nuclear Power Station. As required under the terms of the agreement, the Authority was required to issue $457.5 million of rebates and credits to customers over the five-year period which began May 29, 1998. In order to fund such rebates and credits, the Authority used the proceeds from the issuance in May 1998 of its Capital Appreciation Bonds, Series 1998A Electric System General Revenue Bonds totaling approximately $146 million and the issuance in May 2000 of approximately $325 million of Electric System General Revenue Bonds, Series 2000A.

As provided under the Settlement, beginning in June 2003, Suffolk County customers' bills include a surcharge (the Suffolk Surcharge) to be collected over the succeeding approximate 25 year period to repay the debt service and issuance costs on the bonds issued by the Authority to fund the Settlement as well as its cost of pre-funding certain rebates and credits.

As future rates will be established at a level sufficient to recover all such costs identified above, Authority recorded a regulatory asset in accordance with SFAS No. 71. The balance of the Shoreham property tax settlement regulatory asset as of December 31, 2008 and 2007 was approximately $557 million and $562 million, respectively. The balance represents rebates and credits issued to customers, costs of administering the program plus annual debt service costs on the bonds identified above less surcharges collected since 2003 totaling approximately $197 million.

Fuel and Purchased Power Costs Recoverable

The Authority's tariff includes a fuel recovery provision—the Fuel and Purchased Power Cost Adjustment (FPPCA) that provides for the recovery of fuel and purchased power costs in the period incurred, up to amounts sufficient to allow the Authority to earn a financial target of $75 million with a variance of $50 million above or below such amount in each year. Should fuel and purchased power prices change such that Authority would exceed or fail to meet its financial target, the FPPCA would be reduced or increased accordingly. In no event, however, may Authority recover an amount that exceeds its fuel and purchased power costs incurred.

Prior to 2004, the Authority deferred a portion of its excess fuel and purchased power costs and collected those costs in subsequent years. In order to transition to a current period recovery method, the Authority deferred, in 2003, approximately $365 million of unrecovered fuel and purchased power costs to be recovered over a 10-year period beginning January 1, 2004. As of December 31, 2008 and 2007, the uncollected balance of this deferral totaled approximately $183 million and $219 million, respectively.

In addition, the Authority uses derivative instruments to protect its customers, net assets and cash flows from significant price fluctuations for the purchase of fuel oil, natural gas and electricity. As the Authority is subject to the provisions of SFAS No. 71, unrealized gains and losses on such derivatives are deferred until realized.

Acquisition Adjustment

The acquisition adjustment, an intangible asset, represents the difference between the purchase price paid and the net assets acquired from LILCO and is being amortized and recovered through rates on a straight-line basis using a 35-year life.

Fair Values of Financial Instruments

Effective January 1, 2008, the Authority partially adopted SFAS No. 157, *Fair Value Measurements* (SFAS No. 157) prospectively, for applicable financial instruments that are measured at fair value on a recurring basis. For the Authority SFAS No. 157 establishes a framework for measuring fair value, and expands disclosures about fair value measurements. This statement applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. See note 4 for a further discussion on fair value of financial instruments.

Capitalized Lease Obligations

Capitalized lease obligations represent the net present value of various contracts for the capacity and/or energy of certain generation and transmission facilities in accordance with Emerging Issues Task Force No. 01-08, *Determining if Whether an Arrangement Contains a Lease*, and Statement of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases*. Upon satisfying the capitalization criteria, the net present value of the contract payments is included in both Utility Plant and Capital Lease Obligations.

The Authority recognizes in fuel and purchased power expense an amount equal to the contract payment of the capitalized leases discussed above, as allowed through the ratemaking process. The value of the asset and the obligation are reduced each month so that the balance sheet properly reflects the remaining value of the asset and obligation at each month end.

For a further discussion on the capitalization of capacity and/or energy contracts, see note 12.

Deferred Credits

Deferred credits primarily represents amounts received from KeySpan/National Grid (Grid benefits) as a result of certain renegotiated and other agreements with the Authority. The Authority's management is developing a plan to provide long-term customer benefits including: debt reduction; the creation of a fund for low-income seniors; and funding certain energy-related initiatives. Board approval will be required prior to implementation of these benefits; however, the Board did authorize $100 million of these Grid benefits to be used during 2009 as a reduction to the amounts recoverable from customers through the FPPCA.

Deferred Credits – Financial Derivatives

Represents the net amount that the Authority would be required to terminate these financial derivative instruments as of December 31, 2008 and 2007. The amount shown includes the unamortized balance of cash premiums received at the time of entering into these instruments. The Authority is amortizing such premiums ratably over the life of the instrument.

Claims and Damages

Losses arising from claims including workers' compensation claims, property damage, and general liability claims are partially self-insured. Storm losses are self-insured. Reserves for these claims and damages are based on, among other things, experience, and expected loss.

Revenues

Operating revenues are comprised of cycle billings for electric service rendered to customers, based on meter reads, and the accrual of revenues for electric service rendered to customers not billed at month-end. All other revenue not meeting this definition is reported as nonoperating revenue when service is rendered. For the years ended December 31, 2008 and 2007, the Authority received approximately 53% of its revenues from residential sales, 44% from sales to commercial and industrial customers, and the balance from sales to public authorities and municipalities.

Depreciation and Amortization

The provisions for depreciation for utility plant result from the application of straight-line rates by groups of depreciable properties in service. The rates are determined by age-life studies performed on depreciable properties. The average composite depreciation rate is 2.83% and 2.89% for December 31, 2008 and 2007, respectively.

Leasehold improvements are being amortized over the lesser of the life of the assets or the term of the lease, using the straight-line method. Property and equipment is being depreciated over its estimated useful life using the straight-line method.

The following estimated useful lives and capitalization thresholds are used for utility property:

Category	Useful life		Capitalization threshold
Generation – nuclear	39 – 46 years	$	200
Transmission and distribution	20 – 48 years		200
Common	4 – 41 years		200
Nuclear fuel in process and in reactor	6 years		—
Generation assets under capital lease	10 – 25 years		—

Payments-in-Lieu-of-Taxes

The Authority makes payments-in-lieu-of-taxes (PILOTS) for all operating taxes previously paid by LILCO, including gross income, gross earnings, property, Metropolitan Transportation Authority and certain taxes related to fuels used in utility operations. In addition, the Authority has entered into various PILOT arrangements for property it owns, upon which merchant generation and transmission is built.

Allowance for Borrowed Funds Used During Construction

The allowance for borrowed funds used during construction (AFUDC) is the net cost of borrowed funds used for construction purposes. AFUDC is not an item of current cash income. AFUDC is computed monthly on a portion of construction work in progress, and is shown as a net reduction in interest expense. The AFUDC rates were 4.49% and 5.03% for the years ended December 31, 2008 and 2007, respectively.

Income Taxes

The Authority is a political subdivision of the State of New York and, therefore, is exempt from Federal, state, and local income taxes.

Regulatory Liability – Fuel and Purchased Power Costs

Regulatory liabilities represent amounts that are expected to be refunded to customers through the ratemaking process. In accordance with the FPPCA, the Authority must return any FPPCA revenues it recovers in excess of the fuel and purchased power costs it incurs. Any such over recoveries are recognized as regulatory liabilities. In addition, in accordance with the FPPCA, unrealized mark-to-market gains on commodity derivatives are considered regulatory liabilities and returned to the customer in the period realized.

Asset Retirement Obligation

The Authority adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. An Asset Retirement Obligation (ARO) exists when there is a legal obligation associated with the retirement of a tangible long-lived asset that results from the acquisition, construction, or development and/or normal operation of the asset. The Authority, as an 18% owner of Nine Mile Point 2 (NMP2) Nuclear Power Station, has a legal obligation associated with its retirement. This obligation is offset by the capitalization of the asset which is included in "Utility plant and property and equipment, net". As of December 31, 2008 and 2007, the NMP2 asset retirement obligation totaled approximately $87 million and $86 million, respectively. The Authority maintains a trust for the decommissioning of NMP2. The decommissioning funds are reported at their fair market value and any unrealized gains or losses are deferred as a component of the ARO in accordance with SFAS No. 71 and have no impact to the Authority's net assets.

Additionally, FASB Summary of Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligation*s – an interpretation of SFAS No. 143, *Accounting for Asset Retirement Obligations*, clarifies that the term conditional asset retirement obligation as used in SFAS No. 143, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. As of December 31, 2008 and 2007, the asset retirement obligation for the Authority's utility assets totaled approximately $6 million.

A summary of the asset retirement obligation activity of the Authority for the years ended December 31, 2008 and 2007 is included below (amount in thousands):

		2008	2007
Asset retirement obligation:			
Beginning balance	$	91,541	85,086
Liabilities incurred		(733)	(2,756)
Changes in fair market value of decommissioning fund		(3,718)	4,138
Accretion expense		5,468	5,073
Balance at December 31	$	92,558	91,541

Long-Lived Assets

Long-lived assets, such as property, plant, and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that there is a significant unexpected decline in the service utility of a capital asset. The service utility of a capital asset is the usable capacity that at acquisition was expected to be used to provide service. An impairment is measured using one of three approaches that best reflects the decline in service utility. Assets to be disposed of and assets held for sale are reported at the lower of the carrying amount or fair value less costs to sell.

Use of Estimates

The accompanying financial statements were prepared in conformity with U.S. generally accepted accounting principles which require management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain prior year amounts have been reclassified in the financial statements to conform to the current year presentation.

Recent Accounting Pronouncements

Effective January 1, 2008, the Authority implemented Governmental Accounting Standards Board (GASB) No. 49, *Accounting and Reporting for Pollution Remediation Obligations*. GASB No. 49 was implemented prospectively and required no restatements to previously reported amounts or net assets.

In June 2008, the GASB issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. This statement provides guidance regarding how to identify, account for, and report intangible assets. GASB Statement No. 51 is effective for financial statements for periods beginning after June 15, 2009. The adoption of this statement is not expected to have a material impact on the Authority's financial position or net assets.

Also in June 2008, GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. This statement requires that the fair value of financial arrangements called "derivatives" or "derivative instruments" be reported in the financial statements of state and local governments. If a derivative effectively hedges (significantly reduces) an identified risk of rising or falling cash flows or fair values, then its annual fair value changes are deferred until the hedged transaction occurs or the derivative ceases to be effective. On the other hand, the annual change in the fair value of *other* derivatives should be reported immediately as investment income or loss. Additional information about derivatives should be disclosed in the notes to the financial statements, including identification of the risks to which hedging derivative instruments expose the Authority. GASB No. 53 is effective for financial statements for periods beginning after June 15, 2009. The Authority is currently assessing the financial statement impact of adopting this statement, but does not believe that its impact will be material.

(4) Fair Value of Financial Instruments

The Authority records its financial instruments related to continuing operations at fair value as shown below (amounts in thousands):

	Carrying amount/Fair value Year ended December 31, 2008	2007
Investments	$ 32,562	287,881
Nuclear Decommissioning Trust (included in nonutility plant and other investments)	71,623	70,848
Derivative assets:		
Fuel and purchased power derivatives	—	155,153
Derivative liabilities:		
Financial derivatives (Interest rate swaps)	(497,674)	(195,500)
Fuel and purchased power derivatives	(357,131)	—

The fair values of the financial instruments shown in the above table represent management's best estimates of the amounts that would be received to sell those assets or that would be paid to transfer those liabilities in an orderly transaction between market participants at that date. Those fair value measurements maximize the use of observable inputs. However, in situations where there is little, if any, market activity for the asset or liability at the measurement date, the fair value measurement reflects the Authority's own judgments about the assumptions that market participants would use in pricing the asset or liability. Those judgments are developed by the Authority, in consultation with its risk management advisors, based on the best information available in the circumstances.

The Authority obtained the estimated fair market value of long-term debt from its financial advisor. The financial advisor developed estimated market scales and prices for each type of debt security by taking into account credit ratings, bond insurance, call provisions and any other unique features.

(a) Adoption of SFAS No. 157

The Authority partially adopted SFAS No. 157 on January 1, 2008, for applicable financial instruments that are measured at fair value. This statement establishes a framework for measuring fair value, and expands disclosures about fair value measurements.

SFAS No. 157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three levels as follows:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Authority has the ability to access as of the measurement date. The financial instruments utilizing Level 1 inputs include active exchange-traded securities, exchange based derivatives, and investments in U.S. Treasuries.

- Level 2 – Inputs other than quoted prices included within Level 1 that are directly observable for the asset or liability or indirectly observable through corroboration with observable market data. The financial instruments utilizing Level 2 inputs include fixed income securities, exchange-based derivatives, and over-the-counter derivatives such as swaps, options and forwards.
- Level 3 – Unobservable inputs for the asset or liability only used when there is little, if any, market activity for the asset or liability at the measurement date. The financial instruments utilizing Level 3 inputs include infrequently traded, and nonexchange-based derivatives and commingled investment funds, and are measured using present value pricing models.

In accordance with SFAS No. 157, the Authority determines each items level in the fair value hierarchy in its entirety based on the lowest level input that is significant to its fair value measurement.

(b) Recurring Fair Value Measurements

The following table presents assets and liabilities measured and recorded at fair value on the Authority's balance sheet on a recurring basis and their level within the fair value hierarchy as of December 31, 2008 (amounts in thousands):

		Fair value December 31, 2008			
		Level 1	**Level 2**	**Level 3**	**Total**
Investments	$	—	32,562	—	32,562
Nuclear Decommissioning Trust Fund investments		27,590	35,086	8,947	71,623
Derivative liabilities:					
Financial derivatives		—	—	(497,674)	(497,674)
Fuel and purchased power derivatives		(135,928)	(148,211)	(72,992)	(357,131)
Total	$	(108,338)	(80,563)	(561,719)	(750,620)

The following table reconciles, for the period ended December 31, 2008, the beginning and ending balances for financial instruments that are recognized at fair value in the financial statements at least annually using significant unobservable inputs (amounts in thousands):

	Fair value measurement using significant unobservable inputs (Level 3)			
	NDT fund investments	**Financial derivatives**	**Fuel and purchased power derivatives**	**Total**
Beginning balance at January 1, 2008	$ —	(195,500)	52,103	(143,397)
Total realized/unrealized gains and (losses):				
Included in net assets (realized)	—	6,120	18,778	24,898
Included in decommissioning obligations	8,947	—	—	8,947
Included in regulatory asset/deferred unrealized loss	—	(332,433)	(82,559)	(414,992)
Purchase (sales), net	—	24,139	(60,143)	(36,004)
Transfer into Level 3	—	—	(1,171)	(1,171)
Ending balance at December 31, 2008	$ 8,947	(497,674)	(72,992)	(561,719)

Realized gains and losses included in net assets that are related to the financial derivatives are recorded as a component of interest expense, while those related to energy derivatives are recorded in fuel and purchased power expense.

Unrealized gains and losses related to derivatives are deferred until realized in accordance with how customer rates are set and determined.

(c) Nonderivative Fair Value Measurements

Debt securities are measured using quoted market prices multiplied by the quantity held when quoted market prices are available. If quoted market prices for those debt securities are not available, the fair value is determined using an income approach valuation technique (present value using the discount rate adjustment technique) that considers, among other things, interest rates, the issuer's credit spread, bond insurance, call provisions and illiquidity by sector and maturity. Commingled funds are maintained by investment companies and hold certain investments in accordance with a stated set of fund objectives. The fair values of commingled funds are based on net asset values per fund share (the unit of account), derived from the quoted prices in active markets of the underlying equity securities. However, because the shares in the commingled funds are not publicly quoted, not traded in an active market and are subject to certain restrictions regarding their purchase and sale, the commingled funds are categorized in Level 3.

(d) Derivative Fair Value Measurements

A portion of the Authority's fuel and purchased power derivative contracts are exchange-traded contracts with readily available quoted market prices. Another portion are non exchange-traded contracts valued using prices provided by external sources, primarily price quotations available through brokers or over-the-counter, on-line exchanges. The remainder of the fuel and purchased power as well as the financial derivative products represent contracts for which external sources or observable market quotes are not available. These contracts are valued based on various valuation techniques including but not limited to models internal to the Authority's energy risk management consultant based on extrapolation of observable market data with similar characteristics. Contracts valued with prices provided by models and other valuation techniques make up a significant portion of the total fair value of such derivative contracts. The Authority's policy is to not discount the fair value of each contract using a interest rate which represents default risk associated with a particular counterparty.

Under the guidance of FSP FIN 39-1, entities may choose to offset derivative positions in the financial statements against the fair value of the amounts recognized as cash collateral paid or received under those arrangements. The Authority has credit arrangements within various agreements to call on or pay additional collateral support. The Authority has chosen not to offset positions as defined in this FSP. As of December 31, 2008, the Authority recorded approximately $229 million of cash collateral paid and as of December 31, 2007, the Authority recorded approximately $3 million of cash collateral received on its balance sheet.

(5) Rate Matters

Under current New York State law, the Authority is empowered to set rates for electric service in the Service Area without the approval of the New York State Public Service Commission (PSC) or any other state regulatory body. However, the Authority has agreed, in connection with the approval of the 1998 merger of the Authority and LILCO (d/b/a LIPA) by the New York State Public Authorities Control Board (the PACB), that it will not impose any permanent increase, nor extend or re-establish any portion of a temporary rate increase, in average customer rates over a 12-month period in excess of 2.5% without approval of the PSC, following a full evidentiary hearing. Another of the PACB conditions requires that the Authority reduce average base rates within the service area by no less than 14% over a ten year period commencing on the date when the Authority began providing electric service, when measured against LILCO's base rates in effect on July 16, 1997 (excluding the impact of the Shoreham Property Tax Settlement, but adjusted to reflect emergency conditions and extraordinary unforeseeable events, including a precipitous rise in oil prices).

For purposes of determining compliance with the 2.5% and 14% PACB conditions described in the preceding paragraph, the Authority has interpreted the PACB conditions as allowing the exclusion of increases in the cost of electricity paid by the Authority's customers related to pass through adjustments, such as the FPPCA. Based on the Authority's interpretation of the PACB conditions, the Authority has achieved an average rate reduction of no less than 14% over the ten year period commencing on the date when the Authority began providing electric service. The Authority believes that the PACB conditions will not prevent the Authority from complying with its obligations under the Act. If the Authority's interpretation of the PACB conditions were determined to be incorrect, it may influence the timing and size of rate increases implemented and/or require (i) the modification of the plan to accelerate retirement of debt (ii) the withdrawal of funds from the Rate Stabilization Fund to avoid or minimize rate increases, (iii) various actions designed to increase the liquidity levels to address the timeliness of cost recovery or (iv) other action necessary to meet the conditions of the PACB approval or to comply with such legislation, as the case may be.

The LIPA Act requires that any bond resolution of the Authority contain a covenant that it will at all times maintain rates, fees or charges sufficient to pay the costs of operation and maintenance of facilities owned or operated by the Authority; PILOTS; renewals, replacements and capital additions; the principal of and interest on any obligations issued pursuant to such resolution as the same become due and payable, and to establish or maintain any reserves or other funds or accounts required or established by or pursuant to the terms of such resolution.

The Authority's tariff includes: (i) the FPPCA, to allow for adjustments to customers' bills to reflect changes in the cost of fuel and purchased power and related costs; (ii) a PILOTS recovery rider, which allows for rate adjustments to accommodate PILOTS; and (iii) a rider providing for the recovery of costs associated with the Shoreham Property Tax Settlement.

For a further discussion on rate matters, see note 13.

(6) Utility Plant and Property and Equipment

The following schedule summarizes the utility plant and property and equipment of the Authority as of December 31, 2008 (amounts in thousands):

		Beginning balance	Additions	Deletions	Ending balance
Capital assets, not being depreciated:					
Land	$	15,712	377	—	16,089
Retirement work in progress		24,809	18,930	9,580	34,159
Construction in progress		208,342	283,568	219,177	272,733
Total capital assets not being depreciated		248,863	302,875	228,757	322,981
Capital assets, being depreciated:					
Generation – nuclear		711,256	2,620	—	713,876
Transmission and distribution		2,866,566	205,547	24,437	3,047,676
Common		26,093	5,786	386	31,493
Nuclear fuel in process and in reactor		72,758	578	129	73,207
Office equipment, furniture, and leasehold improvements		3,966	641	—	4,607
Generation and transmission assets under capital lease		2,474,902	344,045	—	2,818,947
Total capital assets being depreciated		6,155,541	559,217	24,952	6,689,806
Less accumulated depreciation for:					
Generation – nuclear		211,247	22,277	—	233,524
Transmission and distribution		554,560	110,829	30,491	634,898
Common		6,547	2,606	386	8,767
Nuclear fuel in process and in reactor		54,177	5,906	—	60,083
Office equipment, furniture, and leasehold improvements		3,228	342	—	3,570
Generation assets under capital lease		253,905	93,030	—	346,935
Total accumulated depreciation		1,083,664	234,990	30,877	1,287,777
Net value of capital assets, being depreciated		5,071,877	324,227	(5,925)	5,402,029
Net value of all capital assets	$	5,320,740	627,102	222,832	5,725,010

In 2008, depreciation expense related to capital assets was approximately $134 million.

The following schedule summarizes the utility plant and property and equipment of the Authority as of December 31, 2007 (amounts in thousands):

	Beginning balance	Additions	Deletions	Ending balance
Capital assets, not being depreciated:				
Land	$ 12,851	2,861	—	15,712
Retirement work in progress	12,693	21,783	9,667	24,809
Construction in progress	176,061	286,649	254,368	208,342
Total capital assets not being depreciated	201,605	311,293	264,035	248,863
Capital assets, being depreciated:				
Generation – nuclear	711,340	3,086	3,170	711,256
Transmission and distribution	2,656,555	218,685	8,674	2,866,566
Common	25,254	997	158	26,093
Nuclear fuel in process and in reactor	59,371	13,387	—	72,758
Office equipment, furniture, and leasehold improvements	3,704	262	—	3,966
Generation and transmission assets under capital lease	1,347,829	1,127,073	—	2,474,902
Total capital assets being depreciated	4,804,053	1,363,490	12,002	6,155,541
Less accumulated depreciation for:				
Generation – nuclear	185,747	25,512	12	211,247
Transmission and distribution	462,698	106,627	14,765	554,560
Common	4,580	2,124	157	6,547
Nuclear fuel in process and in reactor	48,721	5,456	—	54,177
Office equipment, furniture, and leasehold improvements	2,928	300	—	3,228
Generation assets under capital lease	182,209	71,696	—	253,905
Total accumulated depreciation	886,883	211,715	14,934	1,083,664
Net value of capital assets, being depreciated	3,917,170	1,151,775	(2,932)	5,071,877
Net value of all capital assets	$ 4,118,775	1,463,068	261,103	5,320,740

In 2007, depreciation expense related to capital assets was approximately $133 million.

(7) Nine Mile Point Nuclear Power Station, Unit 2 (NMP2)

The Authority has an undivided 18% interest in Nine Mile Point 2 Nuclear Power Station (NMP2), located in Scriba, New York, operated by Constellation Energy Nuclear Group, LLC (Constellation) a division of Constellation Energy Group, Inc. (CEG).

The Authority's share of the rated capability of NMP2 is approximately 207 megawatts (MW). The net utility plant investment, excluding nuclear fuel, was approximately $480 million and $500 million as of December 31, 2008 and 2007, respectively. Generation from NMP2 and operating expenses incurred by NMP2 are shared by the Authority at its 18% ownership interest. The Authority is required to provide its share of financing for any capital additions to NMP2. Nuclear fuel costs associated with NMP2 are being amortized on the basis of the quantity of heat produced for the generation of electricity.

The Authority has an operating agreement for NMP2 with Constellation, which 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 Authority and Constellation have joint approval rights for the annual business plan, the annual budget and material changes to the budget. In addition to its involvement through the management committee, the Authority maintains on-site nuclear oversight representation to provide additional support to protect the Authority's interests.

The Nuclear Regulatory Commission (NRC) granted a license extension for the Nine Mile Point 2 facility extending the license through October 2046.

(a) Nuclear Plant Decommissioning

Provisions for decommissioning costs for NMP2 are based on a site-specific study performed in 1995, as updated by the Authority's engineering consultants. The Authority's share of the total decommissioning costs for both the contaminated and noncontaminated portions is estimated to be approximately $86 million and $81 million as of December 31, 2008 and 2007, respectively, and is included in the balance sheet as a component of the asset retirement obligation. The Authority maintains a nuclear decommissioning trust fund (NDT) for its share of the decommissioning costs of NMP2, which as of December 31, 2008 and 2007, had an approximate value of $72 million and $71 million, respectively. Through continued deposits and investment returns being maintained within these trusts, the Authority believes that the value of these trusts in 2046 will be sufficient to meet the Authority's expected decommissioning obligations.

(b) NMP2 Radioactive Waste

Constellation has contracted with the U.S. Department of Energy (DOE) for disposal of high-level radioactive waste (spent fuel) from NMP2. Despite a court order reaffirming the DOE's obligation to accept spent nuclear fuel by January 31, 1998, the DOE has forecasted the start of operations of its high-level radioactive waste repository to be no earlier than 2010. The Authority has been advised by Constellation that the NMP2 spent fuel storage pool has a capacity for spent fuel that is adequate until 2012. If additional DOE schedule slippage should occur, the storage for NMP2 spent fuel, either at the plant or some alternative location, may be required. The Authority reimburses Constellation for its 18% share of the disposal costs of spent fuel at a rate of $1.00 per megawatt hour of net generation, less a factor to account for transmission line losses. Such costs are included in the cost of fuel and purchased power.

(c) Nuclear Plant Insurance

Constellation procures public liability and property insurance for NMP2 and the Authority reimburses Constellation for its 18% share of those costs.

The Terrorism Risk Insurance Act (TRIA) of 2002 was signed into law in 2002, which was then extended by the Terrorism Risk Insurance Extension Act of 2005 and the Terrorism Risk Insurance Program Reauthorization Act of 2007. Under the TRIA, property and casualty insurance companies are required to offer insurance for losses resulting from Certified acts of terrorism. Certified acts of terrorism are determined by the Secretary of the Treasury, in concurrence with the Secretary of State and Attorney General, and primarily are based upon the occurrence of significant acts of international terrorism as part of an effort to coerce the civilian population of the United States or to influence the policy or affect the conduct of the United States Government by coercion. The nuclear property and accidental outage insurance programs, as discussed later in this section provide coverage for certified acts of terrorism.

Losses resulting from noncertified acts of terrorism are covered as a common occurrence, meaning that if noncertified terrorist acts occur against one or more commercial nuclear power plants insured by the insurer's of NMP2 within a 12-month period, such acts would be treated as one event and the owners of the currently licensed nuclear power plants in the United States would share one full limit of liability (currently $3.24 billion).

The Price Anderson Amendments Act mandates that nuclear power generators secure financial protection in the event of a nuclear accident. This protection must consist of two levels. The primary level provides liability insurance coverage of $300 million (the maximum amount available) in the event of a nuclear accident. If claims exceed that amount, a second level of protection is provided through a retrospective assessment of all licensed operating reactors. Currently, this "secondary financial protection" subjects each of the 104 presently licensed nuclear reactors in the United States to a retrospective assessment of up to $117.5 million for each nuclear incident, payable at a rate not to exceed $17.5 million per year. The Authority's interest in NMP2 could expose it to a maximum potential loss of $21.2 million per incident, through assessments of up to $3.2 million per year in the event of a serious nuclear accident at NMP2 or another licensed U.S. commercial nuclear reactor.

Constellation participates in the American Nuclear Insurers Master Worker Program that provides coverage for worker tort claims filed for radiation injuries. The policy provides a single industry aggregate limit of $200 million for occurrences of radiation injury claims against all those insured by this policy prior to January 1, 2003 and $300 million for occurrences of radiation injury claims against all those insured by this policy on or after January 1, 2003.

Constellation has also procured $500 million of primary nuclear property insurance and additional protection (including decontamination costs) of $1.25 billion of stand alone excess property insurance and a $1.0 billion shared excess policy for Nine Mile Point through the Nuclear Electric Insurance Limited (NEIL). Each member of NEIL, including the Authority, is also subject to retrospective premium adjustments in the event losses at other member facilities exceed accumulated reserves. For its share of NMP2, the Authority could be assessed up to approximately $3.3 million per loss.

The Authority has obtained insurance coverage from NEIL for the expense incurred in purchasing replacement power during prolonged accidental outages. Under this program, coverage would commence twelve weeks after any accidental outage, with reimbursement from NEIL at the rate of approximately $630,000 per week for the first 52 weeks, reduced to $504,000 per week for an additional 110 weeks for the purchase of replacement power, with a maximum limit of $88.2 million over a three-year period.

(8) Cash, and Cash Equivalents and Investments

(a) Authority

The Authority's investments are managed by an external investment manager and consist of two accounts; the Operating Fund and the Rate Stabilization Fund. The Operating Fund is managed to meet the liquidity needs of the Authority and the Rate Stabilization Fund is managed to maximize the return on investment. The Authority must maintain a minimum balance of $150 million in the Rate Stabilization Fund as required by the Authority's bond covenants. Additionally, the Authority is required to maintain compensating balances of $1.2 million.

The Authority's investment policy places limits on investments by issuer and by security type and addresses various risks described below. The Board of Trustees of the Authority may also specifically authorize, as it deems appropriate, other investments that are consistent with the Authority's investment objective. The Authority reviews its investment policy on an annual basis to ensure continued effectiveness.

Credit Risk

The Authority's permissible investments and related minimum credit ratings include U.S. Treasury and Federal Agency obligations (AAA), repurchase agreements (A-1), bankers' acceptances (AA- or Aa3), commercial paper (A1 or P-1), corporate notes (AA- or Aa3), master notes (AA- or Aa3) and asset backed securities (AAA), certificates of deposit (AA- or Aa3), mutual funds (AAAm or AAAm-G), investment contracts (AA- or Aa3, municipal obligations (AA- or Aa3), and variable rate notes (no credit rating limit). The Authority's investment policy prohibits investments involving complex derivatives, reverse repurchase agreements, and short selling and arbitrage related investment activity.

Concentration of Credit Risk

To address concentration of credit risk, the Authority's investment policies have established limits such that no more than 5% of the investment portfolio may be invested in the securities of any one issuer except as follows: (i) U.S. Treasury Obligations up to 100%, (ii) Each Federal agency up to 35%, (iii) repurchase agreements up to 10% or $50 million, (iv) mutual funds up to 50% maximum, and, (v) investment contracts up to 10%.

Custodial Credit Risk

The Authority believes that custodial credit risk related to its investments to be minimal as its guidelines stipulate that deposits and investments be held by a third-party custodian who may not otherwise be a counter-party to the transactions, and that all securities are free and clear of any lien and held in the name of the Authority.

Custodial credit risk for cash deposits is the risk that in the event of a bank failure, the Authority's deposits may not be returned. The Authority's policy to address this risk requires that the custodian or depository bank have a long-term credit rating of Aa3/AA. Custodians or depository banks not meeting this credit rating are required to provide collateral.

As of December 31, 2008 and 2007, the Authority had deposits of $12 million and $29 million respectively, of which approximately $8 million and $18 million were not collateralized or were uninsured. Uncollateralized balances were primarily the result of amounts temporarily held pending investment or disbursement and changes to FDIC limits. Collateral on the remaining deposits is held in an account for the Authority and ranges from 102% to 105% of the deposit balances.

Interest Rate Risk

The Authority's investment policy states that investments have maturities of 12 months or less, generally. Investment maturities may exceed 12 months provided that the maturity does not exceed the expected disbursement date of those funds, the total average portfolio maturity is one year or less and no individual maturity exceeds three years, with the exception of U.S. government obligations and investment contracts. The duration of the Authority's investment maturities are detailed in the chart below.

As of December 31, 2008 and 2007, the Authority had the following investments and maturities (amounts in thousands):

			Investment maturities		
Investment type	**2008 Fair value**	**Percent of portfolio**	**Less than 3 months**	**3 months to 1 year**	**Over 1 year**
Short-term discount notes:					
Commercial paper	$ 132,136	52%	$ 107,916	24,220	—
Federal agencies	4,992	2	—	4,992	—
Master notes/money markets	105,684	42	105,684	—	—
Corporate indentures	3,350	1	—	3,350	
Cash and collateralized deposits	11,558	3	11,558	—	—
Total	$ 257,720	100%	$ 225,158	32,562	—

Investment type	2007 Fair value	Percent of portfolio	Investment maturities Less than 3 months	3 months to 1 year	Over 1 year
Short-term discount notes:					
Commercial paper	$ 455,680	56%	$ 194,620	261,060	—
Federal agencies	239,969	29	220,155	19,814	—
Master notes/money markets	90,000	11	90,000	—	—
Cash and collateralized deposits	28,763	4	21,756	4,005	3,002
Total	$ 814,412	100%	$ 526,531	284,879	3,002

(b) LIPA

LIPA maintains a separate investment policy applicable to the long-term investments in the Nuclear Decommissioning Trust (NDT) which is held to meet LIPA's obligation with respect to the eventual decommission of LIPA's 18% interest in the Nine Mile Point 2 nuclear facility. LIPA guidelines detail permissible investments and portfolio restrictions. LIPA reviews its investment policy at least annually to ensure that the value in the trusts in 2046, (the year in which decommissioning activities are scheduled to begin) will be sufficient to meet its decommissioning obligations.

Credit Risk

LIPA's guidelines minimize risk by limiting permissible investments to include; obligations of the U.S. government and its agencies, corporate or other obligations with an A or better rating, mortgage obligations rated AA or higher, commercial paper with a rating of A1 or P1, certificates of deposit, Eurodollar certificates of deposit and bankers acceptances of domestic banks with A+ rating or better, short-term money market investment accounts that conform to the aforementioned permissible investments, portfolio funds of securities designed to replicate the overall market measured by the S&P 500 Index, and futures contracts on the S&P 500 Index. In 2004 the Board of Trustees authorized the use of equity investments as a permissible vehicle within this portfolio and limited the maximum exposure to 35%. The NDT investment portfolio must be rebalanced quarterly at plus or minus 5% for equity investments. The fixed income portfolio must maintain an average credit rating of AA or better with no more than 30% of the portfolio invested in notes and bonds rated A and no more than 20% of the portfolio invested in municipal securities.

Concentration of Credit Risk

To address this risk, LIPA's investment policies have established limits such that no more than 5% of the portfolio may be invested in the securities of any one issuer with the exception of U.S. government and its agencies securities. In addition, no more than 25% of the portfolio may be invested in securities of issuers in the same industry.

Custodial Credit Risk

LIPA does not have a policy relative to custodial credit risk of its deposits, however, as a practical matter, LIPA defers to the policies of the Authority, as discussed above.

Interest Rate Risk

Due to the long-term nature of the NDT asset, interest rate risk is managed to track the Barclays Capital U.S. government/Credit Bond Index. The portfolio's duration is required to fall within a range of 20% below the duration of the index and 10% above the duration of the index.

As of December 31, 2008 and 2007, LIPA had the following investments (amounts in thousands):

Investment type	2008 Fair value	Percent of portfolio
Corporate notes and bonds	$ 16,452	23%
Mortgage obligations	1,846	3
U.S. government and its agencies obligations	43,729	61
Municipal securities	89	—
Money market	560	1
Commingled equity fund	8,947	12
Total	$ 71,623	100%

Investment type	2007 Fair value	Percent of portfolio
Corporate notes and bonds	$ 14,529	21%
Mortgage obligations	6,367	9
U.S. government and its agencies obligations	35,680	50
Money market	34	—
Commingled equity fund	14,238	20
Total	$ 70,848	100%

The overall duration of the three individual accounts averaged 5.8 and 5.2 years at December 31, 2008 and 2007, respectively, and is within the limits described by LIPA's investment guidelines.

(9) Long-Term and Short-Term Debt

The Authority financed the cost of the merger and the refinancing of certain of LILCO's outstanding debt by issuing approximately $6.73 billion aggregate principal amount of Electric System General Revenue Bonds and Electric System Subordinated Revenue Bonds (collectively, the Bonds). In conjunction with the issuance of the Bonds, LIPA and the Authority entered into a Financing Agreement, whereby LIPA transferred to the Authority all of its right, title and interest in and to the revenues generated from the operation of the transmission and distribution system, including the right to collect and receive the same. In exchange for the transfer of these rights to the Authority, LIPA received the proceeds of the Bonds evidenced by a Promissory Note.

All of the Authority's bonds are secured by a Trust Estate as pledged under the Authority's Bond Resolution (the Resolution). The Trust Estate consists principally of the revenues generated by the operation of LIPA's transmission and distribution system and has been pledged by LIPA to the Authority.

The Authority's bond and note indebtedness and other long-term liabilities as of December 31, 2008 are comprised of the following obligations (amounts in thousands):

	Beginning balance	Accretion/ additions	Maturities	Refundings	Ending balance	Due within one year
Authority debt:						
Electric system general revenue bonds:						
Series 1998A	$ 443,552	7,324 (a)	82,955	—	367,921	86,610
Series 1998B	271,210	—	116,725	—	154,485	72,360
Series 2000A	366,057	21,245 (a)	—	—	387,302	—
Series 2001A	165,175	—	—	—	165,175	—
Series 2001B-K	500,000	—	—	425,000	75,000	—
Series 2001L-P	200,000	—	—	200,000	—	—
Series 2003A	37,675	—	17,780	—	19,895	19,895
Series 2003B	279,850	—	8,495	—	271,355	8,845
Series 2003C	256,000	—	—	—	256,000	—
Series 2003D-O	587,225	—	—	—	587,225	—
Series 2004A	200,000	—	—	—	200,000	—
Series 2006A	839,245	—	—	—	839,245	—
Series 2006B	96,955	—	—	—	96,955	—
Series 2006C	198,020	—	—	—	198,020	—
Series 2006D	328,180	—	615	—	327,565	640
Series 2006E	507,600	—	—	—	507,600	—
Series 2006F	514,495	—	—	—	514,495	—
Series 2008A	—	605,055	—	—	605,055	—
Series 2008B	—	149,340	—	—	149,340	—
Subtotal	5,791,239	782,964	226,570	625,000	5,722,633	188,350
Electric system subordinate revenue bonds:						
Series 1-3	525,000	—	—	—	525,000	—
Series 7	250,000	—	—	93,900	156,100	—
Series 8	104,725	—	—	—	104,725	53,020
Subtotal	879,725	—	—	93,900	785,825	53,020
LIPA debt:						
NYSERDA notes	155,420	—	—	—	155,420	—
Net unamortized discounts/ premiums and deferred amortization	2,899	(26,478)	—	4,565	(28,144)	
Total bonds and notes, net of unamortized discounts/ premiums	$ 6,829,283	756,486	226,570	723,465	6,635,734	241,370
Other long-term liabilities:						
Deferred credits	$ 331,075	16,351	48,354	—	299,072	—
Claims and damages	39,253	37,582	48,805	—	28,030	—
Capital lease obligation	2,220,997	344,045	93,030	—	2,472,012	102,844
Total other long-term liabilities	$ 2,591,325	397,978	190,189	—	2,799,114	102,844

(a) Represents accretion of capital appreciation bonds

The Authority's bond and note indebtedness and other long-term liabilities as of December 31, 2007 are comprised of the following obligations (amounts in thousands):

	Beginning balance	Accretion/ additions	Maturities	Refundings	Ending balance	Due within one year
Authority debt:						
Electric system general revenue bonds:						
Series 1998A	$ 515,108	7,554 (a)	79,110	—	443,552	82,955
Series 1998B	382,560	—	111,350	—	271,210	116,725
Series 2000A	345,980	20,077 (a)	—	—	366,057	—
Series 2001A	165,175	—	—	—	165,175	—
Series 2001B-K	500,000	—	—	—	500,000	150,000
Series 2001L-P	200,000	—	—	—	200,000	50,000
Series 2003A	53,470	—	15,795	—	37,675	17,780
Series 2003B	288,015	—	8,165	—	279,850	8,495
Series 2003C	256,000	—	—	—	256,000	—
Series 2003D-O	587,225	—	—	—	587,225	—
Series 2004A	200,000	—	—	—	200,000	—
Series 2006A	839,245	—	—	—	839,245	—
Series 2006B	96,955	—	—	—	96,955	—
Series 2006C	198,020	—	—	—	198,020	—
Series 2006D	328,770	—	590	—	328,180	615
Series 2006E	507,600	—	—	—	507,600	—
Series 2006F	518,090	—	3,595	—	514,495	—
Subtotal	5,982,213	27,631	218,605	—	5,791,239	426,570
Electric system subordinate revenue bonds:						
Series 1-3	525,000	—	—	—	525,000	—
Series 7	250,000	—	—	—	250,000	—
Series 8	104,725	—	—	—	104,725	—
Subtotal	879,725	—	—	—	879,725	—
LIPA debt:						
NYSERDA notes	155,420	—	—	—	155,420	—
Net unamortized discounts/ premiums and deferred amortization	7,537	(4,638)	—	—	2,899	—
Total bonds and notes, net of unamortized discounts/ premiums	$ 7,024,895	22,993	218,605	—	6,829,283	426,570
Other long-term liabilities:						
Deferred credits	$ 74,367	258,150	1,442	—	331,075	—
Claims and damages	31,639	40,552	32,938	—	39,253	—
Capital lease obligation	1,165,620	1,127,073	71,696	—	2,220,997	90,761
Total other long-term liabilities	$ 1,271,626	1,425,775	106,076	—	2,591,325	90,761

(a) Represents accretion of capital appreciation bonds

The Authority's schedule of capitalization for the years ended December 31, 2008 and 2007 is as follows (amounts in thousands):

	Maturity	Interest rate		Series		December 31 2008	December 31 2007
Electric system general:							
Revenue bonds:							
Serial bonds	Annually to 2011	4.625% to 5.500%	a	1998 A	$	233,060	303,045
Capital appreciation bonds	December 1, 2009 to 2028	4.800% to 5.300%	a	1998 A		134,861	140,507
Serial bonds	Annually to 2011	4.250% to 5.250%	a	1998 B		154,485	271,210
Capital appreciation bonds	June 1, 2010 to 2029	5.360% to 5.950%	a	2000 A		387,302	366,057
Serial bonds	September 1, 2013 to 2014	4.600% to 4.700%	a, d	2001 A		745	745
Term bonds	September 1, 2027 to 2029	5.000% to 5.125%	a, d	2001 A		164,430	164,430
Term bonds	May 1, 2033	3.550%	e	2001 B		75,000	75,000
Term bonds	May 1, 2033	3.600%	b	2001 C		—	25,000
Term bonds	May 1, 2033	3.700%	b	2001 D		—	50,000
Term bonds	May 1, 2033	3.700%	b	2001 E		—	50,000
Term bonds	May 1, 2033	3.800%	b	2001 F		—	50,000
Term bonds	May 1, 2033	4.050%	b	2001 G		—	50,000
Term bonds	May 1, 2033	5.000%	b	2001 H		—	50,000
Term bonds	May 1, 2033	4.150%	b	2001 I		—	50,000
Term bonds	May 1, 2033	4.000%	b	2001 J		—	50,000
Term bonds	May 1, 2033	4.000%	b	2001 K		—	50,000
Term bonds	May 1, 2033	3.450%	b	2001 M		—	50,000
Term bonds	May 1, 2033	4.000%	b	2001 N		—	50,000
Term bonds	May 1, 2033	3.500%	b	2001 O		—	50,000
Term bonds	May 1, 2033	4.000%	b	2001 P		—	50,000
Serial bonds	June 1, 2009	5.000%	a	2003 A		19,895	37,675
Serial bonds	December 1, 2009 to 2014	3.30% to 5.25%	a, d	2003 B		271,355	279,850
Serial bonds	September 1, 2013 to 2028	4.25% to 5.00%	a, d	2003 C		70,480	70,480
Term bonds	September 1, 2027 to 2033	5.00% to 5.25%	a, d	2003 C		185,520	185,520
Term bonds	December 1, 2029	3.34% to 3.40%	b, d	2003 D-H		293,625	293,625
Term bonds	December 1, 2029	3.00% to 4.50%	b, d	2003 I-O		293,600	293,600
Serial bonds	September 1, 2013 to 2025	3.80% to 4.875%	a, d	2004 A		33,900	33,900
Term bonds	September 1, 2029 to 2034	5.00% to 5.10%	a	2004 A		166,100	166,100
Serial bonds	December 1, 2016 to 2026	4.00% to 5.25%	a, d	2006A		839,245	839,245
Serial bonds	December 1, 2035	4.500%	a	2006B		4,240	4,240
Term bonds	December 1, 2035	5.000%	a	2006B		92,715	92,715
Term bonds	September 1, 2035	5.000%	a	2006C		198,020	198,020
Serial bonds	September 1, 2008 to 2025	4.00% to 5.00%	a, d	2006D		327,565	328,180
Serial bonds	December 1, 2017 to 2022	4.00% to 5.00%	a, d	2006E		507,600	507,600
Serial bonds	May 1, 2011 to 2028	4.00% to 5.00%	a	2006F		401,915	401,915
Term bonds	May 1, 2033	4.250%	a	2006F		112,580	112,580
Term bonds	May 1, 2033	5.50% to 6.00%	a	2008A		605,055	—
Term bonds	April 1, 2019 to 2033	5.25% to 5.75%	a	2008B		149,340	—
Electric system subordinated							
Revenue bonds	May 1, 2033	0.70% to 0.80%	c, d	Series 1A-3A		275,000	275,000
	May 1, 2033	1.00% to 1.10%	c, d	Series 1B-3B		250,000	250,000
	April 1, 2025	4.210%	a, d	Series 7		156,100	250,000
	April 1, 2009 to 2011	4.00% to 5.25%	a	Series 8		104,725	104,725
Total general and subordinated revenue bonds						6,508,458	6,670,964

	Maturity	Interest rate		Series	December 31 2008	December 31 2007
Commercial paper notes		0.70% to 1.60%	c	CP-1	$ 100,000	100,000
		0.80% to 0.85%	c	CP-3	100,000	—
					200,000	100,000
NYSERDA Financing notes:						
Pollution control revenue bonds	March 1, 2016	5.150%	a	1985 A,B	108,020	108,020
Electric facilities revenue bonds	November 1, 2023	5.300%	a	1993 B	29,600	29,600
	October 1, 2024	5.300%	a	1994 A	2,600	2,600
	August 1, 2025	5.300%	a	1995 A	15,200	15,200
Total NYSERDA financing notes					155,420	155,420
Unamortized premium and deferred amortization					(28,144)	2,899
Total long-term debt					6,835,734	6,929,283
Less current maturities and short-term debt					441,370	526,570
Long-term debt					6,394,364	6,402,713
Net assets					289,178	262,836
Total capitalization					$ 6,683,542	6,665,549

a Fixed rate.
b Variable rate (rate presented is as of December 31, 2007; amounts were redeemed during 2008); Auction rate mode reset at rates as determined in accordance with auction procedures.
c Variable rate (rate presented is as of December 31, 2008).
d Certain bonds of this series are subject to interest rate exchange agreements – please see note 4.
e Variable rate (rate presented is as of December 31, 2008); Auction rate mode reset at rates as determined in accordance with auction procedures.

The debt service requirements for the Authority's bonds (excluding commercial paper notes) as of December 31, 2008 are as follows (amounts in thousands):

Due		Principal	Interest	Net swap payments	Total
2009	$	241,370	293,949	7,097	542,416
2010		224,960	282,692	7,097	514,749
2011		238,100	272,608	7,097	517,805
2012		278,025	261,604	7,097	546,726
2013		176,060	251,336	7,097	434,493
2014 – 2018		1,070,845	1,182,491	14,554	2,267,890
2019 – 2023		1,188,370	972,666	15,832	2,176,868
2024 – 2028		1,463,455	717,151	16,858	2,197,464
2029 – 2033		1,881,845	345,972	1,279	2,229,096
2034 – 2036		317,245	23,944	—	341,189
		7,080,275	4,604,413	84,008	11,768,696
Unamortized discounts/premiums		(28,144)	—	—	(28,144)
Unaccreted interest on CABs		(416,397)	—	—	(416,397)
Total	$	6,635,734	4,604,413	84,008	11,324,155

Future debt service on the variable rate bonds and all future swap payments use an assumed rate of 4.00% through 2013 and 4.50% thereafter. For bonds subject to floating to fixed rate swap agreements, the "net swap payments" represent the fixed swap rate payment net of the assumed future variable rate swap receipts for each agreement. For bonds subject to fixed to floating rate swap agreements, the net swap payments represents the assumed future variable rate swap payments net of the fixed swap rate receipts.

(a) Electric System General Revenue Bonds

In March 2008, the Authority redeemed $200 million of its insured variable rate Electric System General Revenue Bonds to lower the risks associated with their marketability. The Authority used cash on hand to redeem these securities. The Authority had deferred charges totaling approximately $4 million associated with these bonds that were recognized as an extraordinary loss on early extinguishment of debt.

In May 2008, the Authority, in response to the market-wide disruption in the Auction Rate Securities market, converted $293.6 million of its Electric System General Revenue Bonds Series I through O from Auction Rate mode to weekly variable rate demand notes.

In October 2008, the Authority issued approximately $605 million Electric System General Revenue Bonds, Series 2008A. The proceeds of these fixed rate bonds, net of discount and cost of issuance, were used to replenish the treasury for funds used to finance the Authority's on-going capital program and the remainder was used to redeem $375 million of the Authority's insured auction rate securities in November 2008. This current refunding produced an approximate $58 million net present value savings. The 2008A bonds have an average life of 23 years and an all-in cost of 6.23%.

In November 2008, the Authority issued approximately $149 million Electric System General Revenue Bonds, Series 2008B. The proceeds of these fixed rate bonds, net of discount and cost of issuance were used to redeem $144 million of insured variable rate securities. This current refunding produced an approximate $12 million net present value savings. The 2008B bonds have an average life of 17 years and an all-in cost of 5.99%.

(b) Commercial Paper Notes

The Supplemental Bond Resolution authorizes the issuance of Commercial Paper Notes, Series CP-l through CP-3 (Notes) up to a maximum amount of $300 million. The aggregate principal amount of the Notes outstanding at any time may not exceed $300 million. In connection with the issuance of the Notes, the Authority has entered into a Letter of Credit and Reimbursement Agreement which was renegotiated in 2006. Under the terms of the renegotiated Letter of Credit and Reimbursement Agreement, $250 million expires June 15, 2011 and the remaining $50 million expires on December 15, 2015, subject to the right of early termination by the bank on June 15, 2012. The Notes do not have maturity dates of longer than 270 days from their date of issuance and as Notes mature, the Authority continually replaces them with additional Notes.

The Authority's short-term indebtedness as of December 31, 2008 and 2007 is comprised of the following obligations (amounts in thousands):

	2008			
	Beginning balance	Issuances	Retirements	Ending balance
Short-term debt – CP-1	$ 100,000	402,600	(402,600)	100,000
Short-term debt – CP-3	—	100,000	—	100,000
	$ 100,000	502,600	(402,600)	200,000

	2007			
	Beginning balance	Issuances	Retirements	Ending balance
Short-term debt – CP-1	$ 100,000	401,000	(401,000)	100,000
	$ 100,000	401,000	(401,000)	100,000

(c) Fair Values of Long-Term Debt

The fair values of the Authority's long-term debt as of December 31, 2008 and 2007 were as follows (amounts in thousands):

	Fair value December 31, 2008	Fair value December 31, 2007
Electric System General Revenue Bonds, Series 1998 A	$ 378,622	473,737
Electric System General Revenue Bonds, Series 1998 B	156,159	273,963
Electric System General Revenue Bonds, Series 2000 A	404,217	427,283
Electric System General Revenue Bonds, Series 2001 A	149,162	169,956
Electric System General Revenue Bonds, Series 2001 B	75,000	75,000
Electric System General Revenue Bonds, Series 2001 C through K	—	425,000
Electric System General Revenue Bonds, Series 2003 A	20,208	38,310
Electric System General Revenue Bonds, Series 2003 B	290,051	301,698
Electric System General Revenue Bonds, Series 2003 C	230,181	266,370
Electric System General Revenue Bonds, Series 2003 D through O	587,225	587,225
Electric System General Revenue Bonds, Series 2004 A	176,331	206,955
Electric System General Revenue Bonds, Series 2006 A	789,764	886,926
Electric System General Revenue Bonds, Series 2006 B	81,869	99,320
Electric System General Revenue Bonds, Series 2006 C	167,895	203,616
Electric System General Revenue Bonds, Series 2006 D	314,650	344,015
Electric System General Revenue Bonds, Series 2006 E	499,926	548,311
Electric System General Revenue Bonds, Series 2006 F	494,983	540,567
Electric System General Revenue Bonds, Series 2008 A	593,448	—
Electric System General Revenue Bonds, Series 2008 B	147,822	—
Electric System Subordinated Revenue Bonds, Series 1-3 and 1-6	525,000	525,000
Electric System Subordinated Revenue Bonds, Series 7	156,100	250,000
Electric System Subordinated Revenue Bonds, Series 8 (subseries A-C and F)	107,003	107,972
NYSERDA Notes	152,623	155,795
Total	$ 6,498,239	6,907,019

(10) Retirement Plans

The Authority participates in the New York State Employees' Retirement System (the System), which is a cost-sharing, multi-employer, and public employee retirement system. The plan benefits are provided under the provisions of the New York State Retirement and Social Security Law that are guaranteed by the State Constitution and may be amended only by the State Legislature. For full time employees, membership in and annual contributions to the System are required by the New York State Retirement and

Social Security Law. The System offers plans and benefits related to years of service and final average salary, and, effective July 17, 1998; all benefits generally vest after five years of accredited service.

Members of the System with less than 10 years of service or 10 years of membership contribute 3% of their gross salaries and the Authority pays the balance of the annual contributions for these employees. Effective October 1, 2000, members of the System with at least 10 years of service or membership no longer contribute 3% of their gross salaries. The Authority pays the entire amount of the annual contributions of these employees.

Under this plan, the Authority's required contributions and payments made to the System were approximately $713,000, $892,000, and $1.1 million, for the years ended December 31, 2008, 2007, and 2006, respectively. Contributions are made in accordance with funding requirements determined by the actuary of the System using the aggregate cost method.

The State of New York and the various local governmental units and agencies which participate in the Retirement System are jointly represented, and benefits for Authority employees are not separately computed. The New York State Employees' Retirement System issues a publicly available financial report. The report may be obtained from the New York State and Local Retirement Systems, 110 State Street, Albany, New York 12244.

(11) Postemployment Healthcare Plan

(a) Plan Description

The Authority is a participating employer in the New York State Health Insurance Program (NYSHIP) which is administered by the State of New York as an agent multiple employer defined benefit plan. Under the plan the Authority provides certain health care for eligible retired employees and their dependents. Article XI of the New York State Civil Service Law assigns the authority to NYSHIP to establish and amend the benefit provisions of the plans and to establish maximum obligations of the plan members to contribute to the plan. The Authority's Board is authorized to establish the contribution rates of its employees and retirees below those set by Civil Service Law. Participation in the NYSHIP program provides for employees and/or their dependents to become eligible for these benefits at 55 years of age when the employee has five years of State service. In calculating the five year service requirement, all of the employee's service need not be with the Authority, but may be a composite of New York State service elsewhere, with a minimum of one year with the Authority. Employees with no prior State service must work a minimum of five years before they and their dependents are eligible for the retirement medical benefits. Eligible retirees contribute 10% of the cost of single coverage and 25% the cost of dependent coverage for health insurance benefits. Approximately, 93 participants including 80 current employees, and 13 retired and/or spouses of retired employees were eligible to receive these benefits at December 31, 2008. NYSHIP does not issue a stand-alone financial report and NYSHIP's agent activities are included within the financial statements of the State of New York.

Effective January 1, 2007, the Authority prospectively implemented accrual accounting for its OPEB obligations, based on the approach provided in GASB Statement No. 45, *Accounting and Financial Reporting for Post Employment Benefits Other Than Pensions*, issued in June 2004. Prior to adoption, OPEB provisions were recorded on a pay-as-you-go basis. The first actuarial valuation date is January 1, 2007, and the Authority had not previously recognized an OPEB liability. Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events in the future. Examples include assumptions about employment mortality and the healthcare cost trend. Amounts determined regarding the annual required contributions of the employer are subject to continual revision as actual results are compared to past expectations and new estimates are made about the future.

The Authority's annual OPEB cost for the plan is calculated based on the Annual Required Contribution (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement No. 45. GASB 45 does not require that an employer actually contribute its ARC, but allows for the financing of these benefits on a pay-as-you-go basis. Since the Authority expensed the entire prior service cost in 2007, the ARC in future periods represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year, actuarial assumptions and plan changes, and interest on the unfunded actuarial liability. Amounts "required" but not actually set aside to pay for these benefits are accumulated as part of the Net OPEB Obligation, and as the Authority has not actually funded the "required" amount, future valuations may produce larger ARCs. The current period ARC is approximately $13.7 million as detailed in the chart below.

(b) Funding

The contribution requirements (funding) of the Authority's Net OPEB obligation are at the discretion of management and the Board of Trustees. The Net OPEB obligation continues to be paid on a pay-as-you-go basis. The Authority has not funded a qualified trust or its equivalent.

(c) Actuarial Methods and Assumption

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation. The actuarial methods and assumptions used include techniques that are designed to reduce short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations. In the 2007 actuarial valuation, the projected unit credit actuarial cost method was used. The actuarial assumptions included a 4.5% investment rate of return (net of administrative expenses) and an annual healthcare cost trend rate of 10% (net of administrative expenses) including inflation, declining 1% each year to an ultimate trend rate of 5%. Both rates include a 3% inflation assumption.

(d) OPEB Status and Funding Progress

The OPEB obligation, which is included in deferred credits, and the funded status of the plan as of December 31, 2008 is as follows (amounts in thousands):

		2008	2007
Annual OPEB cost:			
Annual required contribution (ARC):			
Normal cost	$	1,219	1,161
Amortization payment		12,050	10,442
Interest to the end of the year		597	522
Total		13,866	12,125
ARC adjustment		(12,604)	—
Interest on net OPEB obligation		543	—
Annual OPEB cost	$	1,805	12,125
Net OPEB obligation:			
Net OPEB obligation at beginning of fiscal year	$	12,061	—
Annual required contribution:			
Annual OPEB cost		1,805	12,125
Employer contribution:			
Payments for retirees during the year		135	64
To a trust		—	—
Total		135	64
Net OPEB obligation at end of fiscal year	$	13,731	12,061

Actuarial valuation date		July 1, 2007
Actuarial value of assets	$	—
Accrued actuarial liability (AAL)		11,224
Unfunded AAL		11,224
Funded ratio		—%
Covered payroll	$	9,859
UAAL as % covered payroll		113.8%

(12) Commitments and Contingencies

(a) Power Supply Agreement (PSA)

The PSA provides for the sales to the Authority by KeySpan of all of the capacity, energy and, ancillary service output from the oil and gas-fire generating plants on Long Island formerly owned by LILCO. Such sales of capacity and energy are made at cost-based wholesale rates regulated by the Federal Energy Regulatory Commission (FERC). The rates may be modified in accordance with the terms of the PSA for: i) agreed upon labor and expense indices applied to the base year; ii) a return of and return on net capital additions, which require approval by the Authority; and iii) reasonably incurred expenses that are outside of the control of KeySpan. The PSA rates were reset in 2004, and, in accordance with the agreement, will be reset again in 2009. Between 2004 and 2008, the rates were adjusted annually in accordance with the formula established in the PSA. The annual capacity charge in 2008 and 2007 was approximately $363 million and $346 million, respectively, and the variable charge remained unchanged at $0.90/Mwh of electric power generated by the plants.

The PSA provides incentives and penalties for up to $4 million annually to maintain the output capability of the facilities, as measured by annual industry-standard tests of operating capability, and to maintain/or make capital improvements which benefit plant availability. The performance incentives averaged approximately $4 million in 2008 and 2007.

(b) Purchased Power and Transmission Agreements Assumed from LILCO

As a result of the merger with LILCO, the Authority became party to contracts with numerous Independent Power Producers (IPPs) and the New York Power Authority (NYPA) for electric generating capacity. Certain of these agreements have been renegotiated by the Authority or modified to comply with market rules instituted by the New York Independent System Operator (NYISO).

Under the terms of the 2004 amended agreement with NYPA, which will expire in April 2020, the Authority may purchase up to 100% of the electric energy produced at the NYPA facility located within the service territory at Holtsville, New York. The Authority is required to reimburse NYPA for the minimum debt service payments and to make fixed nonenergy payments associated with operating and maintaining the plant.

The Authority also has a contract with NYPA for firm transmission (wheeling) capacity in connection with a transmission cable that was constructed, in part, for the benefit of the Authority. With the inception of the NYISO on November 18, 1999, this contract was provided with “grandfathered rights” status. Grandfathered rights allow the contract parties to continue business as they did prior to the implementation of the NYISO. That is, the concept of firm physical transmission service continues. The Authority was provided with the opportunity to convert its grandfathered rights for Existing Transmission Agreements (ETAs) into Transmission Congestion Contracts (TCCs). TCCs provide an alternative to physical transmission reservations, which were required to move energy from point A to point B prior to the NYISO. Under the rules of the NYISO, energy can be moved from point A to point B without a transmission reservation however, the entity moving such energy is required to pay a tolling fee to the owner of the TCC. This tolling fee is called transmission congestion and is set by the NYISO.

Although the Authority has converted its ETA's into TCCs, the Authority will continue to pay all transmission charges per the ETAs, which expire in 2020. In return, the Authority has the right to receive revenues from congestion charges. All such charges and revenue associated with the TCCs are considered components of or reductions to fuel and purchased power costs.

With respect to contracts entered into with the IPPs, the Authority is obligated to purchase all the energy they make available to the Authority. However, LIPA has no obligation to the IPPs if they fail to deliver energy.

As provided by the Authority's tariff, the costs of all of the facilities noted above except for those subject to the PSA will be includable in the calculation of Fuel and Purchased Power Cost. As such, these costs will be recoverable through the FPPCA.

The following table represents the Authority's commitments under the purchased power and transmission contracts assumed from LILCO, as renegotiated or modified (amounts in thousands):

		PPA	Firm transmission	IPPs*	Total
Years ended:					
2009	$	32,168	20,770	138,100	191,038
2010		32,424	20,780	85,000	138,204
2011		32,837	20,860	81,700	135,397
2012		33,155	21,680	84,200	139,035
2013		33,427	21,120	65,900	120,447
2014 through 2018		167,711	106,790	129,400	403,901
2019 through 2023		44,723	64,510	—	109,233
2024 through 2028		—	23,100	—	23,100
2029 through 2033		—	24,660	—	24,660
2034		—	4,951	—	4,951
Total	$	376,445	329,221	584,300	1,289,966

* Assumes full performance by NYPA and the IPPs.

(c) Additional Power Supplies Agreements

The Authority has entered into Power Purchase agreements (PPAs) with several private companies to develop and operate generating units at sites throughout Long Island. Generally, the PPAs provide for the Authority to purchase 100% of the capacity (and associated energy as needed), for the term of each contract, which vary in duration up to 30 years from contract initiation date.

In accordance with the provisions of FASB Emerging Issues Task Force Issue No. 01-8, *Determining Whether an Arrangements is a Lease*, and SFAS No. 13, *Accounting for Leases*, all but one of the generating units, have been accounted for as capitalized lease obligations, whereas the one remaining unit, is accounted for as operating leases.

In April 2007, the Authority began purchasing up to 346 MW of additional capacity and varying amounts of energy from a portfolio of facilities located in New England. This power is transmitted to Long Island via an undersea high voltage cable running between Connecticut and Long Island pursuant to a long-term firm transmission capacity purchase agreement.

The following table represents the minimum payments under various capacity and/or energy contracts (amounts in thousands):

		Additional Power Supply agreements	
		Capitalized leases	**Other**
Minimum lease/rental payments:			
2009	$	231,283	1,813
2010		230,699	1,818
2011		231,130	1,824
2012		232,299	1,830
2013		233,116	1,836
2014 through 2018		1,133,255	9,276
2019 through 2023		841,818	9,446
2024 through 2028		539,917	9,635
2029 through 2033		92,860	9,842
2034		—	663
Total		3,766,377	47,983
Less imputed interest		1,294,365	—
Net present value	$	2,472,012	47,983

Furthermore, in 2005, the Authority entered into an agreement to purchase 660 MW of transmission capacity via an undersea high voltage cable between New Jersey and New York. The cable was completed in 2007 thus permitting the import of 660 MW of power and energy from the Pennsylvania, New Jersey and Maryland markets (PJM-ISO). The Authority has entered into an agreement with the owners of a facility located in PJM-ISO to secure a long-term power capacity supply contract. This agreement will commence on June 1, 2010.

The Authority also entered into an agreement to acquire 286 MW from a 326 MW plant which is being constructed on Long Island and is expected to be in operation no later than the summer of 2009.

During 2008, the Authority entered into an agreement to purchase renewable energy to be delivered from off-island sources. These purchases are expected to begin in 2009.

(d) Office Lease

The Authority entered into an office lease agreement through January 31, 2011. The future minimum payments under the lease are as follows (amounts in thousands):

Year ended December 31:		
2009	$	1,494
2010		1,550
2011		129
Total	$	3,173

Rental expense for the office lease amounted to approximately $1.6 million for the years ended December 31, 2008 and 2007.

(e) Insurance Programs

The Authority's insurance program is comprised of a combination of policies from major insurance companies, self-insurance and contractual transfer of liability, including naming the Authority as an additional insured and indemnification.

The Authority has purchased insurance from the New York State Insurance Fund to provide against claims arising from workers' compensation. Liability related to construction projects and similar risks is transferred through contractual indemnification and compliance with Authority insurance requirements. The Authority also has various insurance coverages on its interest in Nine Mile Point Nuclear Power Station, Unit 2 as disclosed in detail in note 7.

The Authority is self insured for property damage to its transmission and distribution system and up to $3 million for general liability, including automobile liability. The Authority purchased commercially available excess general liability insurance for claims above the $3 million self insurance provision.

(13) Legal Proceedings

(a) Authority to Set Rates

Under current State law, the Authority is empowered to set rates for electric service in the Service Area without being required by law to obtain the approval of the PSC or any other State regulatory body. However, the Authority agreed, in connection with the approval of the LIPA/LILCO Merger by the PACB in 1997, that it would not impose any permanent increase, nor extend or reestablish any portion of a temporary rate increase, in average customer rates over a 12-month period in excess of 2.5% without approval of the PSC, following a full evidentiary hearing.

Legislation was unanimously passed by the New York State Legislature in June 2008, which would amend the LIPA Act and the State Public Service Law to require the approval by the PSC of an increase in LIPA's average customer rates exceeding 2.5% over a 12-month period or to extend or reestablish any portion of a temporary rate increase exceeding 2.5%. Were such legislation to become law, the Authority would have to notify the PSC of any proposed rate increase, extension or re-establishment exceeding 2.5% over a 12-month period, and an approval of any such the Authority request by the PSC would require a full evidentiary hearing. The proposed legislation was vetoed on September 4, 2008 by Governor Paterson and therefore has not been enacted into law. The Authority cannot predict whether other similar legislation may be introduced and acted upon in the future.

(b) Environmental

In connection with the LIPA/LILCO Merger (the Merger), KeySpan and the Authority entered into Liabilities Undertaking and Indemnification Agreements which, when taken together, provide, generally, that environmental liabilities will be divided between KeySpan and the Authority on the basis of whether they relate to assets transferred to KeySpan or retained by the Authority as part of the Merger. In addition, to clarify and supplement these agreements, KeySpan and the Authority also entered into an agreement to allocate between them certain liabilities, including environmental liabilities, arising from events occurring prior to the Merger and relating to the business and operations to be conducted by the Authority after the Merger (the Retained Business) and to the business and operations to be conducted by KeySpan after the Merger (the Transferred Business).

National Grid is responsible for all liabilities arising from all manufactured gas plant operations (MGP Sites), including those currently or formerly operated by KeySpan or any of its predecessors, whether or not such MGP Sites related to the Transferred Business or the Retained Business. In addition, KeySpan is liable for all environmental liabilities traceable to the Transferred Business and certain scheduled environmental liabilities. Environmental liabilities that arise from the nonnuclear generating business may be recoverable by KeySpan as part of the capacity charge under the PSA. The Authority is responsible for all environmental liabilities traceable to the Retained Business and certain scheduled environmental liabilities.

Environmental liabilities other than those related to MGP sites that existed as of the date of the Merger that are untraceable, including untraceable liabilities that arise out of common and/or shared services have been allocated 53.6% to LIPA and 46.4% to KeySpan, as provided for in the Merger.

(c) Environmental Matters Retained by the Authority

Superfund Sites – Under Section 107(a) of the federal Comprehensive Environmental Response, Compensation and Liability Act (CERCLA, also commonly referred to as the Superfund Legislation), parties who generated or arranged for disposal of hazardous substances are liable for costs incurred by the Environmental Protection Agency (EPA) or others who are responding to a release or threat of release of the hazardous substances.

Metal Bank – In December 1997, the EPA issued its Record of Decision (ROD), in connection with the remediation of a licensed disposal site located in Philadelphia, Pennsylvania, and operated by Metal Bank of America. In the ROD, the EPA estimated that the present cost of the selected remedy for the site is $17.3 million. In June 1998, the EPA issued a unilateral administrative order to 13 Potential Responsible Parties (PRPs), including the Authority, for the remedial design and for remedial action at the site. Under a PRP participation agreement, the Authority is responsible for 7.95% of the costs associated with implementing the remedy. The Authority has recorded a liability equal to its estimated cost representing its estimated share of the additional cost to remediate this site.

The liability phase of the litigation against owners and operators was tried in the fall of 2002, which resulted in a finding of liability against Metal Bank in January 2003. In May, 2003, the Metal Bank parties filed for Federal Bankruptcy protection under Chapter 11, resulting in a reorganization plan that obligated the emerging entity to fund $13.25 million of the final remedy with no further obligation. After mediation, a final global settlement was negotiated, which did not require any monetary payment from the PRPs, but required the collective payment of $9.6 million from two of the owners. In 2005, Final Consent Decrees were published for public comment, the public hearing was held, and the Federal Judge approved the Decrees, making all the settlement terms final, and formally ending the litigation. The Utilities Group (of which the Authority is a party) submitted a Revised Remedial Design Plan and a Revised Remedial Work Plan to the EPA. The plans were approved and remedial work began. After the EPA noticed oil sheens on the Delaware River, meetings were held and modifications to the Plan were made.

As a result of the entry of the Consent Decrees, the Utilities Group were paid approximately $4 million by the defendant owners, which the Utilities Group currently holds in investment accounts and payments toward the $13.25 million remediation funds have commenced by the Union Trust, as the successor in bankruptcy to Metal Bank.

In January of 2008, EPA provided a draft agreement providing for transfer of the balance of the Union Trust's funds to EPA-controlled accounts. This was prompted by a request from the Union Trust's parent to EPA to make use of the funds for other projects. EPA and the Utilities Group agree that the funds should be moved to ensure that they are available for the project. The Utilities Group examined the agreement for consistency with the Group's consent decree with EPA and the bankruptcy settlement documents.

PCB Treatment Inc. – LILCO has also been named a PRP for disposal sites in Kansas City, Kansas and Kansas City, Missouri. The two sites were used by a company named PCB Treatment, Inc. from 1982 until 1987 for the storage, processing, and treatment of electric equipment, oils and other materials containing Polychlorinated Biphenyls (PCBs). According to the EPA, the buildings and certain soil areas outside the buildings were contaminated with PCBs. Certain of the PRPs, including LILCO and several other utilities, formed a group, signed a consent order and investigated environmental conditions at these properties. The work required under this consent order has been completed, and the PRPs, including the Authority, signed a second consent order that obligates them to clean up and restore the two contaminated properties. The Authority has been determined to be responsible for less than 1% of the materials that were shipped to this site. This remedial work has been completed and the site has been formally closed out by the EPA. The PRP Group is currently in the process of terminating the Steering Committee and distributing surplus funds to the PRP Group.

(d) Environmental Matters Which may be Recoverable from the Authority by KeySpan Through the PSA

Asharoken – In March 1996, the Village of Asharoken (the Village) filed a lawsuit against LILCO in the New York Supreme Court, Suffolk County (Incorporated Village of Asharoken, New York, et al. v. Long Island Lighting Company). Although the Village's negligence claims were dismissed, the nuisance causes of action remained at issue. Specifically, the Village sought injunctive relief based upon allegations that the design and construction of the Northport Power Plant upset the littoral drift of sand in the area, thereby causing beach erosion. In a related matter, certain individual residents of the Village commenced an action in New York Supreme Court Suffolk County seeking similar relief (Sbarro v. Long Island Lighting Company). The cases were tried jointly before a judge without a jury. The trial was completed in December 2002 and the parties filed post-trial briefs in March 2003. The judge dismissed the case after reviewing the existing and supplemental record. The Village subsequently filed a notice of appeal of this decision and, on December 22, 2008, the Appellate Division unanimously affirmed the judge's dismissal of the Village of Asharoken's lawsuit against LILCO. While not related to the lawsuit, the U.S. Army Corps of Engineers as a condition of an existing permit may impose requirements on National Grid to deposit additional sand on properties within the Village. Liability, if any, resulting from the U.S. Army Corps orders cannot yet be determined. However, the Authority does not believe that either will have a material adverse effect on its financial position, cash flows or results of operations.

(e) Asbestos Proceedings

Litigation is pending in State Court against the Authority, LILCO, KeySpan and various other defendants, involving thousands of plaintiffs seeking damages for personal injuries or wrongful death allegedly caused by exposure to asbestos. The cases for which the Authority may have financial responsibility involve employees of various contractors and subcontractors engaged in the construction or renovation of one or more of LILCO's six major power plants. These cases include extraordinarily large damage claims, which have historically proven to be excessive. The actual aggregate amount paid to plaintiffs alleging exposure to asbestos at LILCO power plants over the years has not been material to the Authority. Due to the nature of how these cases are litigated, it is difficult to determine how many of the remaining cases that have been filed (or of those that will be filed in the future) involve plaintiffs who were exposed to asbestos at any of the LILCO power plants. Based upon experience, it is likely that the Authority will have financial responsibility in a significantly smaller percentage of cases than are currently pending (or which will be filed in the future) involving plaintiffs who allege exposure to asbestos at any of the LILCO power plants.

(f) Future Environmental Compliance Obligations

The Authority, through its contractual obligations to KeySpan under the PSA and the MSA, and other Independent Power Producers and transmission cable operators, under various power purchase agreements (PPAs), may be subject to the cost of compliance with various current and potential future environmental regulations as promulgated by the federal government and by state and local governments with respect to environmental matters, such as emission of air pollutants, greenhouse gases, cooling water for generation, the handling and disposal of toxic substances and hazardous and solid wastes, the handling and use of chemical products, and the handling and storage of fossil fuels. Electric utility companies generally use or generate a range of pollutants, potentially hazardous products and by-products that are the focus of such regulation. The Authority is also subject to state laws regarding environmental approval and certification of proposed major transmission facilities.

The Clean Air Act Amendments of 1990 (1990 Amendments) limit emissions of sulfur dioxide (SO2), nitrogen oxides (NOx) and other pollutants. The U.S. Environmental Protection Agency (EPA) allocates annual sulfur dioxide emissions allowances to each of the PSA units based on historical output. NOx emissions are regulated on a regional level through the NOx State Implementation Plan Call, and are also controlled through allowance allocations. Generating units under the various PPAs and the PSA units are expected to continue to achieve cost effective compliance with these emission control requirements through the use of allocated allowances, capital expenditures, the use of natural gas fuel, and/or the purchase of emission allowances when necessary. Generating units may be required to purchase additional allowances above the PSA unit allocations, or make other expenditures, based on changes in fuel prices or more restrictive regulations.

In 2003 the State of New York promulgated separate regulations that would further limit SO2 and NOx beginning in 2004. The PSA units have been complying with the NOx requirements without additional material expenditures, and lower sulfur fuel (0.7% S) has been used at Northport and Port Jefferson to meet the SO2 regulations. No additional reduction in fuel sulfur or allowance purchase is expected to be needed to comply with this regulation. In 2003 the State of New York promulgated separate regulations that would further limit SO2 and NOx beginning in 2004. The PSA units have been complying with the NOx requirements without additional material expenditures, and lower sulfur fuel (0.7% S) has been used at Northport and Port Jefferson to meet the SO2 regulations. No additional reduction in fuel sulfur is expected to be needed to comply with this regulation. In 2005, the State of New York adopted additional SO2 and NOx limits pursuant to its acid deposition program.

In March 2005, the Federal Clean Air Interstate Rule (CAIR) was promulgated, requiring further reduction of SO2 and NOx emissions to reduce ozone and fine particulate matter formation in the eastern United States. The State of New York has adopted rules to carry out this program in which compliance requirements for NOx reduction began in 2009. As part of the National Grid/LIPA Agreement, National Grid, subject to the terms of the agreement, plans on installing additional NOx controls on all the units at Northport and Port Jefferson, to help further reduce NOx emissions. The CAIR rules will require the surrender of two SO2 allowances for each ton of SO2 emissions beginning in 2010 and 2.86 allowances per ton of emission in 2015 and beyond. Future projections indicate that the PSA units should be able to comply with the more restrictive surrender ratios by using their existing annual allowance allocations. Though not expected to be necessary, further SO2 reductions, if needed for CAIR compliance, could be achieved through the use of lower sulfur fuels (lower percent sulfur oil, natural gas) or the purchase and use of additional emission allowances. In response to a lawsuit filed by states, environmental groups and industry, on July 11, 2008, the United States Court of Appeals for the District of Columbia issued a decision finding fatal flaws with the

CAIR rule, and thus vacated the rule in its entirety and remanded it back to EPA. That decision raised concerns about the price for NOx and SO2 allowances and the states' strategies for addressing their ozone and fine particulate matter State Implementation Plans. Pursuant to a petition for rehearing, on December 23, 2008, the D.C. Circuit modified its decision, remanding without vacatur EPA's CAIR rule. While the first phase for NOx compliance is now in effect, EPA will need to revise its CAIR program consistent with the Court's decision, and it is possible that the new Administration will use this rulemaking effort to reduce the overall SO2 and NOx caps further.

Another rule issued in March of 2005, the Clean Air Mercury Rule (CAMR) had set new limits for mercury emissions from coal-fueled plants and does not apply to the PSA units. The rulemaking process considered regulating nickel emissions from oil fired units which would have affected some PSA units and units under PPAs that burn oil, but ultimately did not. On February 8, 2008, the D.C. Circuit vacated the CAMR regulation and remanded the regulation back to EPA. Accordingly, it can not be determined how EPA will redevelop the regulation or what, if any, future compliance obligations will be imposed on generating units burning residual fuel oil. Any new regulations designed to reduce mercury emissions from coal plants could impact the pricing of purchased power.

The State of New York is also in the process of developing its eight-hour ozone and fine particulate matter State Implementation Plans. While not yet proposed, the State intends to revise its existing regulations to require that sources of particulate matter sized 2.5 microns or smaller (PM2.5) with the potential to emit 100 tons per year will be required to perform case-by-case Reasonable Available Control Technology (RACT) analyses, and the State might also develop more stringent NOx RACT requirements. In addition, in 2007, member states of the Ozone Transport Commission determined that additional NOx emission reductions would be required from electric generating facilities during High Electric Demand Days (HEDD). Therefore, it is anticipated that additional NOx controls will be required on some of the generating stations under contract to the Authority. Installation of water injection NOx control systems at National Grid's Holtsville combustion turbines is currently ongoing for 5 of the ten units. The system is planned to be operational by May 2009. Installation of the water injection on the remaining units is anticipated by May 2011. The estimated capital cost is approximately $8 million.

Section 185 of the Clean Air Act requires states to collect fees from major sources in those areas defined as a severe or extreme ozone nonattainment area that fail to come into compliance with the ozone National Ambient Air Quality Standards (NAAQS) by the dates provided under the Clean Air Act. Based on EPA guidance, it is expected that the fees, initially set at $5,000 per ton of NOx and VOCs emissions (adjusted annually from 1991 by the consumer price index), will be based on those emissions that exceed 80% of a plant's baseline in year 2007 (for sources located in the New York metropolitan area, including on Long Island), or possibly another period representative of a source's normal operations based on any 24-month period during the prior five-year period. Depending on the baseline year adopted by regulations, which have not yet been proposed, some of the PSA units and units under the PPAs might be subject to this fee requirement.

In 2005, seven Northeast states signed a Memorandum of Understanding called the Regional Greenhouse Gas Initiative (RGGI) for the purpose of capping and then reducing greenhouse gas emissions from power plants. At this time, ten Northeast states have signed on. After January 1, 2009, the ten states' rules will require power plants to obtain enough carbon dioxide (CO2) allowances to cover their emissions over a three-year compliance period. New York State adopted its final regulation in 2008 to implement the requirements of RGGI and to auction most of the CO2 allowances comprising the New York share of the regional cap. The price for the allowances is expected to range from $2 to $9/ton, with the clearing price for the first two auctions that occurred in the fall 2008 at $3.07 and $3.38 per allowance, respectively. The ability of the major PSA units to burn lower CO2 emitting natural gas provides compliance flexibility for these units. Forecast CO2 emissions are on the order of 6 million tons of CO2 annually. Several initiatives, including a cap-and-trade program, carbon tax, and/or source-specific control requirements, are also being considered at the federal level.

National Grid and the DEC are parties to a 1998 Consent Order for opacity, for which certain fines are assessed for occasionally exceeding power plant stack opacity limits. Improvements in plant infrastructure and plant operating practices have significantly reduced such occurrences and the amount of fines in recent years.

The Clean Water Act (CWA) requires that electric generating stations hold State Pollutant Discharge Elimination System (SPDES) permits, which reflect water quality considerations for the protection of the environment. Additional capital expenditures will be required as a result of the New York State Department of Environmental Conservation (DEC) regulations to protect marine life from possible impacts from the steam electric generators' cooling water intake systems under Section 316 of the Act. As directed by DEC, National Grid has undertaken studies of the impact of its cooling water intake systems on aquatic resources and submitted engineering alternatives to DEC for mitigating such impacts. National Grid believes that in most cases implementing technologies and procedures to reduce cooling water flow during certain periods should be sufficient to meet the performance standards established by the DEC. However, the nature and extent of any expenditure cannot be fully determined until ongoing analysis of the impacts and mitigation options are completed by NYSDEC. At this time, estimates for compliance upgrades covering a range of potential mitigation options could be between $60 and $90 million.

The NYSDEC is also contemplating additional regulation of petroleum storage tanks and spill protection systems. Such regulations could require more frequent and comprehensive inspection of existing storage tank internals and improved spill containment systems. Until such regulations are proposed it can not be determined what additional capital and or operating expenditures may be.

(Continued)

(14) Subsequent Events

In January 2009, the Authority issued approximately $436 million of its Electric System General Revenue Bonds, Series 2009A. The proceeds of these fixed rate bonds, net of discount and cost of issuance, will be used to finance on-going capital program and the remainder was used to redeem approximately $231 million of the outstanding insured variable rate securities in a current refunding. This current refunding produced an approximate $45 million net present value savings. The 2009A bonds have `an average life of 20 years and an all-in cost of 5.50%.

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Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

The Board of Trustees
Long Island Power Authority:

We have audited the basic financial statements of the Long Island Power Authority (Authority) as of and for the year ended December 31, 2008, and have issued our report thereon dated March 30, 2009. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered the Authority's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Authority's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Authority's financial statements that is more than inconsequential will not be prevented or detected by the Authority's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Authority's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

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Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Authority's basic financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of Authority management, the Authority's Board of Trustees, the New York State Division of the Budget and the New York State Office of the State Comptroller and is not intended to be and should not be used by anyone other than those specified parties.

KPMG LLP

March 30, 2009