LONG ISLAND POWER AUTHORITY

(A Component Unit of The State of New York)

Basic Financial Statements

December 31, 2003

(With Independent Auditors' Report Thereon)

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

Basic Financial Statements

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KPMG LLP
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Independent Auditors' Report

The Board of Trustees
Long Island Power Authority:

We have audited the balance sheet, statement of revenues, expenses, and changes in net assets, and statement of cash flows of the Long Island Power Authority (Authority), a component unit of the State of New York, as of and for the year then ended December 31, 2003, 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 audit. The financial statements of the Authority as of December 31, 2002, were audited by other auditors whose report dated March 24, 2003 expressed an unqualified opinion on those statements.

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. 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 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 audit provides a reasonable basis for our opinion.

In our opinion, the 2003 financial statements referred to above present fairly, in all material respects, the financial position of the Authority as of December 31, 2003, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying management's discussion and analysis on pages 2 through 11 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. 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.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 20, 2004 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 grants. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

As discussed in note 3(v), the Authority changed its method of accounting for asset retirement obligations.

KPMG LLP

March 20, 2004

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 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.

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

Management's Discussion and Analysis

Year ended December 31, 2003

The following is a summary of the Authority's financial information for 2003, 2002, and 2001 (thousands of dollars):

Balance Sheet Summary

	December 31, 2003	December 31, 2002	December 31, 2001
Assets:			
Current assets:			
Cash, cash equivalents and investments	$ 417,987	$ 610,326	$ 688,369
Other current assets	328,929	319,294	263,933
Noncurrent assets:			
Utility plant, net	3,390,387	3,041,699	2,299,389
Promissory notes receivable	155,425	605,247	605,289
Nonutility property and other investments	63,652	75,324	38,903
Deferred charges	119,570	110,053	76,657
Regulatory assets	957,540	693,082	572,382
Acquisition adjustment, net	3,305,300	3,417,981	3,530,662
Total assets	$ 8,738,790	$ 8,873,006	$ 8,075,584
Liabilities and net assets:			
Current liabilities	$ 802,228	$ 764,418	$ 482,883
Noncurrent liabilities:			
Long-term debt	6,835,943	7,267,657	7,502,131
Capital lease obligation	721,630	538,619	—
Other noncurrent liabilities	367,369	313,565	121,935
Total liabilities	8,727,170	8,884,259	8,106,949
Net assets (deficit):			
Capital assets net of related debt	(566,082)	(583,359)	(743,620)
Unrestricted	577,702	572,106	712,255
Total net assets (deficit)	11,620	(11,253)	(31,365)
Total liabilities and net assets	$ 8,738,790	$ 8,873,006	$ 8,075,584

Summary of Revenues, Expenses, and Changes in Net Assets

	Year ended December 31, 2003	2002	2001
Electric revenue	$ 2,583,603	$ 2,459,210	$ 2,356,351
Operating expenses:			
Operations – fuel and purchased power	1,076,969	924,778	881,335
Operations and maintenance	733,655	767,217	719,853
General and administrative	44,875	49,780	36,746
Depreciation and amortization	230,085	220,654	212,283
Payments in lieu of taxes	213,382	218,156	219,579
Total operating expenses	2,298,966	2,180,585	2,069,796
Operating income	284,637	278,625	286,555
Other income, net	53,988	52,204	72,049
Interest charges	(318,625)	(310,717)	(338,056)
Change in net assets before cumulative effect of change in accounting principle	20,000	20,112	20,548
Cumulative effect of change in accounting principle	2,873	—	—
Change in net assets	22,873	20,112	20,548
Net deficit – beginning of year	(11,253)	(31,365)	(51,913)
Net assets (deficit) – end of year	$ 11,620	$ (11,253)	$ (31,365)

Excess of Revenues over Expenses

The revenues in excess of expenses for the twelve months ended December 31, 2003 and 2002 and 2001 were $20 million, $20 million, and $21 million, respectively.

Revenue

Revenue for the twelve months ended December 31, 2003, increased approximately $124 million when compared to the similar period in 2002. The increase is primarily attributable to system load growth totaling $49 million and higher recoveries of excess fuel costs totaling $96 million, partially offset by the effects of weather totaling $17 million. In 2002, weather contributed positively to overall revenue, where in 2003, weather had no impact on revenue, as LIPA experienced normal weather over that 12-month period. Nonsystem revenue decreased approximately $4 million, primarily due to lower sales of ancillary services to the New York Independent System Operator (NYISO) for sales of installed capacity (ICAP) and lower wheeling revenue.

Revenue for the twelve month period ended December 31, 2002, increased by approximately $103 million when compared to the similar period for 2001. The increase is primarily attributable to system load growth totaling $48 million, higher recoveries of previously deferred fuel and purchased power costs totaling $25 million, the effects of weather estimated to have positively impacted revenue by approximately $24 million, and an increase of nonsystem revenue of approximately $6 million. The increase in non-system revenue was primarily the result of higher sales of ancillary services (ICAP) totaling approximately $4 million, and higher revenue due to increased transmission services fees charged to others who use the Long Island Power Authority (LIPA) transmission and distribution facilities.

Fuel and Purchased Power Costs

Fuel and purchased power expense increased approximately $152 million. This increase is primarily the result of higher Fuel and Purchased Power Cost Adjustment (FPPCA) recoveries of approximately $96 million, $35 million due to higher sales volumes, lower credits derived from derivative transactions totaling approximately $18 million, and lower credits resulting from off-system sales profits totaling approximately $3 million. (For a further discussion of the FPPCA, see footnote 3 of notes to basic financial statements.)

Total fuel and purchased power costs, excluding the impacts of accounting adjustments necessary to comply with LIPA's Tariff for Electric Service (Tariff), increased by approximately $327 million when compared to the year ended December 31, 2002. Approximately $36 million is attributable to increased sales for the 2003 period compared to 2002, and the balance is attributable to increased fuel and purchased power prices.

For the twelve months ended December 31, 2002, fuel and purchased power expense increased approximately $43 million when compared to the similar period of 2001. This increase was the result of higher FPPCA recoveries of approximately $25 million, higher sales volumes of approximately $14 million, increased current recognition of excess fuel costs totaling approximately $47 million, partially offset by higher unrealized gains on fuel related derivatives of approximately $43 million.

Total fuel and purchased power costs in 2002, excluding the impacts of accounting adjustments necessary to comply with LIPA's tariffs, increased by approximately $70 million, when compared to the year ended December 31, 2001. Approximately $14 million of the increase was a result of increased sales. The remaining increase was a result of the increased fuel and purchased power prices.

Effective with the Board's adoption of the 2004 budget in mid-February, the FPPCA surcharge was increased by 4.5%. The revised surcharge is designed to provide sufficient recovery of Excess Fuel Costs throughout 2004 for LIPA to achieve revenue in excess of expenses of $20 million by year-end. The surcharge will be adjusted throughout the year, as necessary, to reflect actual results.

Operations and Maintenance Expense (O&M)

O&M decreased approximately $34 million for the twelve months ended December 31, 2003 when compared to the similar period in 2002. This decrease is attributable to decreased costs of renting temporary emergency stand-by generators totaling approximately $26 million, lower clean energy program costs totaling approximately $15 million, the absence of costs similar to those incurred in 2002 associated with the accelerated completion of certain generating facilities totaling approximately $5 million, and lower Nine Mile Point 2 (NMP2) costs due primarily to the write down of inventory of approximately $4 million in 2002.

These decreases were partially offset by a $5 million charge related to the Shoreham Property Tax Settlement Agreement; the recognition of approximately $4 million related to the accretion of an Asset Retirement Obligation (ARO) as required under Financial Accounting Standards Board Statement No. 143 *Accounting for Asset Retirement Obligations* (as more fully discussed below under the caption *Other Significant Items*); and increased storm damage, repair and restoration costs totaling approximately $7 million.

For the year ended December 31, 2002 O&M increased approximately $47 million when compared to 2001. This increase is primarily attributable to the cost of renting temporary emergency stand-by generators totaling approximately $42 million and costs associated with repairing a 345 kilovolt submarine cable running under the Long Island Sound connecting Long Island to Westchester County, New York (Y-50 cable), totaling approximately $5 million. Other increases included higher costs associated with the clean energy programs totaling approximately $7 million (primarily as a result of the Keep Cool Bounty Program); costs associated with the development of new generating facilities totaling approximately $5 million; increased preventative maintenance costs on substations, totaling approximately $4 million; and increased property taxes totaling approximately $5 million.

These increased costs were offset by lower costs related to NMP2 totaling approximately $4 million (in 2001 LIPA incurred a pension and benefit related curtailment loss due to the sale of the NMP2 by the other co-tenants); decreased costs related to the amortization of deferred costs related to rebates issued to non-Suffolk County customers totaling approximately $14 million and other various costs totaling approximately $3 million.

General and Administrative Expenses (G&A)

For the year ended December 31, 2003, G&A expenses decreased approximately $5 million when compared to the similar period of 2002 due to lower charges related to claims for injuries and damages partially offset by the increased consulting fees associated with auditing and energy risk management and fuel pricing activities.

For the year ended December 31, 2002, G&A increased approximately $13 million primarily due to increasing reserve levels for injuries and damages. There was also a slight increase due to consulting services associated with the development of new generating and transmission facilities on Long Island.

Depreciation and Amortization

For the year ended December 31, 2003, depreciation and amortization increased approximately $9 million when compared to the similar period of 2002. Approximately $6 million of that increase is related to an adjustment to nuclear decommissioning accruals. The remaining increase is due to higher utility plant balances in 2003 when compared to 2002. For the year ended December 31, 2002, depreciation and amortization increased approximately $8 million due to higher plant balances relative to 2001.

Payments in Lieu of Taxes

For the year ended December 31, 2003, payments in lieu of taxes (PILOTs) decreased approximately $5 million, primarily as a result of a $12 million decrease in gross earnings tax due to lower tax rates. This decrease was partially offset by higher property taxes and the recognition of new PILOTS attributable to the new merchant-owned generating facilities which became operational in the summer of 2003.

For the year ended December 31, 2002, PILOTs decreased approximately $1 million, primarily as a result of a $7 million decrease in PILOTs on the Shoreham Nuclear Power Station property as the Authority made its final related payment in January 2002. That decrease was offset by the recognition of new PILOTS primarily attributable to the merchant-owned generating facilities that became operational in the summer of 2002.

Other Income, Net

For the year ended December 31, 2003, other income increased approximately $2 million compared to last year due primarily to an increase in the sale of emission credits totaling approximately $5 million. This increase was partially offset by a decrease in investment income as a result of lower investment balances combined with lower interest rates.

For the year ended December 31, 2002, other income decreased approximately $20 million. This decrease was primarily a result of decreased investment income of approximately $9 million as a result of lower returns realized on cash and investment balances due to the general decline in interest rates. Other income decreased due to the absence of interest earned on ISO re-billings during 2002 totaling approximately $7 million; and lower carrying charge income related to the Regulatory Asset established upon settlement of the Shoreham property tax litigation by approximately $7 million due to a refinement in the calculation method.

Interest Charges and Credits

For the year ended December 31, 2003, total interest charges increased relative to the same period in 2002 due to an increase of approximately $4 million resulting from amortizations of administrative costs, bond issuance costs and deferred losses generated from the 2003 refinancing. Also contributing to the increase was lower credits from the allowance for funds used during construction (AFC) of approximately $4 million due to lower construction work in progress balances in 2003.

For the year ended December 31, 2002 interest charges were lower compared to 2001, despite higher levels of debt outstanding, as interest rates on variable rate obligations were lower in 2002.

Cash, Cash Equivalents, and Investments

The Authority's cash, cash equivalents and investments totaled approximately $418 million, $610 million and $688 million at December 31, 2003, 2002, and 2001, respectively. The decrease from 2002 to 2003 is primarily the result of higher fuel and purchased power costs. The decrease from 2001 to 2002 is primarily the result of higher payments related to fuel and purchased power costs and funding capital expenditures with cash from operations. Cash generated from operations, combined with available cash balances from 2001 exceeded the Authority's operating, construction and refunding requirements for 2002, and as such, the Authority was able to complete the year without the issuance of any new debt. The Authority has been able to maintain a $250 million balance in its Rate Stabilization Fund.

(Continued)

Capital Assets

In 2003 the Authority entered into two Power Purchase Agreements (PPA's), each for 100% of the output from newly constructed 44.4 MW generating units. These leases qualify as capital leases under Statement of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases,* and are included in both Utility Plant and Capital Lease Obligations. As of December 31, 2003, the unamortized net present value of the minimum lease payments of these lease obligations totaled approximately $233 million. During the summer of 2002, LIPA entered into six PPA's for ten 44.4 MW generating units. Four of the PPA's, incorporating seven of the units, qualified as capital leases and are included in both Utility Plant and Capital Lease Obligations. As of December 31, 2003, the net present value of these leases totaled approximately $569 million. As of December 31, 2002, the unamortized net present value of the minimum lease payments was approximately $600 million.

The Authority also continued its program of strategic investment in transmission and distribution upgrades to improve reliability and to enhance capacity needed to meet growing customer demands. For the year ended December 31, 2003, and 2002, capital improvements totaled $202 million and $247 million, respectively. These improvements included the replacement or upgrade of transformer banks and circuit breakers, new substations, enhanced transmission lines and upgraded command and control equipment.

Promissory Notes Receivable

KeySpan Energy: The balance of this note decreased significantly as the Authority called for redemption of $270 million of Long Island Lighting Company Debentures, 8.2% Series due 2023, and NYSERDA financing notes, totaling approximately $177 million, with varying maturity dates between 2019 and 2022. Funding for these redemptions, including interest to the date of redemption and call premiums, was provided by KeySpan Energy in accordance with the terms of a promissory note to LIPA.

Niagara Mohawk Power Corporation: In order to facilitate the sale of NMP2, LIPA sold to Niagara Mohawk Power Corporation (NMPC) certain transmission assets located at the site of NMP2 in exchange for a promissory note totaling approximately $2.8 million. NMPC paid the promissory note in full during the year ended December 31, 2003.

Regulatory Assets

Regulatory assets increased approximately $265 million from December 31, 2002 to December 31, 2003. The increase is the result of (i) the issuance of Shoreham Property Tax Settlement related credits totaling approximately $20 million, additional carrying charges related to the balance of the Shoreham regulatory asset totaling approximately $30 million, offset by the scheduled recovery of approximately $19 million through a surcharge on billings for electric service to customers residing in Suffolk County (the Shoreham surcharge), which began in June 2003 (as discussed in greater detail in note 3 of notes to basic financial statements); and (ii) 2003 deferred Excess Fuel Costs totaling approximately $365 million, to be recovered over the 10-year period which began January 1, 2004, in accordance with LIPA's tariffs; offset by (iii) the recovery of 2002 deferred Excess Fuel Costs totaling approximately $130 million.

Capitalization

The Authority's capitalization, including current maturities of long-term debt, is as follows:

Capitalization
(Thousands of dollars)

	Balance at December 31, 2003	2002	2001
General Revenue Bonds	$ 5,900,544	$ 5,646,894	$ 5,778,595
Subordinated Revenue Bonds	989,645	1,165,518	1,161,196
Commercial Paper Notes	100,000	100,000	100,000
NYSERDA Notes	155,420	332,425	332,425
Debentures	—	270,000	270,000
	$ 7,145,609	$ 7,514,837	$ 7,642,216

During 2003, the Authority undertook various borrowings, remarketings and refundings, as follows: (i) remarketed $27.3 million Electric System Subordinated Revenue Bonds, Series 8C, as fixed rate bonds maturing April 1, 2010; (ii) issued approximately $622 million of uninsured, fixed rate, senior lien bonds (the Series 2003A & B Bonds to refund certain series of the Electric System General Revenue Bonds Series 1998A, 1998B, and 2000A); (iii) in connection with the expiration of certain letters of credit supporting the Authority's $700 million Electric System Subordinated Revenue Bonds, Series 1 through 3, the Authority remarketed $525 million of such Bonds as subordinate lien variable rate or auction rate bonds, and refunded the remaining $175 million with fixed rate senior lien bonds; the Authority also issued approximately $150 million of fixed rate senior lien bonds to fund certain capital expenditures; and (iv) issued approximately $587 million refunding variable rate bonds to refund approximately $587 million Electric System General Revenue Bonds Series 1998A (2029 maturity, 5.50%). The refunding variable rate bonds were issued in connection with the swaption entered into by the Authority in October 2002, which was exercised on February 3, 2003, as more fully described in note 4 to the Authority's basic financial statements for the year ended December 31, 2003. The Authority also called for redemption of $270 million Long Island Lighting Company Debentures, 8.2% Series due 2023, and the early redemption of various NYSERDA financing notes, totaling approximately $177 million, with varying maturity dates between 2019 and 2022. Funding for these redemptions, including interest to the date of redemption and call premium, was provided by KeySpan in accordance with the terms of a promissory note to LIPA.

For the year ended December 31, 2002, long term debt decreased as a result of the scheduled maturities of approximately $140 million, partially offset by the accretion of the capital appreciation bonds totaling $29 million.

The Authority's Supplemental Bond Resolution authorizes the issuance of Commercial Paper Notes, Series CP-1 (the CP-1 Notes) up to a maximum amount of $300 million. In May 2003, the Authority replaced the existing CP Credit Facility securing the CP-1 Notes and re-designated its Commercial paper notes into Series CP-1, CP-2, and CP-3. The three substitute CP Credit Facilities have an aggregate principal of $200 million and are supported by a Letter of Credit and Reimbursement Agreement dated May 1, 2003, which expires June 15, 2006. Unless and until additional letters of credit are delivered, the aggregate principal amount of the commercial paper notes will be limited to $200 million. As of December 31, 2003 and 2002, the Authority had Notes outstanding totaling $100 million, leaving $100 million undrawn liquidity available.

Investment Ratings

The Authority's securities are rated by Standard and Poor's Corporation (S&P), Moody's Investors Service (Moody's), and Fitch Investors Services, LP (Fitch). The ratings remain unchanged from December 31, 2002.

Investment Ratings

	Moody's	Standard & Poors	Fitch
Senior Lien Debt	Baal	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. Such debt carries the ratings of the LOC syndicate or insurance company, not that of the Authority.

In April 2003, S&P removed the Authority's rating from Creditwatch Negative, which had been placed on the Authority in December of 2002, reflecting the favorable resolution of KeySpan's overstatement of LIPA's revenue.

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 hired an external consultant specializing in risk management, energy markets and energy trading to enhance guidelines and protocols for energy trading activities.

Whenever the Authority enters into a transaction to mitigate risk, it becomes exposed in the event of nonperformance by the counterparty. To limit its exposure to risk, the Authority will only enter into derivative transactions with counterparties that have a credit rating of "investment grade" or better.

The goal of the Authority's risk management program is to reduce the impact that energy price volatility and interest rate fluctuations could have on rates if not mitigated with derivative products.

(Continued)

Fuel and purchased power transactions: – The Company uses derivative financial instruments to protect its customers from market price fluctuations for the purchase of fuel oil, natural gas, and/or electricity. These instruments are recorded at their market value. Effective 2003, any unrealized gains and losses are being deferred until realized, in accordance with the modifications to the FPPCA. Upon realization, such costs will be subject to recovery through the FPPCA. Prior to the 2003 modifications, unrealized gains and losses were recognized in current period results, as a component of fuel and purchased power. As of December 31, 2002, the Authority recognized an unrealized gain on its fuel derivatives of approximately $39 million. As of December 31, 2001, the Authority recognized an unrealized loss on these instruments of approximately $8 million.

Interest rate transactions: – In April 2003, the Authority, as part of its plan to reduce its overall exposure to variable rate debt, entered into a floating-to-fixed rate interest swap agreement with a notional amount of $116 million, related to the Authority's 2001L General Revenue Bonds. This swap was designed to reverse a fixed-to-floating swap agreement that the Authority had entered into in May 2001. This swap is for the same term as the original swap, has a floating rate based on BMA Index, and has a fixed interest rate not higher than 5.1875%. The Authority received $8.2 million on the date of closing, which is being amortized as an interest rate modifier over the life of the swap.

In October 2002, the Authority completed the sale of an option to UBS AG (counterparty) to hedge the call feature of its $587 million Electric System General Revenue Bonds, Series 1998A, 5.50% maturing in 2029. In exchange for the option, the Authority received an upfront option premium of $82 million plus administrative and other costs totaling approximately $24.4 million and therefore, recorded the swaption value at $106.4 million. The Authority also recorded a receivable and prepaid expense of approximately $21.6 million and $2.8 million, respectively, which have been subsequently liquidated upon the closing of the sale of bonds in May 2003.

On February 3, 2003, UBS AG exercised its option. As a result, the Authority issued $587 million Electric System General Revenue Bonds in order to redeem the 1998A 5.50% Electric System General Revenue Bonds maturing in 2029. In addition, the $106 million premium that the Authority received in October 2002 is being amortized as an interest rate modifier over the life of the variable rate debt.

The Authority is party to interest rate swap agreements in connection with its $250 million Electric System Subordinated Revenue Bonds Series 7 Bonds. The Authority has two separate agreements having notional amounts of $150 million and $100 million, respectively. These agreements effectively convert the underlying debt obligation from floating to fixed (4.2%). The interest rate swap agreements are co-terminus with the Series 7 Bonds, with optional earlier termination at the Authority's discretion. 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 marked-to-market this swap transaction at December 31, 2003 and 2002, and recorded an unrealized loss of approximately $18 million and $24.1 million, respectively. This loss has been deferred, and will be charged to expense when realized.

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 money 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 Sheet

December 31, 2003 and 2002

(Thousands of dollars)

Assets	**December 31, 2003**	**December 31, 2002**
Current assets:		
Cash and cash equivalents	$ 219,095	$ 491,986
Investments	198,892	118,340
Accounts receivable (net of allowance for doubtful accounts of $19,485)	235,732	221,174
Other accounts receivable	24,978	37,653
Fuel inventory	54,651	46,839
Material and supplies inventory	7,130	7,277
Interest receivable	602	1,409
Prepayments and other current assets	5,836	4,942
Total current assets	746,916	929,620
Noncurrent assets:		
Utility plant and property and equipment, net	3,390,387	3,041,699
Promissory notes receivable:		
KeySpan Energy	155,425	602,427
Niagara Mohawk Power Corporation	—	2,820
Total promissory notes receivable	155,425	605,247
Nonutility property and other investments	63,652	75,324
Deferred loss related to non-fuel derivatives	39,139	39,597
Deferred charges	80,431	70,456
Regulatory assets:		
Shoreham property tax settlement	575,660	544,098
Fuel and purchased power costs recoverable	381,880	148,984
Total regulatory assets	957,540	693,082
Acquisition adjustment (net of accumulated amortization of $790,211 and $677,530, respectively)	3,305,300	3,417,981
Total assets	$ 8,738,790	$ 8,873,006

Liabilities and Net Assets		December 31, 2003		2002
Current liabilities:				
Short-term debt	$	100,000	$	100,000
Current maturities of long-term debt		186,380		147,180
Current portion of capital lease obligation		80,073		61,252
Accounts payable and accrued expenses		329,971		342,318
Accrued payments in lieu of taxes		38,552		41,265
Accrued interest		42,000		47,745
Customer deposits		25,252		24,658
Total current liabilities		802,228		764,418
Noncurrent liabilities:				
Long-term debt		6,835,943		7,267,657
Capital lease obligation		721,630		538,619
Asset retirement obligation		64,452		—
Deferred credits		147,679		131,037
Deferred gain on Series 1998A Bonds		—		25,955
Swaption		133,757		132,366
Claims and damages		21,481		24,207
Commitments and contingencies (note 11)				
Total noncurrent liabilities		7,924,942		8,119,841
Net assets (deficit):				
Invested in capital assets net of related debt		(566,082)		(583,359)
Unrestricted		577,702		572,106
Total net assets (deficit)		11,620		(11,253)
Total liabilities and net assets	$	8,738,790	$	8,873,006

See accompanying notes to basic financial statements.

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

Statement of Revenues, Expenses and Changes in Net Assets

Years ended December 31, 2003 and 2002

(Thousands of dollars)

	Year ended December 31, 2003	Year ended December 31, 2002
Operating revenues – electric sales	$ 2,583,603	$ 2,459,210
Operating expenses:		
Operations – fuel and purchased power	1,076,969	924,778
Operations and maintenance	733,655	767,217
General and administrative	44,875	49,780
Depreciation and amortization	230,085	220,654
Payments in lieu of taxes	213,382	218,156
Total operating expenses	2,298,966	2,180,585
Operating income	284,637	278,625
Nonoperating revenues and expenses:		
Other income, net:		
Investing income	9,501	14,860
Carrying charges on regulatory asset	30,481	29,290
Other	14,006	8,054
Total other income, net	53,988	52,204
Interest charges and (credits):		
Interest on long-term debt, net	295,958	295,911
Other interest	27,576	23,812
Allowance for borrowed funds used during construction	(4,909)	(9,006)
Total interest charges	318,625	310,717
Total nonoperating revenues and expenses	(264,637)	(258,513)
Change in net assets before cumulative effect of change in accounting principle	20,000	20,112
Cumulative effect of change in accounting principle	2,873	—
Change in net assets	22,873	20,112
Total net deficit, beginning of year	(11,253)	(31,365)
Total net assets (deficit), end of year	$ 11,620	$ (11,253)

See accompanying notes to basic financial statements.

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

Statement of Cash Flows

Years ended December 31, 2003 and 2002

(Thousands of dollars)

	Year ended December 31, 2003	Year ended December 31, 2002
Cash flows from operating activities:		
Received from customers for the system sales, net of refunds	$ 2,619,232	$ 2,400,193
Other operating revenues received	36,024	40,002
Paid to suppliers and employees:		
Operations and maintenance	(825,695)	(775,374)
Fuel and purchased power	(1,280,133)	(896,436)
Payments in lieu of taxes	(294,017)	(276,678)
Net cash provided by operating activities	255,411	491,707
Investing activities:		
Net (sales) purchases of investment securities	(80,552)	201,163
Earnings received on investments	8,406	14,532
Other	8,521	(3,603)
Net cash provided by (used in) investing activities	(63,625)	212,092
Cash flows from capital and related financing activities:		
Capital and nuclear fuel expenditures	(201,506)	(246,636)
Insurance proceeds	747	1,209
Swaption proceeds	29,892	82,017
Proceeds of promissory note redemption	447,005	—
Proceeds from the issuance of bonds, net of issuance costs	1,580,368	27,487
Interest paid, net	(278,901)	(277,371)
Redemption of long-term debt	(2,042,282)	(167,385)
Net cash used in capital and related financing activities	(464,677)	(580,679)
Net (decrease) increase in cash and cash equivalents	(272,891)	123,120
Cash and cash equivalents at beginning of period	491,986	368,866
Cash and cash equivalents at end of period	$ 219,095	$ 491,986
Reconciliation to net cash provided by operating activities:		
Operating income	$ 284,637	$ 278,625
Adjustments to reconcile excess of operating income to net cash provided by operating activities:		
Depreciation and amortization	230,085	220,654
Nuclear fuel burned	5,830	5,228
Shoreham credits	(1,081)	(78,287)
Provision for claims and damages	17,000	22,448
Change in the fair market value of fuel related derivatives	—	(39,519)
Accretion of asset retirement obligation	3,648	—
Other, net	(4,597)	3,784
Changes in operating assets and liabilities:		
Accounts receivable, net	(23,526)	(41,420)
Fuel and material and supplies inventory	(7,665)	10,096
Fuel and purchased power costs recovered related to prior periods	149,040	127,508
Excess fuel and purchased power costs deferred	(364,640)	(129,166)
Accounts payable and accrued expenses	(33,320)	111,756
Net cash provided by operating activities	$ 255,411	$ 491,707

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, constituting a political subdivision of the State, created by Chapter 517 of the Laws of 1986 (the Act). As such, it is a component unit of the State and is included in the State's annual financial statements.

The Authority reporting entity is comprised of itself and its operating subsidiary the Long Island Lighting Company, a wholly owned subsidiary of the Authority doing business as LIPA. LIPA has 1 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 substantially controls the operations of LIPA, under Government Accounting Standard Board 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 "Company" in the financial statements. All significant transactions between the Authority and LIPA have been eliminated.

(2) Nature of Operations

LIPA, as owner of the transmission and distribution system located in the New York 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 LIPA in meeting these responsibilities, LIPA contracted with KeySpan Energy (KeySpan) or its affiliates 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). LIPA pays KeySpan directly for these services and KeySpan, in turn, pays the salaries of its employees through these contracts. In 2003, LIPA paid to KeySpan approximately $1.6 billion under the operating agreements, which includes all fees under such agreements, reimbursement for various taxes and PILOTS, certain fuel and purchases power costs, major capital projects, conservation services, research and development and various other expenditures authorized by the Authority.

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 agreements described above.

(3) Summary of Significant Accounting Policies

(a) General

The Company 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 Company 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 which they are earned and expenses are recognized in the period in which they are incurred.

(b) Accounting for the Effects of Rate Regulation

The Company 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 Company 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 Company'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 Company believes that SFAS No. 71 continues to apply.

If the Company had been unable to continue to apply the provisions of SFAS No. 71, as of December 31, 2003, the Company estimates that approximately $957.5 million of regulatory assets would be considered for write-off, and the acquisition adjustment, totaling approximately $3.3 billion would be considered for impairment.

(c) 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 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.

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

(d) 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, the issuance of credits in accordance with the , and Clean Energy initiatives. Investments are reported at amortized cost, which approximates fair market value.

(e) Fuel Inventory

Under the terms of the EMA and various Power Purchase Agreements, LIPA owns the fuel oil used in the generation of electricity at the facilities under contract to LIPA. Fuel inventory represents the value of low sulfur and internal combustion fuels that LIPA 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.

(f) Material and Supplies Inventory

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

(g) Promissory Note Receivable

Niagara Mohawk Power Corporation: In order to facilitate the sale of NMP2, LIPA sold to Niagara Mohawk Power Corporation (NMPC) certain transmission assets located at the site of NMP2 in exchange for a promissory note totaling approximately $2.8 million. NMPC paid the promissory note in full during the year ended December 31, 2003.

KeySpan Energy: as part of the Merger, KeySpan issued promissory notes to LIPA of approximately $1.048 billion. As of December 31, 2003, and 2002, approximately $155.4 million, and $602.4 million remained outstanding, 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 LIPA in the Merger. KeySpan is required to make principal payments to LIPA thirty days prior to the corresponding payment due dates, and LIPA transfers those amounts to the debt holders in accordance with the original debt repayment schedule.

(h) Deferred Loss Related to Non-Fuel Derivatives

The Authority uses financial derivative instruments to manage the impact of interest rates on earnings 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 recognized in earnings or deferred charges. As the Authority has the ability and intent to refund or recover such gains and losses when they become realized, all gains and losses are deferred until realized in accordance with SFAS No. 71.

(i) Deferred Charges

Deferred charges represent primarily the unamortized balance of costs incurred to issue long-term debt. Such amounts are amortized to interest expense over the life of the debt issuance to which they relate.

(j) Regulatory Assets

Shoreham Property Tax 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 issued $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 Capital Appreciation Bonds of its Series 1998A Electric System General Revenue Bonds totaling approximately $146 million and issued approximately $325 million of Electric System General Revenue Bonds, Series 2000A in May 2000.

As provided under the Agreement, beginning in June 2003, LIPA’s Suffolk County customers’ bills include a surcharge (the Suffolk Surcharge) to be collected over the succeeding approximate 25 year period to repay the Authority for debt service on the bonds issued by the Authority to fund the Settlement.

As future rates will be established at a level sufficient to recover all such costs identified above, LIPA recorded a regulatory asset in accordance with SFAS No. 71. The balance of the Shoreham property tax settlement regulatory asset as of December 31, 2003 and 2002 was approximately $575.6 million and $544.1 million, respectively. The balance represents costs recorded from 1998 through 2003 including rebates and credits issued to customers, costs of administering the program and debt service costs on the Bonds identified above less surcharges collected in 2003 totaling approximately $19 million.

Fuel and Purchased Power Costs Recoverable

LIPA's tariff includes a fuel recovery mechanism – the Fuel and Purchased Power Cost Adjustment (FPPCA) – whereby rates may be adjusted to reflect significant changes in the cost of fuel, purchased power and related costs. The FPPCA applies to all service classifications and was designed to ensure that LIPA would recover from or return to customers any fuel and purchased power costs that fall outside an established base fuel and purchased power costs tolerance band. The tolerance band was designed to increase in 1% increments annually until such time as fuel and purchased power costs increase in excess of 5% cumulatively over the original base fuel and purchased power cost. The FPPCA is designed to recover, from that year forward, all costs in excess of the original base cost.

In February 2002, the Trustees approved a waiver of the FPPCA that limited the recovery of fuel and purchase power costs in excess of those included in base rates (Excess Fuel Costs) to 5.8% of base revenue. As a result, the Authority deferred $129.2 million of 2002 Excess Fuel Costs for recovery over a 10-month period that began in March 2003. Over this ten-month period, the Authority collected approximately $129.9 million. The amount over-collected will be used to offset recoveries of Excess Fuel Costs in 2004.

Modification to the FPPCA Mechanism

In February 2003, LIPA's Board of Trustees adopted a proposal to change the method in which the Authority collects Excess Fuel Costs from its customers. The modification, when fully implemented in 2004, will permit the Authority to collect its Excess Fuel Costs in the year incurred (as opposed to on a deferral basis), in amounts sufficient to generate revenues in excess of expenses of $20 million on an annual basis. The modification is being implemented over a two-year transition period (2003 – 2004) as follows:

- With respect to 2003 excess fuel costs: (i) $75 million was scheduled to be collected in 2003 between March and December; and, (ii) an additional amount sufficient to generate an excess of revenue over expenses of $20 million in 2003 was deferred and is to be collected in level annual amounts over a ten year period commencing in January 1, 2004. Approximately $74 million of the $75 million scheduled to be collected in 2003 was billed to customers in 2003. The remaining $1 million will be incorporated in the 2004 FPPCA surcharge. With respect to item (ii) above, approximately $365 million was deferred for collection over the ten year period.

- With respect to 2004 and subsequent years' Excess Fuel Costs, collections of these amounts will be on a current year basis (with the recovery factor adjusted throughout the year as necessary) in amounts sufficient to generate excess revenue over expenses of $20 million.

Pursuant to the provisions of the revised FPPCA, LIPA's Board of Trustee approved a 4.5% increase in the FPPCA surcharge in February 2004. The revised surcharge is designed to provide sufficient recovery of Excess Fuel Costs throughout 2004 for LIPA to achieve revenue in excess of expenses of $20 million by year-end. The FPPCA surcharge will be adjusted periodically throughout the year, if necessary, to reflect actual results.

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

Accordingly, as of December 31, 2003, the Authority deferred its unrealized loss on fuel derivatives of approximately $17 million. This unrealized loss resulted from the change in valuation from December 31, 2002, (unrealized gain totaling $32 million) to December 31, 2003 (unrealized gain totaling $15 million).

As of December 31, 2002, LIPA did not defer unrealized gains and losses on its fuel related derivatives as the FPPCA did not provide for targeted revenue in excess of expenses. Accordingly, LIPA recognized as a credit against fuel and purchased power expense, an unrealized gain on its fuel derivatives of approximately $39 million. This unrealized gain resulted from changes in derivative valuations between December 31, 2001, (unrealized loss totaling $7 million) and December 31, 2002 (unrealized gain totaling $32 million). Despite inclusion of the 2002 amounts in the period earnings, the unrealized gain was not included in the FPPCA calculation until realized.

(k) Acquisition Adjustment

The acquisition adjustment 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.

(l) Fair Values of Financial Instruments

The Company's financial instruments approximate their fair market value as of December 31, 2003 and 2002. The fair values of the Company's long-term debt and derivative instruments are based on quoted market prices.

(m) Capitalized Lease Obligations

During 2003 and 2002, LIPA entered into Purchase Power Agreements (PPA's) for two 55 MW generating units and ten 44.4 MW generating units, respectively. The 2003 PPA's and four of the 2002 PPA's, incorporating seven of the 2002 units, qualify as capital leases under SFAS No. 13, *Accounting for Leases*. Included in both Utility Plant and Capital Lease Obligations is approximately $801.7 million, representing the unamortized net present value of the minimum lease payments under the PPA's that qualified for capitalization. Those leases not qualifying as capital leases are being accounted for as operating leases.

As permitted under SFAS No. 71, LIPA recognizes in Fuel and Purchased Power expense an amount equal to the rental 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.

(n) Deferred Credits

Deferred credits represent amounts received by the Authority, the final disposition of which remains undetermined. Accordingly, the Authority has deferred the recognition of income until such determination is reached. Certain of these amounts may be returned to customers, the New York Independent System Operation (NYISO), other NYISO market participants, KeySpan or the Internal Revenue Service.

(o) Claims and Damages

Losses arising from claims against LIPA, including workers' compensation claims, property damage, and general liability claims are partially self-insured. Storm losses are self-insured by LIPA. Reserves for these claims and damages are based on, among other things, experience and expected loss. In certain instances, significant portions of extraordinary storm losses may be recoverable from the Federal Emergency Management Agency.

(p) 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 year ended December 31, 2003, LIPA received approximately 51% of its revenues from residential sales, 46% from sales to commercial and industrial customers, and the balance from sales to public authorities and municipalities.

(q) Depreciation

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 2.87%.

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	37 – 38 years	$ 200
Transmission and distribution	23 – 46 years	200
Common	4 – 42 years	200
Nuclear fuel in process and in reactor	6 years	200
Generation assets under capital lease	15 – 25 years	—

(r) Payments-in-Lieu-of-Taxes

The Company is required to make 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.

(s) Allowance for Borrowed Funds Used During Construction

The allowance for 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.

(t) Income Taxes

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

(u) Derivative Instruments

The Authority uses financial derivative instruments to manage the impact of interest rates, energy prices and fuel cost changes on its customers and cash flows. Effective January 1, 2001, the Authority adopted SFAS No. 133 – *Accounting for Derivative Instruments 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*, to the extent appropriate under Governmental Accounting Standards.

These standards require that an entity recognize the fair value of all derivative instruments as either assets or liabilities in the balance sheet with the offsetting gains or losses recognized in earnings. 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. Accordingly, the Authority's balance sheet reflects the inclusion of deferred losses in deferred charges, and the deferred gains in deferred credits.

(v) Asset Retirement Obligation

On January 1, 2003, 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. LIPA, as an 18% owner of Nine Mile Point 2 Nuclear Power Station, has a legal obligation associated with its retirement. This obligation is offset by the capitalization of the obligation which is included in "Utility plant, net". As of December 31, 2003, the asset retirement obligation was $64.5 million.

In connection with the adoption of SFAS No. 143, net provision for the decommissioning costs related to the nuclear facility of $36.8 million has been reclassified from accumulated depreciation, where it has been recorded previously, to the asset retirement obligation. The Company recorded an additional asset retirement obligation of $26.8 million and increased property, plant and equipment. The required obligation under the standard was approximately $60.8 million as of January 1, 2003, therefore the cumulative effect of the change in accounting principle results in a benefit of approximately $2.8 million.

(w) Long-Lived Assets

Effective January 1, 2002, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*, which replaces SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long Lived Assets to be Disposed Of*. The accounting treatment for long-lived assets to be disposed of by sales applies to all long-lived assets, including discontinued operations, and replaces the provisions of APB Opinion No. 30, *Reporting Results of Operations – Reporting the Effects of Disposal of a Segment of a Business*, for the disposal of segments of business. In accordance with SFAS No. 144, 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 the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is assessed by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flow, an impairment charge to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the asset. 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, whether reported in continuing operations or in discontinued operations, and are no longer depreciated.

(x) Use of Estimates

The accompanying financial statements were prepared in conformity with accounting principles generally accepted in the United States of America 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.

(y) Reclassifications

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

(z) Recent Accounting Pronouncements

Derivative Instruments

In May 2003, the FASB issued Statement of Financial Accounting Standards No. 149, *Amendment of Statement No. 133 on Derivative Instruments and Hedging Activities* (SFAS No. 149). This Statement clarified under what circumstances a contract with an initial net investment meets the characteristic of a derivative as discussed in Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS No. 133). It also clarified when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 also amended certain other existing pronouncements regarding derivatives. It is effective for contracts entered into or modified after June 30, 2003. The adoption of this standard had no material impact on the Authority's financial position or results of operations.

(4) Risk Management

The Authority is routinely exposed to commodity and interest rate risk. In order to mitigate such exposure, the Authority, in 2002, formed an Executive Risk Management Committee.

Fuel and purchased power transactions: – The Authority uses derivative financial instruments. These instruments are recorded at their fair value as of December 31, 2003 as detailed below (thousands of dollars):

Fuel Derivative Transactions

Type of contract	Duration	Volume per month	Fair value
Oil Contracts (*volumes in barrels):*			
Options			
Put Short	Dec 03 – Dec 05	25,000-100,000	$ (278)
Call Long	Dec 03 – Dec 05	25,000-50,000	3,879
Swap	Dec 03 – Dec 05	10,000-50,000	7,458
Gas Transactions (*volumes in decatherms):*			
Put Short	Dec 03 – Dec 04	2,500-310,000	(1,322)
Put Long	Jan 04 – Feb 04	145,000-155,000	132
Call Short	Jan 04 – Feb 04	145,000-155,000	(70)
Call Long	Dec 03 – Dec 04	2,500-310,000	2,789
Swap	Dec 03 – Dec 05	2,500-310,000	2,914
Basis Transactions:			
Swap Long	Dec 03 – Mar 04	2,500-155,000	(897)
Energy Transactions:			
Swap Long	Jan 04 – Feb 04	8,000-8,900	13
Fair value			$ 14,618

Swaption: – In October 2002, the Authority sold an option to UBS AG (counterparty) to hedge the call feature of its 1998A 5.5% Electric System General Revenue Bonds maturing in 2029. In exchange for the option, the Authority received an upfront option premium totaling $82 million. In 2003, the counterparty exercised its option. As a result, the Authority issued Series 2003D through O, variable rate bonds, in May 2003 in order to redeem its Series 1998A, 5.50% Electric System General Revenue Bonds. Effective with the issuance of the variable rate bonds, the Authority has changed the interest charges on the underlying securities from floating to fixed. The Authority continues to mark-to-market the value of this swaption, and has deferred a loss totaling approximately $21.6 million. Any unrealized gains or losses will be deferred until realized.

In addition, various administrative fees totaling approximately \$2.8 million were paid by the counterparty and the counterparty paid closing costs totaling approximately \$21.6 million associated with the variable rate bonds that the Authority issued and, therefore, the Authority recorded the swaption value of approximately \$106.4 million. The premium is included in the swaption balance on the balance sheet and the related amortization of such premium is included as a reduction of interest expense. Also included in the swaption balance is the current period unrealized fair value adjustment of the swaption.

Interest rate transactions: – The Authority is party to an interest rate swap agreement in connection with its \$116 million Electric System General Revenue Bonds Series 2001L. Under this swap, the Authority has effectively converted the terms of the underlying debt obligation from fixed to variable. Under the terms of this agreement, the Authority pays a variable rate equivalent to the Bond Market Association (BMA) Index (1.09% and 1.52% as of December 31, 2003, and 2002, respectively) and receives fixed rate payments at 5.1875%. The agreement allows for the counterparty to terminate the agreement each May 1 and November 1, commencing on May 1, 2011. The term of the swap is equal to the maturity of the Series L Bonds, May 1, 2033. In accordance with SFAS No. 133, the Authority marked-to-market this swap transaction as of December 31, 2003, and recorded an unrealized gain of approximately \$8.5 million. However, as the Authority is subject to the provisions of SFAS No. 71, this gain has been deferred, and will be recorded as a reduction to expense when realized.

During 2003, the Authority entered into an interest rate swap agreement to unwind the existing swap discussed above. The agreement has the same terms as the above agreement and the Authority received approximately \$8.2 million as a premium on this agreement. In accordance with SFAS No. 133, the Authority marked-to-market this swap transaction as of December 31, 2003, and recorded an unrealized loss of approximately \$8.0 million. However, as the Authority is subject to the provisions of SFAS No. 71, this loss has been deferred, and will be charged to expense when realized.

The Authority is also party to interest rate swap agreements in connection with its \$250 million Electric System Subordinated Revenue Bonds Series 7 Bonds. The Authority has two separate agreements having notional amounts of \$150 million and \$100 million, respectively. These agreements effectively convert the underlying debt obligation from floating to fixed (4.2%). The interest rate swap agreements are co-terminus with the Series 7 Bonds, with optional earlier termination at the Authority's discretion. In accordance with SFAS No. 133, the Authority marked-to-market these transactions as of December 31, 2003, and recorded an unrealized loss of approximately \$18 million. However, as the Authority is subject to the provisions of SFAS No. 71, this loss has been deferred, and will be charged to expense when realized.

(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 Merger 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 LIPA's service area by no less than 14% over a ten year period commencing on the date when LIPA 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).

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 Company; 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.

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

(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, 2003 (thousands of dollars):

	Beginning balance	Additions	Deletions	Ending balance
Capital assets, not being depreciated:				
Land	$ 9,057	$ 776	$ —	$ 9,833
Retirement work in progress	15,570	14,794	23,504	6,860
Construction in progress	99,772	189,149	259,115	29,806
Total capital assets not being depreciated	124,399	204,719	282,619	46,499
Capital assets, being depreciated:				
Generation – nuclear	666,007	27,176	—	693,183
Transmission and distribution	1,961,080	258,833	12,880	2,207,033
Common	4,462		22	4,440
Nuclear fuel in process and in reactor	35,848	1,294	—	37,142
Office equipment, furniture, and leasehold improvements	2,513	407	—	2,920
Generation assets under capital lease	612,415	232,499	—	844,914
Total capital assets being depreciated	3,282,325	520,209	12,902	3,789,632
Less accumulated depreciation for:				
Generation – nuclear	112,471	25,239	31,053	106,657
Transmission and distribution	211,620	85,421	36,376	260,665
Common	109	566	22	653
Nuclear fuel in process and in reactor	26,875	5,830	—	32,705
Office equipment, furniture, and leasehold improvements	1,406	447	—	1,853
Generation assets under capital lease	12,544	30,667	—	43,211
Total accumulated depreciation	365,025	148,170	67,451	445,744
Net value of capital assets, being depreciated	2,917,300	372,039	(54,549)	3,343,888
Net value of all capital assets	$ 3,041,699	$ 576,758	$ 228,070	$ 3,390,387

In 2003, depreciation expense related to capital assets was approximately $111.7 million.

The following schedule summarizes the utility plant and property and equipment of the Authority as of December 31, 2002 (thousands of dollars):

	Beginning balance	Additions	Deletions	Ending balance
Capital assets, not being depreciated:				
Land	$ 10,889	$ 2,551	$ 4,383	$ 9,057
Retirement work in progress	24,652	10,672	19,754	15,570
Construction in progress	140,939	238,249	279,416	99,772
Total capital assets not being depreciated	176,480	251,472	303,553	124,399
Capital assets, being depreciated:				
Generation – nuclear	663,492	2,573	58	666,007
Transmission and distribution	1,705,112	277,345	21,377	1,961,080
Common	4,116	685	339	4,462
Nuclear fuel in process and in reactor	27,579	8,269	—	35,848
Office equipment, furniture, and leasehold improvements	2,282	324	93	2,513
Generation assets under capital lease	—	612,415	—	612,415
Total capital assets being depreciated	2,402,581	901,611	21,867	3,282,325
Less accumulated depreciation for:				
Generation – nuclear	84,084	28,445	58	112,471
Transmission and distribution	173,107	78,420	39,907	211,620
Common	(195)	643	339	109
Nuclear fuel in process and in reactor	21,647	5,228	—	26,875
Office equipment, furniture, and leasehold improvements	1,029	470	93	1,406
Generation assets under capital lease	—	12,544	—	12,544
Total accumulated depreciation	279,672	125,750	40,397	365,025
Net value of capital assets, being depreciated	2,122,909	775,861	(18,530)	2,917,300
Net value of all capital assets	$ 2,299,389	$ 1,027,333	$ 285,023	$ 3,041,699

In 2002, depreciation expense related to capital assets was approximately $104.2 million.

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

LIPA has an undivided 18% interest in Nine Mile Point 2 Nuclear Power Station (NMP2), located in Scriba, New York, operated by Constellation Nuclear LLC (Constellation).

LIPA's share of the rated capability of NMP2 is approximately 205 megawatts (MW). LIPA's net utility plant investment, excluding nuclear fuel, was approximately $587 million and $591 million as of December 31, 2003 and 2002, respectively. Generation from NMP2 and operating expenses incurred by NMP2 are shared by LIPA at its 18% ownership interest. LIPA 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.

LIPA 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. LIPA 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, LIPA employs on-site nuclear oversight personnel to provide additional support to protect LIPA's interests.

Nuclear Plant Decommissioning

LIPA is making provisions for decommissioning costs for NMP2 based on a site-specific study performed in 1995, as updated by LIPA's engineering consultants. LIPA's share of the total decommissioning costs for both the contaminated and noncontaminated portions is estimated to be approximately $64.4 million as of December 31, 2003, and is included in the balance sheet as the asset retirement obligation. LIPA maintains a trust fund for its share of the decommissioning costs of NMP2, which as of December 31, 2003, and 2002, had an approximate value of $48.9 million, and $43 million, respectively. Through continued deposits and investment returns being maintained within these trusts, the Company believes that the value of these trusts in 2026 will be sufficient to meet the Company's decommissioning obligations.

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. LIPA 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. LIPA reimburses Constellation for its 18% share of the cost under the contract 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.

Nuclear Plant Insurance

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

In November 2002, the Terrorism Risk Insurance Act (TRIA) of 2002 was enacted by the federal government. Under the TRIA, property and casualty insurance companies are required to offer insurance for losses resulting from Certified acts of terrorism. The United States Secretary of State and Attorney General determine certified acts of terrorism. 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 103 presently licensed nuclear reactors in the United States to a retrospective assessment of up to $100.6 million for each nuclear incident, payable at a rate not to exceed $10 million per year. LIPA's interest in NMP2 could expose it to a maximum potential loss of $18.1 million, per incident, through assessments of up to $1.8 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. Effective January 1, 1998, this program was modified to provide coverage to all workers whose nuclear-related employment began on or after the commencement date of reactor operations. Waiving the right to make additional claims under the old policy was a condition for coverage under the new policy. The old and new policies are described below:

> Nuclear worker claims reported on or after January 1, 1998 are covered by an insurance policy with an annual industry aggregate limit of $300 million for radiation injury claims against all those insured by this policy.
>
> All nuclear worker claims reported prior to January 1, 1998 are still covered by the old policy. Insureds under the old policies, with no current operations, are not required to purchase the newer policy described above, and may still make claims against the old policies through 2007. If radiation injury claims under these old policies exceed the policy reserves, all policyholders could be retroactively assessed, with LIPA's share being up to $300,000.

Constellation has also procured $500 million of primary nuclear property insurance and approximately $2.25 billion of additional protection (including decontamination costs) in excess of the primary layer through the Nuclear Electric Insurance Limited (NEIL). Each member of NEIL, including LIPA, is also subject to retrospective premium adjustments in the event losses exceed accumulated reserves. For its share of NMP2, LIPA could be assessed up to approximately $3.0 million per loss.

LIPA 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 $553,000 per week for the purchase of replacement power with a maximum limit of $77.4 million over a three-year period.

NMP2 License Renewal

Constellation is in the process of submitting an application to extend the licensed life of NMP2 by 20 years. If successful, this would extend the license dates to the year 2046. The application is expected to be submitted in May 2004, and the current review cycle history of the Nuclear Regulatory Commission (NRC) indicates that approval could be expected by midyear 2006.

To maximize its options, LIPA has agreed to fund a pro rata share of the license renewal costs up to the point of approval by the NRC. At the point of approval, LIPA will then have an option to participate in the extended license.

(8) Cash and Cash Equivalents and Investments

All investments of the Authority are held by designated custodians in the name of the Authority. Investments are reported at amortized cost, which approximates fair market value as of December 31, 2003 and 2002. Investments with maturities when purchased of less than 90 days are classified as cash and cash equivalents. Certain cash and cash equivalents and investments have been designated by the Authority's Board of Trustees to be used for specific purposes such as rate stabilization, capital additions, debt repayment, the funding of credits in accordance with the , and Clean Energy initiatives.

The bank balances were $11.9 million and $5.6 million as of December 31, 2003 and 2002, respectively. Cash deposits at banks were collateralized for amounts above the Federal Deposit Insurance Corporation (FDIC) limits with securities held by the custodian banks in the Authority's name. The Authority is required to maintain compensating balances of approximately $1 million. All Authority investment securities are classified as securities acquired by a financial institution for the Authority and held by the financial institutions trust department in the Authority's name.

Cash and cash equivalents and investments of the Authority as of December 31, 2003 and 2002 are detailed below (thousands of dollars):

Cash and cash equivalents and investments

	December 31,			
	2003		2002	
	Cost	Fair value	Cost	Fair value
Commercial Paper	$ 161,883	$ 161,883	$ 391,582	$ 391,582
U.S. Government/Agencies	207,684	208,127	135,050	135,946
Money market mutual funds	13,244	13,244	13,097	13,097
Repurchase Agreement	—	—	24,310	24,587
Master Notes	564	564	13,009	13,010
Certificate of Deposit	—	—	10,000	10,243
Corporate Bonds	9,998	10,022	6,788	6,787
Time and demand deposits	24,614	24,614	16,490	16,490
Total cash and cash equivalents and investments	$ 417,987	$ 418,454	$ 610,326	$ 611,742

(9) Long-Term and Short-Term Debt

In 2003, the Authority undertook various borrowings, remarketings and refundings, including: (i) the remarketing of $27.3 million Electric System Subordinated Revenue Bonds, Series 8C, as fixed rate bonds maturing April 1, 2010; (ii) issued approximately $622 million of uninsured, fixed rate, senior lien bonds (the Series 2003A & B Bonds) to refund certain series of the Electric System General Revenue Bonds Series 1998A, 1998B, and 2000A; (iii) in connection with the expiration of certain letters of credit supporting the Authority’s $700 million Electric System Subordinated Revenue Bonds, Series 1 through 3, the Authority remarketed $525 million of such Bonds as subordinate lien variable rate or auction rate bonds, and refunded the remaining $175 million with fixed rate senior lien bonds; the Authority also issued approximately $150 million of fixed rate senior lien bonds to fund certain capital expenditures; and (iv) issued approximately $587 million refunding variable rate bonds to refund approximately $587 million Electric System General Revenue Bonds Series 1998A (2029 maturity, 5.50%). The refunding variable rate bonds were issued in connection with the swaption entered into by the Authority in October 2002, which was exercised on February 3, 2003, as more fully described below.

The Authority also called for redemption $270 million Long Island Lighting Company Debentures, 8.2% Series due 2023, and the early redemption of various NYSERDA financing notes, totaling approximately $177 million, with varying maturity dates between 2019 and 2022. Funding for these redemptions, including interest to the date of redemption and call premium, was provided by KeySpan in accordance with the terms of a promissory note to LIPA.

The Company's bond and note indebtedness and other long-term liabilities as of December 31, 2003 are comprised of the following obligations (thousands of dollars):

	Beginning balance	Additions	Deletions	Ending balance	Due within one year
Authority Debt					
Electric system general revenue bonds:					
Series 1998A	$ 3,117,288	$ 8,581	$ 906,233	$ 2,219,636	$ 69,980
Series 1998B	1,076,020	—	331,815	744,205	32,625
Series 2000A	376,494	17,755	102,126	292,123	—
Series 2001A	300,000	—	—	300,000	—
Series 2001B-K	500,000	—	—	500,000	—
Series 2001L-P	316,000	—	—	316,000	—
Series 2003A	—	106,400	—	106,400	19,500
Series 2003B	—	516,075	4,500	511,575	36,975
Series 2003C	—	323,380	—	323,380	—
Series 2003D-O	—	587,225	—	587,225	—
Subtotal – bonds	5,685,802	1,559,416	1,344,674	5,900,544	159,080
Electric system subordinate revenue bonds:					
Series 1-3	700,000	—	175,000	525,000	—
Series 7	250,000	—	—	250,000	—
Series 8 (subseries A-H)	216,720	25,225	27,300	214,645	27,300
Subtotal – bonds net	1,166,720	25,225	202,300	989,645	27,300
LIPA Debt					
Debentures	270,000	—	270,000	—	—
NYSERDA notes	332,425	—	177,005	155,420	—
Subtotal – debt	602,425	—	447,005	155,420	—
Net unamortized discounts/premiums and deferred amortization	(14,155)	(5,740)	3,391	(23,286)	—
FMV 1998A Term Bond	(25,955)	—	(25,955)	—	—
Total bonds and notes net of unamortized discounts/ premiums	$ 7,414,837	$ 1,578,901	$ 1,971,415	$ 7,022,323	$ 186,380
Other long-term liabilities:					
Deferred credits	$ 131,037	$ 27,199	$ 10,557	$ 147,679	$ —
Claims and damages	24,207	17,000	19,726	21,481	—
Capital lease obligation	599,871	232,499	30,667	801,703	80,073
Total other long-term liabilities	$ 755,115	$ 276,698	$ 60,950	$ 970,863	$ 80,073

Additions to the Series 2000A and Series 1998A bonds represent the current accretion on the capital appreciation bonds.

The Company's bond and note indebtedness and other long-term liabilities as of December 31, 2002 are comprised of the following obligations (thousands of dollars):

	Beginning balance	Additions	Deletions	Ending balance	Due within one year
Authority Debt					
Electric system general revenue bonds:					
Series 1998A	$ 3,160,760	$ 8,768	$ 52,240	$ 3,117,288	$ 67,625
Series 1998B	1,163,865	—	87,845	1,076,020	79,555
Series 2000A	356,326	20,168	—	376,494	—
Series 2001A	300,000	—	—	300,000	—
Series 2001B-K	500,000	—	—	500,000	—
Series 2001L-P	316,000	—	—	316,000	—
Subtotal – bonds	5,796,951	28,936	140,085	5,685,802	147,180
Electric system subordinate revenue bonds:					
Series 1-3	700,000	—	—	700,000	—
Series 7	250,000	—	—	250,000	—
Series 8 (subseries A-H)	216,860	27,160	27,300	216,720	—
Subtotal – bonds	1,166,860	27,160	27,300	1,166,720	—
LIPA Debt					
Debentures	270,000	—	—	270,000	—
NYSERDA notes	332,425	—	—	332,425	—
Subtotal – debt	602,425	—	—	602,425	—
Net unamortized discounts/premiums and deferred amortization	(24,020)	404	(9,461)	(14,155)	—
FMV 1998ATerm Bond	—	(25,955)	—	(25,955)	—
Total bonds and notes net of unamortized discounts/premiums	$ 7,542,216	$ 30,545	$ 157,924	$ 7,414,837	$ 147,180
Other long-term liabilities:					
Deferred credits	$ 98,467	$ 48,337	$ 15,767	$ 131,037	$ —
Claims and damages	23,468	22,447	21,708	24,207	—
Capital lease obligation	—	612,415	12,544	599,871	61,252
Total other long-term liabilities	$ 121,935	$ 683,199	$ 50,019	$ 755,115	$ 61,252

Additions to the Series 2000A and Series 1998A bonds represent the current accretion on the capital appreciation bonds.

The Company's schedule of capitalization for the years ended December 31, 2003 and 2002 is as follows (thousands of dollars):

	Maturity	Interest rate		Series	December 31 2003	December 31 2002
Electric system general						
Revenue bonds:						
Serial bonds	Annually to 2016	4.250% to 6.000%	a	1998 A	$ 795,320	$ 1,083,990
Term bonds	December 1, 2018 to 2029	5.000% to 5.750%	a	1998 A	1,263,350	1,850,575
Capital appreciation bonds	December 1, 2003 to 2028	4.400% to 5.300%	a	1998 A	160,966	182,723
Serial bonds	Annually to 2016	4.000% to 5.250%	a	1998 B	687,060	1,018,875
Term bonds	April 1, 2018	4.750%	a	1998 B	57,145	57,145
Capital appreciation bonds	June 1, 2005 to 2029	5.000% to 5.950%	a	2000 A	292,123	376,494
Serial bonds	September 1, 2013 to 2021	4.600% to 5.375%	a	2001 A	21,960	21,960
Term bonds	September 1, 2025 to 2029	5.000% to 5.375%	a	2001 A	278,040	278,040
Term bonds	May 1, 2033	0.950%	b	2001 B	75,000	75,000
Term bonds	May 1, 2033	1.000%	b	2001 C	25,000	25,000
Term bonds	May 1, 2033	1.050%	b	2001 D	50,000	50,000
Term bonds	May 1, 2033	1.000%	b	2001 E	50,000	50,000
Term bonds	May 1, 2033	0.950%	b	2001 F	50,000	50,000
Term bonds	May 1, 2033	1.000%	b	2001 G	50,000	50,000
Term bonds	May 1, 2033	1.110%	b	2001 H	50,000	50,000
Term bonds	May 1, 2033	1.080%	b	2001 I	50,000	50,000
Term bonds	May 1, 2033	1.100%	b	2001 J	50,000	50,000
Term bonds	May 1, 2033	1.100%	b	2001 K	50,000	50,000
Term bonds	May 1, 2033	5.375%	a	2001 L	116,000	116,000
Term bonds	May 1, 2033	1.150%	b	2001 M	50,000	50,000
Term bonds	May 1, 2033	1.150%	b	2001 N	50,000	50,000
Term bonds	May 1, 2033	1.050%	b	2001 O	50,000	50,000
Term bonds	May 1, 2033	1.000%	b	2001 P	50,000	50,000
Serial bonds	June 1, 2004 to 2009	3.00% to 5.00%	a	2003 A	106,400	—
Serial bonds	December 1, 2003 to 2014	3.00% to 5.25%	a	2003 B	511,575	—
Serial bonds	September 1, 2013 to 2028	4.25% to 5.50%	a	2003 C	137,860	—
Term bonds	September 1, 2027 to 2033	5.00% to 5.25%	a	2003 C	185,520	—
	December 1, 2029	0.920% to 1.25%	b	2003 D-O	587,225	—
Electric system subordinated						
Revenue bonds	May 1, 2033	1.12% to 1.27%	b	Series 1	175,000	250,000
	May 1, 2033	1.10% to 1.27%	b	Series 2	150,000	250,000
	May 1, 2033	1.10% to 1.30%	b	Series 3	200,000	200,000
	April 1, 2025	4.210%	a	Series 7	250,000	250,000
	April 1, 2009 to 2012	4.000% to 5.250%	a	Series 8	214,645	216,720
Total general and subordinated revenue bonds					6,890,189	6,852,522
Commercial paper notes		0.95% to 1.00%	b	CP-1	100,000	100,000
Debentures	March 15, 2023	8.200%	a		—	270,000

	Maturity	Interest rate		Series		December 31 2003		2002
NYSERDA Financing notes:								
Pollution control revenue bonds	March 1, 2016	5.150%	a	1985 A,B	$	108,020	$	108,020
Electric facilities revenue bonds	September 1, 2019	7.150%	a	1989 A,B		—		35,030
	June 1, 2020	7.150%	a	1990 A		—		73,900
	December 1, 2020	7.150%	a	1991 A		—		26,560
	February 1, 2022	7.150%	a	1992 A,B		—		13,455
	August 1, 2022	6.900%	a	1992 C,D		—		28,060
	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		332,425
Fair market value adjustment						—		(25,955)
Unamortized premium and deferred amortization						(23,286)		(14,155)
Total long-term debt						7,122,323		7,514,837
Less current maturities						186,380		247,180
Long-term debt						6,935,943		7,267,657
Net assets (deficit)						11,620		(11,253)
Total capitalization					$	6,947,563	$	7,256,404

a – Fixed rate
b – Variable rate (rate presented is as of December 31, 2003)

The Company's short-term indebtedness as of December 31, 2003 and 2002 is comprised of the following obligations (thousands of dollars):

		Beginning balance	Additions	Deletions		Ending balance
Short term debt – CP-1	$	100,000	—	—	$	100,000

The debt service requirements for the Company's bonds as of December 31, 2003 are as follows (thousands of dollars):

	December 31, 2003			
Due	**Principal**	**Interest**	**Net Swap**	**Total**
2004	$ 186,380	$ 251,135	$ 31,887	$ 469,402
2005	193,630	244,496	31,850	469,976
2006	229,625	236,689	31,660	497,974
2007	241,720	225,488	31,848	499,056
2008	253,155	215,451	31,724	500,330
2009-2013	1,070,815	911,999	158,932	2,141,746
2014-2018	1,059,220	694,214	158,930	1,912,364
2019-2023	1,180,285	495,861	145,282	1,821,428
2024-2028	1,425,070	263,436	114,520	1,803,026
2029-2033	1,756,030	87,140	8,512	1,851,682
	7,595,930	3,625,909	745,145	11,966,984
Unamortized discounts/premiums	(23,286)	—	—	(23,286)
Unaccreted interest on CABs	(550,321)	—	—	(550,321)
Total	$ 7,022,323	$ 3,625,909	$ 745,145	$ 11,393,377

Authority Debt

The Authority financed the cost of the merger and the refinancing of certain of LILCO's outstanding debt by the issuance of 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.

The 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.

Electric System General Revenue Bonds

Series 2003A

The Authority issued Series 2003A Electric System General Revenue Bonds totaling $106.4 million in order to refund a portion of its Series 2000A Capital Appreciation Bonds. Series 2003A is comprised of Serial Bonds with maturities beginning June 1, 2004 and continuing through 2009 and pays interest at a fixed rate every June 1 and December 1.

A debt refinancing charge of approximately $9.6 million resulted from these refundings/refinancings. In accordance with the provisions of GASB No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities* (GASB No. 23), the refinancing charge associated with this transaction has been deferred and shown in the balance sheet as deferred amortization within long term debt and is being amortized, on a straight line basis, over the life of the new debt or the old debt, whichever is shorter.

Series 2003B

The Authority issued Series 2003B Electric System General Revenue Bonds totaling approximately $516.1 million in order to refund a portion of its Series 1998A and Series 1998B Bonds. Series 2003B is comprised of Serial Bonds with maturities beginning December 1, 2003 and continuing through 2014 and pays interest at a fixed rate every June 1 and December 1.

A debt refinancing charge of approximately $25.2 million resulted from these refundings/refinancings. In accordance with the provisions of GASB No. 23, the refinancing charge associated with this transaction has been deferred and shown in the balance sheet as deferred amortization within long term debt and is being amortized, on a straight line basis, over the life of the new debt or the old debt, whichever is shorter.

Series 2003C

The Authority issued Series 2003C Electric System General Revenue Bonds totaling approximately $323.4 million in order to refund a portion of its Series 1 and Series 2 Bonds totaling $175 million. The remaining proceeds were used to reimburse the Authority’s treasury for prior capital expenditures, and to pay the costs associated with the issuance of the bonds. Series 2003C is comprised of Serial and Term Bonds with maturities beginning September 1, 2013 and continuing through 2033 and pays interest at a fixed rate every March 1 and September 1.

Series 2003D through O

Series 2003 D through O Electric System General Revenue Bonds totaling approximately $587.2 million were issued as part of the swaption transaction (discussed below in more detail) to refund, the Authority’s Electric System General Revenue Bonds Series 1998A maturing on December 1, 2029, 5.50% coupon. Series D through H are comprised of variable rate bonds maturing on December 1, 2029. Interest is calculated in the Weekly Mode and payable on the first business day of each month.

Series 2003 I through O, are comprised of Auction Rate Term Bonds with a maturity date of December 1, 2029. Each Series bears interest at an auction rate that the Auction Agent advises results from an auction conducted for each applicable auction period. The auction date and auction period for each Series as of December 31, 2003 is as follows:

Series	Auction date	Auction period	Interest payment date
2003 I	Each fifth Thursday	35 day	Each fifth Friday
2003 J	Each fifth Friday	35 day	Each fifth Monday
2003 K	Each fifth Friday	35 day	Each fifth Monday
2003 L	Each Tuesday	Seven day	Each Wednesday
2003 M	Each Wednesday	Seven day	Each Thursday
2003 N	Each Monday	Seven day	Each Tuesday
2003 O	Each Wednesday	Seven day	Each Thursday

A debt refinancing charge of approximately $18.1 million resulted from these refundings/refinancings. The refinancing charge associated with this transaction has been deferred and shown in the balance sheet as deferred amortization within long term debt and is being amortized, on a straight line basis, over the life of the new debt or the old debt, whichever is shorter.

Optional Redemption

Each Series in the Weekly Mode shall be subject to redemption at the option of the Authority on any business day. Each Series of the Auction Rate Bonds are subject to optional redemption prior to maturity, by the Authority, in whole or in part, on any interest payment date immediately following an auction period, at a redemption price equal to the principal amount plus accrued interest to the redemption date; provided, however, that in the event of a partial redemption of Auction Rate Bonds of a Series, the aggregate principal amount of Auction Rate Bonds of such Series which will remain outstanding shall be equal to or more than $10 million unless otherwise consented to by the broker-dealer which acts as the Auction Agent for such Series.

Sinking Fund

These Bonds are subject to redemption, in part, beginning on December 1, 2027 through May 1, 2029 from mandatory sinking fund installments.

Series 2001A

The Authority issued Series 2001A Electric System General Revenue Bonds totaling $300 million for various capital purposes and to pay costs of issuance. This Series is comprised of Serial Bonds with maturities beginning September 1, 2013 and continuing through 2021 and Term Bonds with maturities beginning September 1, 2025 and continuing through 2029. These Bonds pay interest at a fixed rate every March 1 and September 1.

Optional Redemption

These Bonds are subject to redemption prior to maturity, at the option of the Authority, on any date on and after September 1, 2011 in whole, or in part from time to time, and in any order of maturity selected by the Authority, at a redemption price of par plus accrued interest on such principal amount to the redemption date.

Sinking Fund

The Bonds that mature on September 1, 2025 (approximately $75.6 million) and September 1, 2027 (approximately $112 million) are also subject to redemption, in part, through mandatory sinking fund installments each September 1, 2022 through 2027 at 100% of the principal amount, plus accrued interest to the redemption date.

Series 2001 B through K

The Authority issued Series 2001 B through K Electric System General Revenue Bonds totaling $500 million to refund $500 million Electric System Subordinated Revenue Bonds, Series 5 and 6. Series 2001 B through K, are comprised of Auction Rate Term Bonds with a maturity date of May 1, 2033. Each Series bears interest at an auction rate that the Auction Agent advises results from an auction conducted for each applicable auction period. The auction date and auction period for each Series as of December 31, 2003 is as follows:

Series	Auction date	Auction period	Interest payment date
2001 B	Each Business day	Daily	First Business day of the succeeding month
2001 C	Each Tuesday	Seven day	Each Wednesday
2001 D	Each Tuesday	Seven day	Each Wednesday
2001 E	Each Thursday	Seven day	Each Friday
2001 F	Each fifth Monday	35 day	Each fifth Tuesday
2001 G	Each Wednesday	Seven day	Each Thursday
2001 H	Each fifth Wednesday	35 day	Each fifth Thursday
2001 I	Each fifth Tuesday	35 day	Each fifth Wednesday
2001 J	Each Thursday	Seven day	Each Friday
2001 K	Each Wednesday	Seven day	Each Thursday

Optional Redemption

Each Series of the Auction Rate Bonds are subject to optional redemption prior to maturity, by the Authority, in whole or in part, on any interest payment date immediately following an auction period, at a redemption price equal to the principal amount plus accrued interest to the redemption date; provided, however, that in the event of a partial redemption of Auction Rate Bonds of a Series, the aggregate principal amount of Auction Rate Bonds of such Series which will remain outstanding shall be equal to or more than $10 million unless otherwise consented to by the broker-dealer which acts as the Auction Agent for such Series.

Sinking Fund

These Bonds are subject to redemption, in part, beginning on December 1, 2030 through May 1, 2033 from mandatory sinking fund installments.

Series 2001L through P

The Authority issued Electric System General Revenue Bonds, Series L through P totaling $316 million maturing on May 1, 2033 in order to refund $300 million of the Authority's Electric System Subordinated General Revenue Bonds consisting of Series 4 and a portion of Series 3, and to pay certain costs of issuance related to Series B through P.

Series M through P bear interest at an auction rate that the Auction Agent advises results from an auction conducted for each applicable auction period. The auction date and auction period for each Series as of December 31, 2003 is as follows:

Series	Auction date	Auction period	Interest payment date
2001 M	Each Monday	Seven day	Each Tuesday
2001 N	Each Friday	Seven day	Each Monday
2001 O	Each fifth Monday	35 day	Each fifth Tuesday
2001 P	Each Thursday	Seven day	Each Friday

Series 2001 L are Fixed Rate Term Bonds that pay interest semiannually each May 1 and November 1.

Optional Redemption

Series L Bonds are subject to redemption prior to maturity, at the option of the Authority on any date on and after May 1, 2011 in whole or in part from time to time, and in any order of maturity selected by the Authority, at a redemption price of par plus accrued interest. Each Series of the M through P Auction Rate Bonds shall be subject to optional redemption by the Authority on any interest payment date immediately following an auction period, at a redemption price equal to the principal amount, plus accrued interest to the redemption date; provided, however, that in the event of a partial redemption of Auction Rate Bonds of a Series, the aggregate principal amount of Auction Rate Bonds of such Series which will remain outstanding shall be equal to or more than $10 million unless otherwise consented to by the broker-dealer which acts as the Auction Agent for such Series.

Sinking Fund

These Bonds are subject to redemption, in part, beginning on May 1, 2030 through May 1, 2033 from mandatory sinking fund installments.

Series 2000A

These Bonds were issued to fund certain rebates and credits in accordance with the Shoreham Property Tax Settlement Agreement. These Bonds are comprised of tax-exempt Capital Appreciation Bonds (CAB) with maturities beginning in June 2010 and continuing each year through 2029 and are not subject to optional redemption, mandatory sinking fund redemptions or any other redemption prior to maturity.

During 2003, certain of these Bonds were refunded by the issuance of Series 2003A. The Authority deposited in an irrevocable escrow deposit account amounts sufficient to pay the principal and interest on the following bonds:

Series	Maturity	Coupon
2000A CAB	6/1/2005	5.000%
2000A CAB	6/1/2006	5.150%
2000A CAB	6/1/2007	5.210%
2000A CAB	6/1/2008	5.270%
2000A CAB	6/1/2009	5.320%

The Authority will realize a gross debt service increase from this refunding of approximately $2.9 million over the original life of the bonds. The refunding produced an economic loss (the present value of the increase in debt service requirements) of approximately $3.5 million.

Series 1998A

This Series is comprised of Current Interest and Capital Appreciation Bonds (CAB). The Current Interest Bonds include: (i) tax exempt Serial Bonds with maturities that began in December 1999 and continue each year through December 2016; and (ii) tax exempt Term Bonds with maturities beginning in December 2018 and a final maturity in December 2026. The Capital Appreciation Bonds are tax exempt bonds with maturities beginning in December 2003 continuing each year through December 2028. The Current Interest Bonds pay interest at a fixed rate every June 1 and December 1. During the year ended December 31, 2003, the Authority retired at maturity, with cash from operations, its $54.7 million 4.30% Serial Bonds. During the year ended December 31, 2002, the Authority retired at maturity, with cash from operations, its $18.6 million 5.25% and its $33.7 million 4.30% Serial Bonds.

Optional Redemption

The 5.0% Serial Bonds due on December 1, 2014 ($39.4 million) and the Serial and Term Bonds maturing on or after December 1, 2015 (except the Term Bonds maturing on December 1, 2029), which total $207 million and $1.3 billion, respectively, are subject to redemption prior to maturity, at the option of the Authority, at a price of 101% of the principal amounts on any date beginning on June 1, 2008 through May 31, 2009, or at 100.5% beginning on June 1, 2009, through May 31, 2010, or at 100% beginning June 1, 2010, through maturity, in whole, or in part from time to time, and in any order of maturity selected by the Authority. Interest accrued on such principal amount redeemed is added to the redemption price.

During 2003, the Authority's Term Bonds maturing on December 1, 2029, ($587.2 million) that were subject to redemption prior to maturity, at the option of LIPA, on any date on and after June 1, 2003, were called at a redemption price of 101% of the principal amounts, together with the interest accrued on such principal amount to the redemption date.

The Authority will realize a gross debt service savings from this refunding of approximately $105 million over the original life of the bonds. The refunding produced an economic gain (the present value of the debt service savings) of approximately $89 million.

In addition, the Authority refunded with the issuance of Series 2003B, the Series 1998A bonds listed below. The Authority deposited in an irrevocable escrow deposit account amounts sufficient to pay the principal and interest on the bonds.

Series	Maturity	Coupon
1998A CAB	12/1/2010	5.000%
1998A CAB	12/1/2011	5.050%
1998A	12/1/2012	5.500%
1998A	12/1/2013	5.500%
1998A	12/1/2014	5.250%

The Authority will realize a gross debt service increase from this refunding of approximately $0.6 million over the original life of the bonds. The refunding produced an economic loss (the present value of the increase in debt service requirements) of approximately $1.7 million.

The Serial Bonds maturing through December 1, 2013, ($833.1 million) and the 5.25% Serial Bonds due on December 1, 2014, ($56.7 million) are not subject to redemption prior to maturity. In addition, the Capital Appreciation Bonds and the Taxable Term Bonds are not subject to redemption prior to maturity.

Sinking Fund

Certain Term Bonds are subject to redemption, in part, beginning on December 1, 2017 through December 1, 2026 at 100% of the principal amounts, plus accrued interest at the redemption date, from mandatory sinking fund installments which are required to be made in amounts sufficient to redeem such Bonds.

Series 1998B

This Series is comprised of Serial Bonds with maturities that began in April 2000 and continue each year through April 2016 and Term Bonds maturing in April 2018. These Bonds pay a fixed rate of interest every April 1 and October 1.

During the year ended December 31, 2003 the Authority retired at maturity, with cash from operations, its \$35.0 million, 4.25%, and its \$44.5 million 5.0% Current Interest bonds. In addition, during 2003, approximately \$252.3 million of Series 1998B Bonds were refunded with Series 2003B. The Authority deposited in an irrevocable escrow deposit account amounts sufficient to pay the principal and interest on the refunded bonds as listed below:

Series	Maturity	Coupon
1998B	4/1/2004	4.000%
1998B	4/1/2005	4.000%
1998B	4/1/2005	5.000%
1998B	4/1/2006	4.500%
1998B	4/1/2006	5.000%

The Authority will realize a gross debt service increase from this refunding of approximately \$0.6 million over the original life of the bonds. The refunding produced an economic loss (the present value of the increase in debt service requirements) of approximately \$1.8 million.

During the year ended December 31, 2002 the Authority retired at maturity, with cash from operations, its \$25.0 million, 4.0%, and its \$62.8 million 5.0% Current Interest bonds.

Optional Redemption

Securities maturing on and after April 1, 2009 (\$483.5 million) are subject to redemption prior to maturity, at the option of the Authority, at a redemption price of 101% of the principal amount on any date beginning on April 1, 2008, through May 31, 2009, or at 100.5% beginning on April 1, 2009 through May 31, 2010, or at 100% beginning April 1, 2010, through maturity, in whole, or in part from time to time, and in any order of maturity selected by the Authority. Interest accrued on such principal amount redeemed is added to the redemption price.

Sinking Fund

The Term Bond that matures on April 1, 2018 is subject to redemption, in part, beginning on April 1, 2017 at 100% of the principal amount, plus accrued interest to the redemption date, from mandatory sinking fund installments which are required to be made in amounts sufficient to redeem such Bonds.

Electric System Subordinated Revenue Bonds

Series 1 through 3

As a result of a reduction to the Authority's letter of credit capacity during 2003, the Authority was unable to remarket its entire outstanding portfolio of Series 1A through 3B bonds, therefore, the Authority refunded, with Series 2003C, certain of its Series 1A through 3B as detailed below (thousands of dollars):

	Outstanding at December 31, 2002	Refinancing transactions	Outstanding at December 31, 2003
Series 1A	$ 125,000	$ —	$ 125,000
Series 1B	125,000	(75,000)	50,000
Series 2A	125,000	(75,000)	50,000
Series 2B	100,000	—	100,000
Series 2C	25,000	(25,000)	—
Series 3A	100,000	—	100,000
Series 3B	100,000	—	100,000
	$ 700,000	$ (175,000)	$ 525,000

As a result of the above refinancing transaction the Authority will realize a gross debt service increase of approximately $10 million over the original life of the bonds. The refunding produced an economic loss (the present value of the increase in debt service requirements) of approximately $32 million.

The remaining Bonds are variable rate bonds payable from and secured by the Trust Estate subject to and subordinated to the Authority's Electric System General Revenue Bonds and are supported by letters of credit that expire on June 15, 2006. These Bonds are classified into various modes that determine the frequency that the interest rate is re-determined, the interest rate applied and the optional redemption features, Subseries 1A, 2A, and 3A are currently Weekly Mode bonds, therefore, the applicable interest rate is re-determined on a weekly basis. Subseries 1B, 2B, and 3B are currently Daily Mode, and as such, the interest rates are re-determined daily.

Provisions of the indenture allow for a change in interest rate modes, at the option of the Authority. In addition to the daily and weekly modes, the Authority also has the option to adopt a Term mode, (thereby changing the reset period e.g., from daily to monthly, semi-annually or annually), a Fixed mode, or a Commercial Paper Mode.

Series 7

This Series is comprised of variable rate bonds in the Weekly Mode. Provisions of the indenture allow for a change of interest rate modes, at the option of the Authority. In addition to the daily, weekly and commercial paper modes, the Authority also has the option to adopt a Term mode, (thereby changing the reset period e.g., from daily to monthly, semi-annually or annually) or a Fixed term mode.

Principal and interest on these Bonds are secured by a financial guaranty insurance policy and the Authority has executed a Standby Bond Purchase Agreement to provide funds for the purchase of Series 7 Bonds tendered but not remarketed. The standby agreement expires in November 2008.

Optional and Mandatory Redemption

Series 7 Bonds are redeemable on their respective interest rate re-determination dates at the option of the Authority. These Bonds are redeemable at face value when they are in the Weekly, Daily or Commercial Paper mode. Term or Fixed rate mode bonds are redeemable at rates varying between 100% and 101 % when the life of the mode is greater than four years. Term or Fixed Rate mode bonds are not redeemable if the life of the mode is less than four years.

Series 1A through 3B and Series 7 Bonds are also subject to mandatory redemptions from sinking funds such that they will be redeemed by their respective maturity dates. Sinking funds for Series 1A through 3B begin on December 1, 2030 and on Series 7 sinking funds begin April 1, 2019.

Series 8 (Subseries A-H)

This Series is comprised of Current Interest Bonds issued as follows (thousands of dollars):

This series is comprised of Subseries	Mandatory Purchase date (April 1)	Maturity (April 1)		Principal outstanding	Interest rate to mandatory purchase date
8A		2009	$	23,360	5.25%
8A		2009		2,500	4.13%
8B		2009		17,160	4.30%
8B		2009		10,000	5.25%
8C		2010		25,225	5.00%
8D	2004	2010		27,300	4.50%
8E	2005	2011		27,300	4.50%
8F	2006	2011		27,300	5.00%
8G	2007	2012		27,300	5.00%
8H	2008	2012		27,200	5.00%
			$	214,645	

Immediately prior to the mandatory purchase date, the Authority will determine to either purchase the Subseries or have such Subseries remarketed. Remarketed securities would then become due at the maturity date or such earlier date as determined by the remarketing. Additionally, the original interest rate on the debt issued will remain in effect until the mandatory purchase date, at which time the interest rate will change in accordance with market conditions at the time of remarketing if the Authority chooses to remarket. Principal, interest and purchase price on the mandatory purchase date are secured by a financial guaranty insurance policy.

During the years ended December 31, 2003 and 2002, the Authority remarketed its Subseries 8C Bonds and Subseries 8B Bonds, respectively. Subseries 8A through 8C bonds are in the Fixed Rate Mode, and pay interest on April 1 and October 1 of each year through its maturity date.

The Authority intends to redeem its Subseries 8D Bonds on the mandatory purchase date of April 1, 2004.

No Subseries of Series 8 is subject to optional redemption or mandatory sinking fund redemption prior to its mandatory purchase date.

Commercial Paper Notes

The Authority's Supplemental Bond Resolution authorizes the issuance of Commercial Paper Notes, Series CP-l through CP-3 (Notes) up to a maximum amount of $200 million. The aggregate principal amount of the Notes outstanding at any time may not exceed $200 million. As of December 31, 2003 and 2002, the Authority had Notes outstanding totaling $100 million. In connection with the issuance of the Notes, the Authority has entered into a Letter of Credit and Reimbursement Agreement, expiring on June 15, 2006. 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.

LIPA Debt

The LILCO debt assumed by LIPA as part of the Merger, consisted of $1.186 billion of General and Refunding Bonds, (G&R Bonds), that were defeased by LIPA immediately upon the closing of the Merger, debentures totaling $2.27 billion, and tax exempt debt totaling approximately $915.7 million. As part of the Merger, KeySpan and LIPA executed Promissory Notes whereby KeySpan was obligated to LIPA for approximately $1.048 billion of the assumed debt (the Promissory Notes). KeySpan is required to pay LIPA principal and interest on the Promissory Notes 30 days in advance of the date amounts are due to bondholders. The balance of the Promissory Notes between KeySpan and LIPA totaled approximately $155.4 million and $602.4 million as of December 31, 2003 and 2002, respectively.

The tax exempt debt assumed by LIPA were notes issued on behalf of LILCO by the New York State Research and Development Authority (NYSERDA) to secure tax-exempt Industrial Development Revenue Bonds, Pollution Control Revenue Bonds (PCRBs), and Electric Facilities Revenue Bonds (EFRBs) issued by NYSERDA.

Bond Defeasance/Refundings

A portion of the proceeds of the Authority's Electric System General Revenue Bonds and Subordinated Bonds (which include fixed and variable rate debt) were used in 1998 to refund all the G&R Bonds, certain Debentures and certain NYSERDA notes issued by LILCO that were assumed by LIPA as a result of the Merger. The purpose of these refundings was to achieve debt service savings.

General and Refunding Bonds

On May 29, 1998, LIPA refunded all the G&R Bonds totaling $1.186 billion by depositing $1.190 billion in an irrevocable escrow deposit account to be invested in the direct obligations of the United States of America. The maturing principal of and interest on these obligations were sufficient to pay the principal and interest on the G&R. Bonds, which were defeased on June 29, 1998. As of December 31, 2003 and 2002, approximately $1.1 billion of the G&R Bonds, outstanding are considered defeased.

The Authority will realize gross debt service savings from this refunding of approximately $588 million over the original life of the bonds. The refunding produced an economic gain (the present value of the debt service savings) of approximately $576 million.

Debentures

In March 2000, LIPA deposited approximately $58 million that it generated from operations, in an irrevocable escrow deposit account to be invested in direct obligations of the United States of America.

The Company has received certification from an independent verification agent that the maturing principal of and interest on these obligations will be sufficient to pay the principal and interest on the following debentures that LIPA assumed as part of the Merger, which includes the fair market value adjustment on the date of purchase (reflected at the Company's carrying value) (thousands of dollars):

Maturity	Interest rate		Carrying value
3/15/2003	7.050%	$	5,890
3/1/2004	7.000%		2,999
6/1/2005	7.125%		14,307
11/1/2022	9.000%		26,532

In February 2003, the Authority called for redemption in March, its $270 million Long Island Lighting Company Debentures, 8.2% Series due 2023. Funding for this redemption, including interest to the date of redemption and call premium, totaling approximately $281 million was provided by KeySpan in accordance with the terms of a promissory note with LIPA.

NYSERDA Notes

During 1998, the Authority deposited $379 million in an irrevocable escrow deposit account to be invested in direct obligations of the United States of America. The maturing principal of, and interest on, such securities will be sufficient to pay the principal, interest and applicable call premium on the following issues of NYSERDA Notes: approximately $11.9 million Series 1985A, approximately $50 million Series 1989A, approximately $15 million Series 1989B, approximately $26 million Series 1990A, approximately $73 million Series 1991A, $50 million Series 1992A, approximately $36.5 million Series 1992B, $50 million Series 1992C and approximately $22 million Series 1992D, (collectively, the Refunded NYSERDA Notes). As of December 31, 2001, the above-mentioned outstanding Refunded NYSERDA Notes are considered defeased.

As a result of this refunding and the deposit with the Escrow Agent, the Refunded NYSERDA Notes are deemed to have been paid, and they cease to be a liability of LIPA. Accordingly, the Refunded NYSERDA Notes (and the related deposit with the Escrow Agent) are excluded from the Balance Sheet. The Authority will realize gross debt service savings from this refunding of approximately $287 million over the life of the bonds. The refunding produced an economic gain (the present value of the debt service savings) of approximately $66 million.

In March 2003, the Authority redeemed the following NYSERDA financing notes (thousands of dollars):

NYSERDA notes

Series		Principal	Rate	Maturity date		Call premium
EFRBs Series 1989 B	$	35,030	7.15%	9/1/2019	$	701
EFRBs Series 1990 A		73,900	7.15%	6/1/2020		1,478
EFRBs Series 1991 A		26,560	7.15%	12/1/2020		531
EFRBs Series 1992 B		13,455	7.15%	2/1/2022		269
EFRBs Series 1992 D		28,060	6.90%	8/1/2022		561
Total	$	177,005			$	3,540

KeySpan also provided funding for this redemption in accordance with the terms of a promissory note with LIPA.

Deferred Amortization

A debt refinancing charge of $61.9 million resulted from the refundings that the Authority has undertaken between May 28,1998 and December 31, 2000, primarily because of the difference between the amounts paid for refundings, including amounts deposited with the Escrow Agent, and the carrying amount of the G&R Bonds, Debentures and NYSERDA Notes. In accordance with the provisions of GASB No. 23, approximately $61.9 million was deferred and shown in the balance sheet as deferred amortization within long term debt and is being amortized, over the shorter of the life of the new debt or the old debt. The unamortized balance as of December 31, 2003 and 2002 totaled $15.8 million and $21.0 million, respectively.

Fair Values of Long-Term Debt

The fair values of the Company's long-term debt as of December 31, 2003 and 2002 were as follows (thousands of dollars):

Fair Value

	December 31, 2003	December 31, 2002
Electric System General Revenue Bonds, Series 1998 A	$ 2,380,812	$ 3,281,925
Electric System General Revenue Bonds, Series 1998 B	812,504	1,155,662
Electric System General Revenue Bonds, Series 2000 A	344,145	428,211
Electric System General Revenue Bonds, Series 2001 A	304,592	297,011
Electric System General Revenue Bonds, Series 2001 B through K	500,000	500,000
Electric System General Revenue Bonds, Series 2001 L through P	316,502	312,544
Electric System General Revenue Bonds, Series 2003 A	112,738	—
Electric System General Revenue Bonds, Series 2003 B	546,392	—
Electric System General Revenue Bonds, Series 2003 C	330,063	—
Electric System General Revenue Bonds, Series 2003 D through O	587,225	—
Electric System Subordinated Revenue Bonds, Series 1-3 & 1-6	525,000	700,000
Electric System Subordinated Revenue Bonds, Series 7	250,000	250,000
Electric System Subordinated Revenue Bonds, Series 8 (subseries A-H)	238,673	236,593
Electric System Commercial Paper Notes, CP-1	100,000	100,000
Debentures	—	283,160
NYSERDA Notes	152,124	333,183
Total	$ 7,500,770	$ 7,878,289

(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 $426,000, $131,000, and $114,000, for the years ended December 31, 2003, 2002, and 2001, 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 it is not possible to determine the actuarial computed value of benefits for the Authority on a separate basis. 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) Commitments and Contingencies

Existing Purchased Power and Transmission Agreements

As a result of the Merger, LIPA has assumed contracts with numerous Independent Power Producers (IPPs) and the New York Power Authority (NYPA) for electric generating capacity. Under the terms of the agreement with NYPA, which will expire in May 2014, LIPA may purchase up to 100% of the electric energy produced at the NYPA facility located within LIPA's service territory at Holtsville, New York. LIPA is required to reimburse NYPA for the minimum debt service payments and to make fixed nonenergy payments associated with operating and maintaining the plant.

With respect to contracts entered into with the IPPs, LIPA is obligated to purchase all the energy they make available to LIPA at prices that often exceed current market prices. However, LIPA has no obligation to the IPPs it they fail to deliver energy. For purposes of the table below, LIPA has assumed full performance by the IPPs, as no event has occurred to suggest anything less than full performance by these parties.

LIPA had also assumed a contract with NYPA for firm transmission (wheeling) capacity in connection with a transmission cable that was constructed, in part, for the benefit of LIPA. With the inception of the New York Independent System Operator (ISO) 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 ISO. That is, the concept of firm physical transmission service continues. LIPA 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 ISO. Under the rules of the ISO, 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 ISO.

Although LIPA has converted its ETA's into TCCs, LIPA will continue to pay all transmission charges per the ETAs, which expire in 2020. In return, LIPA 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, and as such are included in the FPPCA calculation.

The following table represents LIPA's commitments under existing purchased power and transmission contracts (thousands of dollars):

Purchased power and transmission contracts assumed from LILCO

	NYPA Holtsville					
	Debt service	Other Fixed charges	Energy*	Firm transmission	IPPs*	Total business*
For the years ended:						
2004	$ 22,146	$ 14,370	$ 17,854	$ 24,140	$ 137,100	$ 215,610
2005	22,246	14,934	16,709	25,308	120,400	199,597
2006	22,351	15,251	16,506	25,903	122,400	202,411
2007	22,462	15,576	15,714	25,795	122,700	202,247
2008	22,578	15,909	15,376	25,795	125,500	205,158
2009 through 2013	100,451	90,275	79,646	128,975	335,600	734,947
2014 through 2018	3,655	5,454	5,922	128,975	98,000	242,006
2019 through 2023	—	—	—	128,975	—	128,975
2024 through 2028	—	—	—	128,975	—	128,975
2029 through 2032	—	—	—	103,180	—	103,180
Total	$ 215,889	$ 171,769	$ 167,727	$ 746,021	$ 1,061,700	$ 2,363,106

*Assumes full performance by NYPA and the IPPs.

Additional Power Supplies

Purchase Power Agreements

The Company entered into agreements with six private companies to construct and operate twelve generating units at eight sites throughout the service area. LIPA has entered into power purchase agreements (PPA) with each of the companies for 100% of the capacity, and energy if needed, for the term of each PPA. The PPAs vary in duration from three to 25 years.

In accordance with the provisions of SFAS No. 13, *Accounting for Leases*, six of the leases, covering nine of the twelve generating units, will be accounted for as capitalized lease obligations, whereas the remaining two leases, covering the other three generating units, will be accounted for as operating leases.

The following table represents LIPA's minimum lease payments for the PPAs (thousands of dollars):

Purchase Power Agreements

	Capital	Operating
Minimum lease/rental payments:		
2004	$ 80,073	$ 29,354
2005	78,747	19,634
2006	77,511	—
2007	76,876	—
2008	75,249	—
2009 through 2013	367,299	—
2014 through 2018	337,504	—
2019 through 2023	100,284	—
2024 through 2027	43,047	—
Total	1,236,590	48,988
Less imputed interest	434,887	—
Net present value	$ 801,703	$ 48,988

Submarine Cable

In 2002 the Company entered into a capital lease for a submarine cable running between Connecticut and Long Island whereby LIPA would be entitled to up to 330 megawatts of transmission capacity. The cable was not able to obtain an operating license, as it had been determined that several sections of the cable were not buried to depths required by its permits. During 2003, the Department of Energy (DOE) issued an emergency order allowing the cable to operate. Because the cable owner has not been able to obtain an operating license, the Authority is under no obligation to remit payments to the owner based on the 2002 lease agreement. However, in order for the Authority to utilize the cable under the emergency order issued by the DOE, the Authority has entered into an interim agreement for 330 megawatts of capacity at a rate of approximately $1.4 million per month. The interim agreement will remain in place over the term of the emergency order. Under the terms of this interim agreement, LIPA incurred capacity and other costs totaling $7.6 million in 2003.

The Authority's original agreement was for 300 megawatts of firm transmission capacity and expires in 2022. Under the original agreement, LIPA would be obligated to pay approximately $19.4 million annually, escalating to approximately $22.5 million in 2022. The remaining 30 megawatts of capacity could have been purchased by LIPA in the open market, subject to LIPA's needs.

As provided by LIPA's tariff, the costs of all of the facilities noted above will be includable in the calculation of Fuel and Purchased Power Cost. As such, these costs will be recoverable through the Fuel and Purchased Power Cost Adjustment mechanism.

Office Lease

The Authority entered into a noncancelable office lease agreement through January 31, 2011. The future minimum payments under the lease are as follows (thousands of dollars):

Year ended December 31:		
2004	$	1,243
2005		1,290
2006		1,338
2007		1,388
2008		1,440
2009 through 2011		3,174
Total	$	9,873

Rental expense for the office lease amounted to approximately $1.3 million and $1.2 million for the period ended December 31, 2003 and 2002, respectively.

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 State of New York 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 footnote 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.

(12) Legal Proceedings

Environmental

In connection with the Merger, KeySpan and LIPA entered into Liabilities Undertaking and Indemnification Agreements which, when taken together, provide, generally, that environmental liabilities will be divided between KeySpan and LIPA on the basis of whether they relate to assets transferred to KeySpan or retained by LIPA as part of the Merger. In addition, to clarify and supplement these agreements, KeySpan and LIPA 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 LIPA after the Merger (the Retained Business) and to the business and operations to be conducted by KeySpan after the Merger (the Transferred Business).

KeySpan 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. LIPA is responsible for all environmental liabilities traceable to the Retained Business and certain scheduled environmental liabilities.

Environmental liabilities 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.

Environmental Matters Retained by LIPA

Long Island Sound Transmission Cables – The Connecticut Department of Environmental Protection (DEP) and the New York State Department of Environmental Conservation (DEC) separately have issued Administrative Consent Orders (ACOs) in connection with releases of insulating fluid from an electric transmission cable system located under the Long Island Sound that LIPA owns jointly with the Connecticut Light and Power Company (CL&P). The ACOs require the submission of a series of reports and studies describing cable system condition, operation and repair practices, alternatives for cable improvements or replacement, and environmental impacts associated with prior leaks of fluid into the Long Island Sound. LIPA and CL&P are under a directive from the DEP to overcome institutional and business issues preventing the replacement or removal of the cable, however, the parties have been unable to reach agreement due to business issues under negotiation. LIPA's inability to reach agreement with CL&P on cable replacement or removal may result in violations of the DEP ACO. Liability, if any, resulting from this proceeding cannot yet be determined. However, LIPA does not believe that this proceeding will have a material adverse effect on its financial position, cash flows or results of operations.

In November 2002, a work boat, owned and operated by a third party, dragged its anchor, causing extensive damage to four of the seven cables of the 138-kilovolt facility and the release of a minimal amount of dielectric cable fluid into the Long Island Sound. The work boat had been at the cable site working as part of a large natural gas pipeline project. Temporary repairs were promptly carried out (the cable ends were capped) and permanent repairs completed in June 2003. Litigation arising from the incident commenced in December 2002 and in that litigation LIPA and CL&P have been aggressively pursuing the owner of the work boat as well as the other parties involved in the natural gas pipeline project and who were involved in this incident.

The same natural gas pipeline project also resulted in another anchor drag incident in February 2003, which damaged the Y-49 Cable, a facility owned by NYPA but maintained by LIPA as the primary user. Here, a large barge involved in the project dragged its anchor resulting in the damage to one of the four cables of this facility. Temporary repairs (cable was capped) were completed within ten days and permanent repairs were done by September 2003. Litigation arising from the incident commenced in August 2003. LIPA, as well as NYPA and its property damage insurer are actively engaged in litigation against the barge owner as well as the other parties involved in the incident.

Simazine. Simazine is a commercially available herbicide manufactured by Novartis that was used by LILCO as a defoliant until 1993 under the direction of a New York State Certified Pesticide Applicator. Simazine contamination was found in groundwater at one of the LIPA substations in 1997. LIPA has conducted studies and monitoring activities in connection with this herbicide and is currently working cooperatively with the DEC and others in this matter. The liability, if any, resulting from the use of this herbicide cannot yet be determined. However, LIPA does not believe that it will have a material adverse effect on its financial position, cash flows, or results of operations.

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 worth 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 LIPA, for the remedial design and for remedial action at the site. LIPA cannot predict with reasonable certainty the actual cost of the selected remedy, who will implement the remedy, or the cost, if any, to LIPA. Under a PRP participation agreement, LIPA is responsible for 7.95% of the costs associated with implementing the remedy. LIPA 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 case was tried in the fall of 2002, which resulted in a finding of liability against Metal Bank in January 2003. At a March, 2003 conference before the federal judge, the court ordered that the second stage trial (determination of the final remedy) be held on November 1, 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. At the present time all the parties (EPA, the Utilities Group, and the Schorsch brothers [adjudicated liable early last year along with the Metal Bank parties]) are in nonbinding mediation of two issues: i) the scope of the remedy, and ii) whether and how much the Schorsch brothers are prepared to contribute. The EPA is now seeking to expand the scope of the remedy, which if approved could increase the estimated cost to $30 million. To date the EPA claims also that its past costs are $6 million. Should mediation fail, a trial will commence in November 2004.

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 PCE 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 are 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 LIPA, recently signed a second consent order that obligates them to clean up and restore the two contaminated properties. LIPA has been determined to be responsible for less than 1% of the materials that were shipped to this site. Although LIPA is currently unable to determine its precise liability for costs to remediate these sites, LIPA does not believe that this liability will have a material adverse effect on its financial position, cash flows or results of operations.

Mattiace Petrochemical Site. This site in Glen Cove operated as a bulked and drummed solvent retailer from the 1960s until 1987, and as a drum reconditioning facility from 1974 through June 1983. In 1988, EPA began remediating the heavily contaminated soil found at the site. LIPA was identified as a PRP by the EPA for LILCO's distribution of empty drums that may have contained solvent residues for reconditioning at the site and for the purchase of solvents during the 1980s. Pursuant to negotiations with EPA, a judicial consent decree settlement was entered in federal court on June 19, 2003. LIPA's portion of the settlement was approximately $466,000.

Environmental Matters Which May be Recoverable from LIPA 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 causes of action sounding in nuisance remain at issue. Specifically, the Village seeks 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. Since that time, the judge passed away and the case has been reassigned. The parties have agreed that the new judge can decide the case on the existing record in lieu of a new trial. Liability, if any, resulting from this proceeding cannot yet be determined. However, LIPA does not believe that this proceeding will have a material adverse effect on its financial position, cash flows or results of operations.

Asbestos Proceedings

Litigation is pending in State Court against LIPA, 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 LIPA 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 LIPA. 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 LIPA 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 .

Environmental Matters Which are Currently Untraceable for Which LIPA Could Have Responsibility

Other Superfund Sites. The Attorney General is in negotiations with LIPA and other parties to achieve settlements at three municipal landfills where LILCO allegedly disposed of hazardous substances. The landfills are located in Towns of North Hempstead, the Port Washington Landfill; Huntington, the East Northport Landfill; and Southampton, the North Sea Landfill. All three landfills have been remediated and the Attorney General is seeking to recover the monies spent by the State in remediating the sites. All three sites are the subject of tolling agreements to extend the statute of limitations so that the State does not have to initiate litigation in order to achieve settlements with the various parties. LIPA's share of alleged liability at each site has not been established.

Other Matters

LIPA may from time to time become a party to various legal proceedings arising in the ordinary course of its business. In the judgment of the Authority and LIPA, these matters will not individually or in the aggregate, have a material effect on the financial position, results of operations or cash flows of LIPA.

Future Environmental Compliance Obligations

LIPA, through its contractual obligations to KeySpan under the PSA and the MSA, is subject to 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, the handling and disposal of toxic substances and hazardous and solid wastes, and the handling and use of chemical products. Electric utility companies generally use or generate a range of potentially hazardous products and by-products that are the focus of such regulation. LIPA is also subject to state laws regarding environmental approval and certification of proposed major transmission facilities.

From time to time environmental laws, regulations and compliance programs may require changes in KeySpan's operations and facilities, and may increase the cost of energy delivery service. Historically, rate recovery has been authorized for environmental compliance costs.

The Clean Air Act Amendments of 1990 (1990 Amendments) limit emissions of sulfur dioxide (SO2) and nitrogen oxides (NOx). The U. S. Environmental Protection Agency (EPA) allocates annual sulfur dioxide emissions allowances to each of the PSA units based historical output. NOx are regulated on a regional level through the Ozone Transportation Commission, and are also controlled through allowance allocations. The PSA units are expected to continue to achieve cost effective compliance with these emission control requirements through capital expenditures, the use of natural gas fuel, and the purchase of emission allowances when necessary. LIPA may be required to purchase additional allowances above the PSA unit allocations based on changes in fuel prices. Future requirements of the 1990 Amendments may require further reduction of SO2 and NOx emissions, as well as new limits on mercury and nickel emissions. However, specific control requirements have not been determined by the EPA, and the costs, if any cannot be estimated at this time

In 2003 the State of New York promulgated separate regulations that would further limit SO2 and NOx beginning in 2004. The PSA units are expected to comply with the NOx requirements without additional material expenditures, and utilize lower sulfur fuel to meet the SO2 regulations at an approximate cost of $10 million.

In 2003, the Governor of New York initiated the Regional Greenhouse Gas Initiative to control greenhouse gas emissions in ten Northeastern states. Several similar initiatives are also being considered at the federal level. It is not possible at this time to predict the nature of the requirements that may be imposed, nor their potential operational or financial impacts.

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 may be required by the New York State Department of Environmental Conservation (DEC) upon the periodic renewal of these water discharge permits due to potential changes in Section 316(b) of the CWA. KeySpan is undertaking the study of the impact of current permit conditions on aquatic resources in consultation with the DEC. The nature and extent of any expenditures cannot be determined until these regulations are finalized, and the studies are completed.

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

The Board of Trustees
Long Island Power Authority and Subsidiaries:

We have audited the basic financial statements of the Long Island Power Authority (Authority) as of and for the year ended December 31, 2003, and have issued our report thereon dated March 20, 2004. 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.

Compliance
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 grants, 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 that are required to be reported herein under *Government Auditing Standards*.

Internal Control Over Financial Reporting
In planning and performing our audit, we considered the Authority's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the basic financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of Authority management, the Authority's Board of Trustees, New York State's Division of the Budget and 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 20, 2004