



**Report on the Results of the
Strategic Organizational Review**





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December 15, 2005

Ms. Elizabeth McCarthy
Chief Financial Officer
Long Island Power Authority
333 Earle Ovington Boulevard
Suite 403
Uniondale, NY 11553

Dear Ms McCarthy:

Attached is FTI Consulting's Report on the Results of the Strategic Organizational Review that we performed for the Long Island Power Authority (the "Authority").

We are pleased to have had this opportunity to work with you and the staff of the Authority on this important project and appreciate all of the cooperation and courtesies that were extended to us.

Very truly yours,

Michael J. Hamilton
Senior Managing Director

Attachment

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Long Island Power Authority Report on the Results of the Strategic Organizational Review

Executive Summary –

Overview –

In the mid to late 1990's, the Long Island Lighting Company ("LILCO") was unable to contain the rate impact of its stranded investment in the Shoreham Nuclear Generating Station, Long Island electric customers had lost faith in LILCO management, the reliability of the Long Island electric transmission and distribution system was becoming an ongoing concern and there was a major property tax case that threatened the financial stability of several Suffolk County taxing jurisdictions. As a result, Governor George Pataki called for and achieved the takeover of the LILCO transmission and distribution system by the Long Island Power Authority ("LIPA" or the "Authority").

The Authority, a tax exempt entity, developed a plan to address these issues, resulting in its acquisition of LILCO assets using low cost tax-exempt debt and implemented an immediate and substantial rate decrease of nearly 20%. To ensure operational continuity, the Authority entered into a contract (the Management Services Agreement or "MSA") with KeySpan Energy ("KeySpan") for the day-to-day operation of the transmission and distribution system using LILCO's existing workforce. KeySpan simultaneously purchased the LILCO generating facilities and retail gas distribution business located on Long Island. The Authority then entered into a contract with KeySpan to purchase all of the output from KeySpan's on-Island generating facilities through May 28, 2013, with an option to extend the contract thereafter on substantially similar terms. In addition, the Authority received an option to purchase all of the generating plants that KeySpan purchased from LILCO (the "Generation Purchase Right Agreement" or "GPRA"). KeySpan and the Authority also entered into an Energy Management Agreement (the "EMA") for the management of fuel and energy purchases and sales, completing the contractual arrangements for the provision of electric service to all of Long Island.

The original arrangements are running their course. The GPRA must soon be executed or allowed to expire. Part of the EMA and all of the MSA are coming to the end of their terms.

In many ways, the Governor's original objectives with regard to the Authority's takeover of LILCO have been achieved (i.e., rates have been lowered, confidence

in electric system management has been restored, system reliability is the best in New York State and the property tax cases have been settled). But the electric utility industry has changed significantly since the acquisition and, as noted above, the Authority is facing a number of key decision points with respect to its contracts. As a result, LIPA's Board and Senior Management have been called upon to seriously review the Authority's structure going forward.

The Strategic Organizational Review

In August of 2004, Richard Kessel, the Chairman and Chief Executive Officer of the Authority initiated a review of the strategic organization and governance issues facing the Authority. The purpose of the review was to decide whether the Authority, as currently organized and governed, was in the best position to provide Long Island with reliable power at the lowest cost over the long-term.

FTI Consulting ("FTI"), together with Bear, Stearns & Co. Inc., Hawkins Delafield & Wood, LLP, Thelen Reid & Priest, LLP and Hunton & Williams, LLP, were retained to assist the Authority in reviewing strategic organizational options. It was determined that the Authority's potential organizational options, ranged from (i) continuing as a public / private partnership (i.e., maintain the "Status Quo"); (ii) taking over the operations and maintenance of the transmission and distribution system from KeySpan as the contracts expired (i.e., "Full Municipalization") or (iii) selling the transmission and distribution assets to a private entity, who would then own and operate the transmission and distribution system on Long Island subject to New York Public Service Commission ("NYPSC") regulation (i.e., "Privatization"). It was agreed with the Authority that FTI should also review the GPRA and make a recommendation as to whether to exercise the option or let it expire.

An extensive examination of the Authority's current situation and practices was conducted, which included:

- Meetings with an advisory group of the Board of Trustees charged with monitoring the progress of this review;
- Interviews with the senior executives of a number of large east coast investor-owned electric utilities and large public power entities;
- Public hearings in Nassau and Suffolk Counties and in the Rockaways,
- Meetings with local and state political leaders, officials of the NYPSC and the U.S. Department of the Treasury and the Internal Revenue Service;
- Benchmarking of the Authority's costs against other municipal and investor-owned electric utilities;
- An evaluation and quantification of the value of the Long Island electric transmission and distribution system;

- Identification of issues and / or leverage points that the Authority would have in any of the scenarios;
- Extensive due diligence with regard to the KeySpan generating plants that are subject to purchase under the GPRA;
- Interviews with the Authority's external subject matter experts; and
- An economic evaluation of all of the scenarios.

FTI also had access to the work that the Authority and its consultants (the "MSA Re-Bid Team") were performing in preparation for a possible re-bid of the MSA. The MSA Re-bid Team had identified provisions in the current MSA contract that they would attempt to change and clarify in the re-bid process.

Conclusions Reached as a Result of the Strategic Organizational Review –

FTI has determined that under any of the organizational models, electric system reliability could be maintained at its current high level and customer service would not be adversely affected. However, each of the organizational models has different economic and operational implications.

Organizational Options

FTI concluded that the current public / private partnership model has served the Authority and its stakeholders well since inception, particularly from a system reliability and customer satisfaction standpoint and that generally the Status Quo model is the best organizational model for the Authority at this time. FTI concluded that, as a result of the significantly higher capital and tax costs of a private entity and the lack of sufficient cost savings from private operation, it would be impossible to currently accomplish a privatization transaction without an immediate or near-term rate increase in the 6% to 10% range. Therefore, we do not believe the time is right for privatization from a customer cost standpoint, particularly given the current pressure on customer bills caused by historically high fuel costs. FTI did not, however, rule this option out for the future. FTI concluded there are significant cost, labor and management issues that would rule out the Full Municipalization model.

While the Status Quo model was identified as the best current alternative, because the MSA was the first contract of this type for an organization the size of the Authority, and the electric industry has changed significantly since the acquisition, there are a number of financial and operational aspects of the contract that have to be addressed in order for this structure to provide the best benefit to the Authority and its stakeholders. In addition, there are a number of open contract disputes between the Authority and KeySpan that would best be settled on a global basis. Therefore, focus was given to how to improve the Status

Quo organizational model to assure that the costs to customers was minimized, reliability and customer satisfaction were optimized, the contracts were transparent and easier for the Authority to administer and the matters that led to the contract disputes were resolved and addressed going forward. In addition, the potential risks associated with a re-bid of the MSA were identified and evaluated, including the risks that costs, particularly in the near term, may not be lower, that synergies LIPA currently captures through KeySpan's joint operation of the electric and gas business on Long Island may be lost and that the contract may need to be split among multiple vendors, increasing the risk that some tasks may "fall through the cracks."

Given the risks of a re-bid and the significant leverage LIPA has in a potential re-negotiation of the existing MSA with KeySpan, LIPA pursued a negotiated settlement with KeySpan addressing all open issues. The goals of the Authority were (i) lowering costs to the customer; (ii) addressing the issues of the current contract; (iii) reaching a favorable settlement of the global issues and (iv) maximizing the benefit to the Authority of the GPRA option which was set to expire near the end of 2005.

Discussions were initiated with KeySpan in the Spring of 2005 and continued through December. As a result of those discussions, the Authority and KeySpan have reached an Agreement in Principle that:

- Achieves significant cost reductions immediately which continue over the life of the new MSA;
- Settles the global issues for a significant payment to the Authority;
- Simplifies the MSA and makes it more transparent to administer, including incorporating operating metrics that will facilitate the monitoring of the contract;
- Replaces the GPRA (which FTI had concluded was of limited benefit to the Authority) with a new purchase option with regard to plant sites that would significantly benefit from re-powering;
- Extends the MSA contract through 2013;
- Gives the Authority, at any time during the contract, the right to terminate the MSA at a relatively modest cost if and when the Authority chooses to pursue a privatization; and
- Eliminates the significant risks and costs inherent in a re-bid of the MSA contract.

FTI believes that the successful conclusion of the re-negotiation of the MSA contract with KeySpan has produced the optimal current result for the Authority while maintaining the maximum flexibility to change organizational structure if and when it is beneficial to do so.

Finally, there was a single overriding issue that was identified in this review that should be addressed; the need to recover the costs of the Shoreham Regulatory Asset as quickly as is economically feasible. Originally, the Authority had intended for the debt associated with this stranded asset to be paid by 2013 through a series of scheduled and optional debt pay downs. But, as a result of other priorities (primarily unprecedented increases in the price of natural gas and oil used to generate electricity and purchased power costs), the anticipated optional debt repayments were forgone in order to subsidize customer fuel and purchased power costs. FTI concluded that the Authority should continue to accelerate the repayment of the debt related to the stranded asset which will result in reduced cost to customers over the long-term regardless of which organizational structure the Authority adopts.

FTI Consulting's Scope of Services

FTI has been retained by the Authority to provide advisory services to the Authority with respect to the following issues:

1. How the Authority should structure and govern itself to assure low cost, reliable electric services to Long Island consumers in the long-term, considering:
 - a. Range of ownership and organizational models (including LIPA's current model);
 - b. Long and short term risks and rewards of each of these models;
 - c. How these models fit with the Authority's mission statement;
 - d. The optimal form of governance of each of these models;
 - e. The hurdles to achieving these models or to functioning under them;
 - f. How those hurdles can be effectively overcome;
 - g. Impact on rates of any alternatives recommended; and
 - h. Impact on competitive wholesale and retail services of the options considered.
2. What is the appropriate path and timeline to achieving the recommended structure and governance model?

In addressing these questions, FTI considered the best practices for both publicly held and investor-owned utilities, the evolution in the energy industry in New York and surrounding areas and the views of all stakeholders. We also addressed the GPRA in the context of the decisions that the Authority will have to make in the near-term.

We have worked as part of a team of advisors that included Bear, Stearns & Co. Inc., Hawkins Delafield & Wood LLP, Thelen Reid & Priest LLP and Hunton & Williams LLP. This report documents the conclusions that FTI has reached, after consultation with the other named advisors, with regard to the issues identified above.

Overview of the Authority

Background –

This section will describe the history of the Authority and its wholly-owned subsidiary, the Long Island Lighting Company ("LILCO") which does business as the retail electric transmission and distribution company on Long Island under the name LIPA ("LIPA"). The Authority, acting through LIPA, provides this electric service in its service area (the "Service Area") which includes two

counties on Long Island – Nassau County and Suffolk County (except for the Nassau County villages of Freeport and Rockville Centre and the Suffolk County village of Greenport, each of which has its individually owned municipal electric system) – and a portion of the Borough of Queens known as the Rockaways.

The Authority is a corporate municipal instrumentality and a political subdivision of the State of New York (the "State"), exercising essential governmental and public powers. The Authority was created by the State Legislature under and pursuant to the Long Island Power Authority Act, being Title 1-A of Article 5 (§ 1020 et seq.) of the Public Authorities Law of the State of New York, as amended (the "Act"). LIPA is a stock corporation formed and existing under the Business Corporation Law of the State of New York.

LIPA Statute and Mission –

“As the public agency responsible for delivering electricity on Long Island, LIPA has the following mission –

Provide safe, reliable, lowest cost, environmentally sound electricity with care for our customers needs.”

Original LIPA Transaction

The Authority took over as the retail supplier of electric service in the Service Area on May 28, 1998 by acquiring LILCO as a wholly-owned subsidiary of the Authority through a merger (the “LIPA/LILCO Merger”). Since the LIPA/LILCO Merger, LILCO has done business under the name LIPA. Before the LIPA/LILCO Merger, LILCO was a publicly traded, shareholder-owned corporation that was the sole supplier of both retail electric and gas service in the Service Area. LIPA (LILCO) no longer provides gas service in the Service Area or owns electric generation. For the period prior to the LIPA/LILCO Merger, LILCO is referred to as “LILCO” and, for the subsequent period, is referred to as “LIPA.”

As part of the LIPA/LILCO Merger, LIPA retained only the electric transmission and distribution systems (the “T&D System”), certain agreements and contracts for power supply and transmission, an 18% undivided ownership interest in Unit 2 of the Nine Mile Point nuclear electric generating station located in Oswego, New York and certain other assets and liabilities, primarily regulatory assets and liabilities assumed from LILCO and relating to the former Shoreham Nuclear Plant. The term “System” means all of the assets of the Authority and LIPA that are used in the furnishing of electric service.

As part of the LIPA/LILCO Merger, the remainder of LILCO's electric service assets (including all of its fossil-fueled generating units), and its entire gas supply system, were transferred to certain wholly-owned subsidiaries (each a "KeySpan Sub" and, collectively, the "KeySpan Subs") of KeySpan Corporation. KeySpan Corporation is a publicly-traded shareholder-owned corporation and does business under the name KeySpan Energy ("KeySpan").

Relationship of the Authority and LIPA

LIPA is a New York Corporation and a wholly-owned subsidiary of the Authority. The members of the board of directors of LIPA are elected by the Authority. Accordingly, LIPA is controlled by the Authority. The present members of the board of directors of LIPA are the Trustees of the Authority (the "Trustees"). The Trustees are the Authority's governing body.

The Authority and LIPA are parties to a Financing Agreement (the "Financing Agreement") providing for their respective duties and obligations relating to the financing and operation of the retail electric business in the Service Area.

Pursuant to the terms of the Financing Agreement, LIPA conducts the electric business in the Service Area and is responsible for providing service to customers in the Service Area. The Authority is responsible for raising external capital necessary for LIPA to maintain the system. This includes all Bonds and Subordinated Indebtedness issued and to be issued. The proceeds of all such debt are loaned by the Authority to LIPA which repays such loans from the revenues LIPA receives from its electric business. To secure the loans, LIPA has pledged all of its revenues to the Authority which has, in turn, pledged such revenues as security for such debt.

The Authority and LIPA are also parties to an administrative Services Agreement which sets forth the terms and conditions under which the Authority provides personnel, personnel-related services and other services necessary for LIPA to provide electric service in the Service Area.

System Operation by the Authority

In order to assist in providing electric service in the Service Area, at the time of the LIPA/LILCO Merger, the Authority entered into a Management Services Agreement (the "MSA"), a Power Supply Agreement (the "PSA") and an Energy Management Agreement (the "EMA") (these three agreements are collectively referred to as the "Operating Agreements"), each with a separate KeySpan Sub, and assigned them to LIPA. These KeySpan Subs include KeySpan Generation, the subsidiary to which LILCO transferred its fossil-fueled generating facilities

simultaneously with the LIPA/LILCO Merger. The performance of each such KeySpan Sub under its respective Operating Agreement as well as any payment obligations it may have under such agreement are guaranteed by KeySpan. The purpose of the Operating Agreements is to provide the Authority and LIPA with the operating personnel and a significant portion of the power supply resources necessary for LIPA to provide electric service in the Service Area. The Authority assigned its rights and obligations under the Operating Agreements to LIPA.

The Authority oversees the operation of the System and manages the Operating Agreements with a staff of approximately 100 and with the support of outside financial, engineering, accounting and legal advisors and consultants. Day-to-day operations and maintenance of the electric system during the terms of the Operating Agreements is being performed by the workforce of the KeySpan Subs or its sub-contractors.

The Authority provides the continuity of policy making, rate setting, financial planning and management of the T&D System by maintaining the capability of its management team and in-house staff to administer the Operating Agreements and to make efficient use of outsourced services. A wide variety of skills and experience are required to establish policy, evaluate T&D System needs, and assess T&D System operations and related matters. The requirements are periodic and vary in the level of effort required. Outsourcing some of these services has enabled the Authority to obtain the skills needed without the expense of committing to full-time positions. The Authority employs several outside consultants to assist it in managing the T&D System.

Operating Agreements

MSA

The MSA provides for the KeySpan Sub party thereto (the “Manager”) to perform the day-to-day operation and maintenance of the T&D System, including, among other functions, transmission and distribution facility operation, customer service, billing and collection, meter reading, financial and operations reporting, planning, engineering, and construction, all in accordance with policies and procedures adopted by LIPA.

The Authority and LIPA exercise control over the performance of the T&D System through specific standards for performance and incentives and penalties to the Manager contained in the MSA. The primary standards of performance for the delivery of power are adherence to capital and operating budgets and the reliability of the T&D System.

Under the MSA, the Manager is paid an annual service fee as compensation. In addition to the service fee, the Manager is also paid or reimbursed for certain capital and unforeseeable costs. The Manager is entitled to incentive payments for cost savings and is subject to penalties for cost overruns on both the operating and capital budgets. In addition to the cost savings incentives, the Manager is eligible annually for incentives for performance above certain threshold target levels and is subject to penalties for performance below certain threshold minimum levels with regard to System reliability. The MSA also provides for additional performance incentives and penalties.

Originally, the term of the MSA was to run from May 28, 1998 to May 28, 2006. In 2002, the expiration date of the MSA was extended to December 31, 2008. The provisions of the MSA provide that the management services for the T&D System performed by the Manager will be competitively bid after December 31, 2005 for a new management agreement beginning in 2008.

PSA

The PSA provides for the sale to LIPA by KeySpan Generation LLC (“GENCO”) of all of the capacity and, to the extent LIPA requests, energy from the existing oil and gas-fired generating plants on Long Island formerly owned by LILCO (the “GENCO Generating Facilities”). Such sales of capacity and energy from the GENCO Generating Facilities are made at cost-based wholesale rates regulated by the Federal Energy Regulatory Commission (“FERC”).

The PSA provides incentives and penalties for GENCO of up to \$4 million annually to maintain the output capability of the GENCO Generating Facilities, as measured by annual industry-standard tests of operating capability, and to maintain and/or make capital improvements which benefit plant availability.

The PSA provides LIPA with all of the capacity from the GENCO Generating Facilities. However, LIPA has no obligation to purchase energy from the GENCO Generating Facilities and is able to purchase energy on a least-cost basis from all available on-Island sources, as well as off-Island sources, consistent with existing transmission interconnection limitations of the T&D System. The PSA expires on May 28, 2013 and is renewable for 15 years on similar terms. However, the PSA provides LIPA the option of electing to reduce or “ramp down” the capacity it purchases from GENCO beginning May 28, 2004 in accordance with schedules set forth in the PSA. The PSA will be terminated in the event that LIPA exercises its right to purchase at fair market value all of the GENCO Generating Facilities during the period beginning on November 29, 2004 and ending on December 15, 2005, subject to certain cost considerations. (See the discussion of the Generation Purchase Right Agreement below.)

EMA

The EMA provides for the KeySpan Sub party thereto (“Energy Manager”) to (i) procure and manage fuel supplies for LIPA to fuel the GENCO Generating Facilities, (ii) perform off-system capacity and energy purchases on a least-cost basis to meet LIPA’s needs, and (iii) make off-system sales of energy, capacity and other ancillary services from the GENCO Generating Facilities and other power supplies either owned by or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales arranged by the Energy Manager. The term for the service provided in (i) above is through May 28, 2013, and the term for the service provided in (ii) and (iii) above is through May 28, 2006.

The Energy Manager is compensated for fuel management services through the payment by LIPA of: (i) a monthly fuel management fee; (ii) the cost of fuel purchased on LIPA’s behalf; and (iii) a fuel purchase performance incentive/disincentive payment. Additionally, the energy Manager receives one-third of net revenues from off-system sales, plus an annual system power supply management fee and a system power supply performance incentive/disincentive payment. While LIPA pays for the actual fuel and electricity purchased, the EMA further provides incentives for control of the cost of fuel and electricity purchased on behalf of LIPA by the Energy Manager. The electricity purchase incentive or penalty under the EMA, together with the net other performance incentives and penalties under the MSA, cannot exceed \$7.5 million for any year.

Other Rights

Pursuant to certain other agreements between LIPA and KeySpan or KeySpan Subs, certain future rights have been granted to LIPA. These rights include continuation of the present gas transportation rate for gas delivered over the gas distribution system to the GENCO Generating Facilities and to certain new generation resources until 2009, with cost-based adjustments to meet gas delivery system expansion needs. Subject to certain conditions, these rights also include the right until 2097 to lease or purchase, or to allow its designee to lease or purchase, at fair market value, parcels of land and to acquire unlimited access to, as well as appropriate easements at, each parcel of land upon which an existing GENCO Generating Facility is situated, as well as access to land contiguous to such parcels for the purpose of constructing new electric generating facilities to be owned by LIPA or its designee. Subject to LIPA’s right of first refusal, KeySpan and its subsidiaries also have the right to sell or lease these properties to third parties.

KeySpan or various of its subsidiaries owns the common plant (such as administrative office buildings and computer systems) formerly owned by LILCO and LIPA is charged for its beneficial use through the Operating Agreements. KeySpan has agreed to provide LIPA, for the period through 2097, the right to enter into leases at fair market value for common plant or sub-contract for common services which it may assign to a subsequent manager of the T&D System. KeySpan has also agreed for the period through 2097 not to compete with LIPA as a provider of transmission or distribution service on Long Island.

Generation Purchase Right Agreement

When the Authority became the retail supplier of electric service in the Service Area through the acquisition of LILCO in May 1998, it obtained a one-time unilateral right (the "Generation Purchase Option") to acquire all the equity interests in GENCO at fair market value pursuant to the Generation Purchase Right Agreement (the "GPRA"). GENCO owns all of the former LILCO on-Island generation consisting of 53 generating units at 13 locations totaling approximately 4,000 MW in capacity. The GPRA was amended in 2002 to provide that the Generation Purchase Option can be exercised only during the period beginning on November 29, 2004 and ending on May 28, 2005, provided that if the Generation Purchase Option is exercised during that period any election by LIPA to operate the generating facilities itself or by an affiliate would not be effective prior to May 28, 2005. The GPRA was again extended on March 27, 2005 until December 15, 2005, with no change in its terms other than extending the date by which LIPA has to decide whether to exercise the GPRA. The GPRA provides that notice of exercise of such option must be given by the Authority to KeySpan prior to determination of the acquisition price. The GPRA further provides that prior to issuing such notice; the Authority must have (i) the approval of the Trustees by at least a two-thirds vote and (ii) New York State Public Authorities Control Board (the "PACB") approval of the exercise of the right and related financing. The notice to acquire GENCO would be legally binding on the Authority, with certain exceptions, subject to third party approvals, including the New York State Comptroller's Office, the New York State Attorney General's office and the PACB. The acquisition price is to be determined, considering the terms of the existing PSA, through negotiation by investment bankers retained by KeySpan and the Authority, or by a third, mutually agreed upon investment bank if the first two cannot agree.

Current Issues

The original LIPA transaction included several future decision points where either critical options had to be exercised or major contracts were set to expire and decisions made with regard to re-letting those contracts. These decision points are summarized below:

<u>Agreement</u>	<u>Expiration</u>
Generation Purchase Right Agreement	December 15, 2005
“Ramp down” rights in the Power Supply Agreement	Various times between now and the end of the PSA in 2013
Energy Management Agreement	May 28, 2006 ¹
Management Services Agreement	December 31, 2008 ²
Power Supply Agreement	May 28, 2013 ³

Given that these contracts comprise the vast majority of LIPA’s operations and LIPA must make decisions regarding exercising or re-letting three of these four major agreements over the next three years, the Authority has decided to take advantage of this opportunity and evaluate whether or not a different operational and governance structure would better serve the needs of its electric customers. In this effort, the Authority and its advisors evaluated alternative organizational structures that broadly fall under the following three main categories –

- Privatization,
- Full Municipalization and
- Status Quo.

Evaluation of Options

In evaluating the organizational structures under consideration, each alternative was analyzed utilizing the following decision criteria:

- *Impact on rates* – How will a new organizational structure impact rates in both the short and long-term?

¹ Two of the three services provided under this contract expire on May 28, 2006, while the third service expires on May 28, 2013.

² LIPA is allowed to begin the re-bid process after December 31, 2005.

³ LIPA can renew the existing contract for an additional 15 year term under substantially similar terms.

- *Impact on customer service and reliability* – Will customer service and reliability be negatively impacted by a change in organizational structure? Does one governance structure provide these services more efficiently than the others?
- *Consistency with New York State and FERC policies and industry evolution* – Do the proposed new structures fit within current New York State and FERC standards? Can the structure adapt as the industry evolves?
- *Ability to manage the regulatory assets* – How will LIPA’s regulatory assets be managed under each of the scenarios? How will the management of these regulatory assets impact current and future rates?
- *Feasibility* – How will the proposed structures be received by the Authority’s customers, bondholders, governmental entities and other interested parties and stakeholders?
- *Union considerations* – How will the workforce be impacted under the new structure?
- *Timeframe and complexity to accomplish change* – How long will it take to implement the proposed new structures? How hard will it be to obtain any required approvals for such a change, including legislative, bondholder, and IRS approvals, as applicable?

The most critical of the above factors is how to minimize the rate impacts of LIPA’s regulatory assets, while providing quality service, at the lowest cost.

FTI Analysis of the GPRA –

We believe that the GPRA, as it is currently structured is of limited value because it requires (i) that all of GENCO Generating Facilities must be purchased at fair value in one transaction and (ii) that the cost of the plants will not be known until after the decision to exercise the GPRA is made. In addition, the Authority would have to obtain approval from its Trustees and the PACB prior to exercising the option, when the actual exercise price is still unknown. The LIPA Statute requires that the PACB find that the transaction would result in “generally lower rates” before approving the transaction. We believe reaching this conclusion will be difficult because the purchase price will be unknown at the time of the request for PACB approval. In the current interest rate environment, the price that LIPA could pay for the GENCO Generating Facilities, without incurring higher costs than it currently pays under the PSA, is well below KeySpan’s estimated fair market value of the facilities. Further, if the Authority is able to complete the transaction, then it would become responsible for the decommissioning of these old, environmentally challenged plants.

In addition, the market value of the GENCO Generating Company assets has been declining, primarily as a result of actions that the Authority has taken to

obtain off-Island generation (e.g., the Cross Sound Cable and the Neptune Cable) as well as due to the construction of new generation facilities on Long Island. Because these new cables and facilities generate or deliver electricity in a more cost effective manner, they are displacing, and will displace, in the future the generation from the GENCO Generating Facilities, thereby reducing the value of those plants.

We are aware that the Authority has other alternatives for the construction of new generation on Long Island that could have the same effect as repowering some of the existing GENCO Generating Facilities (i.e., the Authority has the right to acquire land owned by GENCO adjacent to several of the existing generating plants that would permit the Authority to build new plants on those sites which would be a less expensive alternative to repowering any of the existing plants).

Further, the Authority has significant potential benefit in the value of the Ramp-Down Rights contained in the PSA that permits it to effectively eliminate up to 1,400 megawatts of the total 4,000 megawatts for which it is currently obligated to pay capacity charges. Beginning on May 28, 2004, (the end of the sixth year of the contract), the Authority has the option to reduce (“ramp down”) the capacity that it purchases under the PSA, at specified amounts and intervals. If the Authority were to exercise the GPRA, it would lose this valuable option.

We also considered whether the Authority could use the GPRA as a means to foster competition by “flipping” or re-selling the plants to other owner/operators. “Flipping” may increase the diversity of the ownership of generation on Long Island, but will not result in a competitive market for generation.

As noted above, KeySpan controls approximately 70% of Long Island’s generating capacity. Exercising the GPRA would eliminate the influence KeySpan has over the generation market on Long Island; however, with GENCO comprising 13 plant locations with varying operating performance characteristics, it is questionable if breaking up the GENCO portfolio could truly create competition on Long Island. In California’s failed attempt at competition, there were only 5 market participants and no excess capacity in the market. Finding more than five participants to take over the 13 plant facilities will be challenging, especially in light of the limited useful life of some of the older plants and all of the new generation resources that the Authority has acquired or is planning to acquire prior to the expiration of the PSA on May 28, 2013.

FTI GPRA Recommendation

For all these reasons, we believe that the Authority should either inform KeySpan that they will not exercise the GPRA before the December 15, 2005 deadline or allow the GPRA option to expire on December 15, 2005.

Potentially, the Authority could negotiate with KeySpan to cancel the existing GPRA and obtain an option on one or more of the plants that would be likely candidates for repowering. If this is possible, the purchase price, or a clear methodology for determining such price, should be included in the new option contract, which will facilitate obtaining Trustee and PACB approval of the exercise of the option, if applicable.

Critical Overall Issues

There are a number of overriding issues to consider in any attempt to change the LIPA organizational model, but the single most critical issue is continuing to collect interest and principal on the amount of debt outstanding attributable to the Shoreham-related regulatory assets in the most economic manner possible. The amortization of these regulatory assets through rates is the driver with regard to providing the lowest cost service; therefore minimizing the cost of the stranded asset while assuring its recovery is critical to any reorganization plan. The following chart demonstrates this point.

Long Island Power Authority
Recast Summarized Balance Sheet
December 31, 2004
(Dollars in Thousands)

Assets		Capitalization and Liabilities	
Tangible Assets			
Utility assets, net of depreciation			
Distribution	\$1,403,368		
Transmission	602,074		
Nine Mile Point	499,766		
Cash	335,068		
Other tangible assets	224,436		
Total tangible utility assets	3,064,712	Long-term debt and net assets	\$6,935,102
Intangible Assets	4,249,126	Other liabilities and deferred credits	378,736
Generation assets under lease	862,352	Capital lease obligation	862,352
Total assets	\$8,176,190	Total capitalization and liabilities	\$8,176,190

In a more typical utility situation, capitalization (i.e., equity and debt) would roughly equal tangible assets. Since that is not the case in this situation, the Authority is forced to charge for recovery of non-productive regulatory assets. Another way to view this situation is that approximately 58% of total assets (excluding generation assets under lease) do not contribute to the delivery of electricity. Electric rates on Long Island will be substantially higher than they otherwise would be until the debt related to the Intangible Assets is repaid.

If an investor-owned utility with its cost of capital approximately 500 basis points higher than LIPA were to acquire the Authority's assets, the revenues necessary to provide the additional return on both the tangible and the intangible assets would increase rates to customers by more than \$400 million on an annual basis.

When the Authority acquired LILCO, the Authority recognized the benefit of retiring the debt associated with the Shoreham-related intangible assets as quickly as possible. The Authority planned to use excess revenues to either retire this debt by December 2013 or avoid the issuance of new debt by funding capital expenditures with revenues. The objective of the Authority was that the outstanding debt at such time would approximate the book value of the physical assets of the System. This was to be accomplished through a combination of front-loaded amortization of debt through December 1, 2013 (approximately \$870 million more debt amortization than if the debt had been amortized on a level debt service basis) and anticipated optional future defeasances and redemption of debt. But, as a result of other priorities (primarily unprecedented increases in the price of natural gas and oil used to generate electricity and purchased power costs), the anticipated optional debt repayments were foregone in order to subsidize customer fuel and purchased power costs.

Customer rates on Long Island will remain high until the retirement of the debt related to these non-productive assets. Therefore, regardless of the organizational model ultimately chosen for LIPA, the financing of the Intangible Assets needs to continue to be done using tax-exempt debt in order to minimize the cost of financing and the resulting cost to LIPA's customers. In addition, the resumption of optional repayments to eliminate this debt as quickly as possible will help to provide for lower rates in the future.

Overview of Alternative Organizational Models

The Authority's potential organizational options ranged from, sale of the T&D System to a private owner ("Privatization"), fully municipalizing the electric

operations (“Full Municipalization”) and remaining a public / private partnership (which we describe as the “Status Quo”).

In order to assess all three of these alternative strategic organization models, FTI and / or the other advisors did the following –

- Met with an advisory group of the Board of Trustees charged with monitoring the progress of this review to determine their views on the future direction of the Authority;
- Conducted interviews with the chief executive and other senior management of a number of investor-owned electric utilities and large public power entities to discuss current issues in the electric utility industry and their perception of the Authority’s role as the electric service provider on Long Island, the benefits and limitations of being either a public power or a privately held entity and ways to improve the operations of the Authority;
- Conducted extensive interviews with all of the senior officers at the Authority to obtain their assessment of the effectiveness of the Authority and where change would be desirable to improve operations;
- Arranged and participated in meetings in Nassau and Suffolk Counties and the Rockaways to obtain customer feedback on the operation of the Authority;
- Met with local and state political leaders, staff of the NYPSC and the U.S. Department of the Treasury and the Internal Revenue Service;
- Met with the leaders of the KeySpan unions performing work for the Authority to obtain their views with regard to the operation of the Authority and its future structure;
- Completed an extensive benchmarking evaluation of the Authority’s costs compared against a number of other public power and investor-owned electric utilities, including comparing salaries at the Authority with a salary study performed by the American Public Power Association;
- Participated in an evaluation and quantification of the value of the Long Island electric T&D System considering a number of different assumptions;
- Participated in the identification of issues and / or leverage points that the Authority would have in each of the strategic organization scenarios;
- Performed extensive due diligence with regard to the KeySpan generating plants that are subject to purchase under the GPRA;
- Reviewed and analyzed recent utility mergers and attempts by public entities to acquire utility operating assets from private entities, including the rationale, in each case, for the proposed transaction;
- Conducted interviews with the Authority’s external subject matter experts; and

- Participated in an economic evaluation of the financial effects of all of the strategic organization scenarios.

Benchmarking

FTI performed a benchmarking analysis of the Authority compared to a number of northeast investor-owned electric utilities and a number of the larger municipal utilities throughout the United States and those municipal utilities in New York State. Our analysis demonstrates that while LIPA's transmission and generation operations and maintenance costs are competitive, its administrative and general costs and customer services costs are significantly higher than most other entities in our comparative data base. We estimate that if LIPA's administrative and general costs and customer service costs were brought in-line with its peers, costs could be reduced by \$25 million to \$30 million from current levels. These potential savings were considered in our evaluation of each of the organizational options.

Appendix A contains a more detailed discussion of the results of our benchmarking work.

Reliability

The Authority has made a major capital commitment to improving and maintaining electric reliability on Long Island; making over \$1.5 billion in reliability oriented capital expenditures since 1998. The results of this commitment to reliability are impressive and have positioned the Authority at the top of the reliability statistics for New York State since 1998. In performing our analyses, we did not find that one form of organizational model consistently produced better reliability results than any other organization model; rather, it was management's commitment and the financial stability required to maintain reliability that distinguished those companies that had strong reliability records. Therefore, we have concluded that any of the three organization models can continue to produce reliability comparable to the reliability that the Authority has achieved.

Privatization

Recent Industry Merger Developments

There has been an increase in merger activity in the electric utility space recently with utilities looking to acquire other utilities in order to gain size, diversify regulatory risk and obtain cost savings from the combination of operations. We believe that this trend could work to the Authority's benefit in a privatization

transaction because the Authority's service territory is desirable from a growth and customer demographics standpoint and there is an opportunity to achieve cost savings in the operation of the T&D System. In addition, the recent repeal of the Public Utility Holding Company Act now makes it easier for non-contiguous utilities to merge as well as making it easier for non-utility entities to purchase utility assets, thus expanding the universe of possible acquisition candidates. See Appendix B for additional detail on recent industry merger developments.

Description

For purposes of our analysis, we have assumed that LIPA has three broad classes of assets that could be privatized and a significant amount of intangible assets that would remain with a "Residual LIPA." Assets that could be privatized include the transmission assets (with a book value of \$602 million), the distribution assets (with a book value of \$1,403 million) and the 18% investment in the Nine Mile Point 2 nuclear generating unit ("Nine Mile 2") (with a book value of \$500 million).

It is reasonable to assume that the market value of the T&D System would be at least equal to its book value as the system is in extremely good condition, there is a large residential and commercial customer base and customer growth prospects on Long Island are above the industry average. Given the level of LIPA's revenues, net of the residual debt service, we do not believe that a book value purchase can be supported without the need for a significant rate increase in the near-term.

Based upon recent bids for nuclear generating assets, we believe that the market value of the Nine Mile 2 nuclear generating plant investment is significantly less than its book value (we estimate that the market value is between 30% to 40% of its book value, depending on the length of any associated power purchase agreement that the Authority may enter into as a condition of a sale).

In the privatization scenario, the T&D System could either be sold as a package or sold separately. We believe that the most efficient option, from an engineering and operating and maintenance perspective, would be to sell the T&D System to the same buyer, thereby maximizing flexibility of the work force and enhancing both scheduling and cross-training of that work force. At this point in time, we believe that there would be a number of qualified companies that would be interested in acquiring the Authority's T&D System.

Similarly, we would expect that there would be several parties interested in acquiring LIPA's interest in Nine Mile 2, including Constellation Energy, the 82% owner / operator of the plant, particularly in light of its Right of First Refusal for

the interest. However, we do not expect that the offered purchase price will be a high enough offer to pay off the Authority's Nine Mile 2 related debt. One significant benefit of the Authority's investment in Nine Mile 2 is the fuel diversity that it brings to a system that consists almost entirely of oil and gas fired generating units. We believe that the benefits of fuel diversity outweigh the risks of having a higher level of debt on LIPA's balance sheet relating to Nine Mile 2.

In our Privatization scenario, we have assumed that the Authority would retain the Shoreham-related intangible assets and its investment in Nine Mile 2 and continue to finance those assets with tax-exempt debt. The proceeds from the sale of the T&D System will be used to pay down the T&D System-related debt. "Residual LIPA" would solely exist to hold, pay down and report on the debt related to the Shoreham-related regulatory assets and the Authority's investment in Nine Mile 2. The new owner of the transmission and/or distribution system would be regulated by the FERC with regard to transmission rates and the NYPSC with regard to distribution rates. LIPA's branding of electricity service on Long Island would be replaced with the branding of the new owners of the electric distribution system.

Benefits of a Privatization

The provision of electricity on Long Island has traditionally been a private sector function and the State only stepped in to contain the rate impact of LILCO's stranded investment in the Shoreham Nuclear Generating Station and the Shoreham property tax issue. The private sector continues to provide electric services to substantially all of the rest of the State. The privatization of the T&D System would return what has traditionally been a private sector function back to the private sector and would retain the benefits of public sector financing for the Shoreham-related intangible assets.

We believe that the private sector profit motive should result in cost savings that could be used to offset the higher cost of capital requirement of the private sector. In addition, an acquirer would bring the stability of a large pool of experienced utility managers to operate the T&D System. A private acquirer's profit opportunities would be subject to NYPSC regulation that is applicable to substantially all of the other electric utilities in the State.

The Sale of the Transmission & Distribution Assets Would Require Bondholder Consent

The Authority raises capital through its issuance of revenue bonds under the Authority's Electric System General Revenue Bond Resolution the ("General Resolution") or its Electric System General Subordinated Revenue Bond

Resolution (the “Subordinated Bond Resolution” and, collectively, the “Resolutions”). Funds raised are passed to LIPA under the Financing Agreement between the Authority and LIPA. The Authority has approximately \$7 billion of bonds outstanding under its Resolutions.

Both the Resolutions and the Financing Agreement contain covenants which place constraints on the Authority’s and LIPA’s ability to dispose of real or personal property of the T&D System. These covenants require that the Authority bondholders not redeemed or defeased with sale proceeds must consent to the sale of the T&D System, because such a sale could be materially disadvantageous to the Authority’s bondholders.

As a practical matter, it would be very difficult, if not impossible, to achieve the necessary bondholders consent. However, the Authority frequently employs credit enhancement in the form of bond insurance or bank letters of credit. In such situations, the credit enhancer’s consent may be substituted for the consent of the underlying bondholders. Approximately 79% of the Authority’s outstanding Bonds are so enhanced.

We anticipate that credit enhancers would consent to a sale of the T&D System if the credit quality of the Bonds outstanding after the retirement of the T&D System related debt was superior to the existing credit quality, as demonstrated through one or more rating upgrades on the Authority’s outstanding Bonds. We believe an administrative securitization credit structure, similar to that discussed below, could achieve this goal.

The Authority would use its statutory powers under its enabling legislation to continue to fix a portion of the rates and charges for the furnishing of electric power within its service territory. The Authority would annually determine and establish its revenue requirement in amounts sufficient to pay (i) all debt service and financing costs due on its then outstanding Bonds; (ii) any expenses of operating or maintaining assets which are not sold by the Authority; (iii) any amounts needed to restore agreed upon Authority reserve funds; and (iv) any general or administrative expenses incurred by the Authority in carrying out its remaining duties and responsibilities.

The resulting revenue requirements could be imposed on a per kilowatt hour basis as a separate line item on each customer’s bill. The private owner/operator of the system would seek an order from the NYPSC authorizing it to collect this charge and remit the funds so collected to an Authority Trustee. The owner/operator would also be authorized by the NYPSC to enter into a servicing agreement to establish its obligation to the Authority to collect and remit these charges. There would be a “true up” mechanism in the servicing agreement, authorized in the NYPSC order, providing that this charge will be reviewed at

least annually and increased or decreased as necessary to assure that collections in the upcoming year meet the Authority's revenue requirements.

While the State could adopt specific legislation (which might result in a rating of AAA/Aaa, like that of other stranded cost securitization), the combination of the Authority's statutory power with an order of the NYPSC and contractual arrangements between the owner/operator and the Authority will provide a basis for repayment stronger than the existing bond resolution. Therefore, we believe that implementing such a credit structure as a step in the privatization structure could permit the Authority to proceed without violating its General Resolution or Financing Agreement covenants with the Bondholders.

Internal Revenue Service Issues in a Privatization

There are a number of tax issues related to a privatization transaction. The critical issues include (i) the ability to continue to use tax-exempt debt to fund the non-Transmission and Distribution assets retained by LIPA; (ii) depreciation recapture issues (i.e., potentially triggering a large tax liability on the part of the Authority when the property is sold) and; (iii) the sheltering from tax of gains that may be obtained upon the sale of the T&D System. Obtaining favorable tax rulings on these issues, particularly with regard to the ability to continue to use tax-exempt debt to fund the acquisition adjustment are critical to a privatization transaction.

As a part of the strategic organization study, the Authority's tax and bond counsel met with officials in the U.S. Department of Treasury ("Treasury") and the Internal Revenue Service (the "IRS") to discuss hypothetical privatization transactions and identify any issues that could potentially raise critical tax issues.

Tax determinations are fact intensive; all of the facts cannot be known until an actual transaction is proposed and accepted and preliminary indications from Treasury and IRS officials are not binding. However, if an actual transaction included fact patterns similar to the fact patterns included in the presentations to the Treasury and IRS officials, there is a reasonable case to be made that the Authority will be able to continue to use tax-exempt bonds to support both the LILCO acquisition adjustment and the Authority's investment in Nine Mile 2 and that there will be no depreciation recapture or tax on any gain generated in a privatization transaction.

Additional Costs for an Investor-owned Utility

There would be additional costs incurred by an investor-owned utility that are not currently incurred by the Authority. Primarily, these additional costs relate to the following items:

- The requirement for an equity return and the income taxes related to that return,
- Higher debt costs due to the taxable nature of the debt that would be used to finance the acquisition, and
- A non-KeySpan acquirer would need to obtain land and facilities on Long Island at current market rates to replace land and facilities that KeySpan now charges the Authority for based on its original historical cost and would potentially lose the benefit of the combination of certain of the electric and gas operations on Long Island.

The additional costs for an investor-owned utility related to the T&D System, based on the approximately 500 basis point differential in the cost of capital would result in approximately \$120 million of additional capital costs that would have to be collected from customers.

Potential Savings in a Privatization Transaction

We believe that in a privatization transaction for the T&D System, there are opportunities for both the acquirer and the Authority to achieve cost savings to offset the higher costs described above. However, many of the opportunities that the Authority has for cost savings are temporary. These cost savings opportunities relate primarily to the issues discussed below.

Cost Saving Opportunities (Acquirer Action)

Based on the results of our benchmarking and our understanding of the costs charged to the Authority by KeySpan, we believe that there are synergy and cost savings opportunities available to an acquirer in the \$25 million to \$30 million range. Primarily, these cost savings would result from eliminating redundant costs and spreading overhead costs over a larger base, thus lowering total overhead costs. In addition, with the acquisition of the operations of the Authority, a large portion of the Authority's operating budget would be eliminated, eliminating another \$25 million to \$30 million in cost.

Reduction in Renewable and Energy Efficiency Spending (Acquirer Action)

LIPA currently plans and administers its own energy efficiency program, named the Clean Energy Initiative ("CEI"). This Board authorized initiative is a 10 year, \$355 million dollar commitment to promote clean new electric generation

technologies, including energy conservation programs and investment in research and development efforts. LIPA's program is similar to the energy efficiency programs promoted by the New York State Energy Research and Development Authority that are paid through a System Benefits Charge ("SBC") on the electricity transmitted and distributed by New York investor-owned electric utilities. LIPA currently spends significantly more on CEI initiatives, adjusted for the size of the utility, than any other utility in the State. For example, the Authority's planned 2005 spending on CEI will be approximately \$40 million (which spending level represents approximately 27% of the combined 2005 spending by all of the New York State investor-owned electric utilities on clean energy initiatives), an increase of more than 50% from the 2004 spending level. We would anticipate that CEI spending would be reduced in a privatization to a level that approximates CEI spending levels of the other New York State investor-owned utilities (approximating \$20 million).

Release of the Authority's Working Capital (Authority Action)

In a privatization scenario, we believe that the Authority would be able to release approximately \$300 million of existing cash working capital, currently needed by LIPA as the owner of the T&D System. This freed up cash could be used to meet scheduled debt maturities related to the Shoreham-related regulatory assets over the near-term, thereby lowering overall costs to customers for that period.

Write-off of the Authority's Deferred Fuel Balance (Authority Action)

Additionally, in 2003, the Authority recorded a regulatory asset to recover approximately \$369 million of deferred fuel and purchased power cost over the ten year period 2004 through 2013. The Authority could write this regulatory asset off for financial reporting purposes as there is no related debt. Assuming that revenues remain the same, this action produces additional annual revenues to an acquirer of approximately \$37 million through 2013.

Our current analysis indicates that there are not sufficient cost savings available to offset the higher cost of capital and income tax requirements inherent in a privatization over the long-term. Therefore, we believe that it would be impossible to currently accomplish a privatization transaction without an immediate or near-term rate increase in the 6% to 10% range.

Consistency of the Privatization Model with the Stated Objectives of this Review

- *Impact on rates* – How will a Privatization Model impact rates in both the short and long-term?

- We believe that, based on financial modeling, a Privatization transaction could be constructed so as to be neutral to customer rates over a five-year period. The model indicates, that base rates would probably increase approximately 6% to 10% in the sixth year after a Privatization transaction and would increase periodically thereafter as additional capital was expended on electric system upgrades and expansion. However, the significant reduction in non-transmission and distribution debt service after 2013 creates an opportunity to mitigate this higher cost. In addition, privatization of the T&D System contemporaneously with the merger of other utilities could provide synergies just as the 1998 LILCO and Brooklyn Union merger derived that are sufficient to offset increased costs for the long-term.
- *Impact on customer service and reliability* – Will customer service and reliability be negatively impacted by a change in organizational structure? Does one governance structure provide these services more efficiently than the others?
 - We don't believe that a Privatization transaction will negatively impact the existing levels of customer service or reliability.
- *Consistency with New York State and FERC policies and industry evolution* – Do the proposed new structures fit within current New York State and FERC standards? Can the structure adapt as the industry evolves?
 - We believe that a Privatization transaction would be fully consistent with both current New York State and FERC standards and would be the best structure to adapt to the evolving nature of the electric utility industry.
- *Ability to manage the regulatory assets* – How will LIPA's regulatory assets be managed under each of the scenarios? How will the management of these regulatory assets impact current and future rates?
 - With favorable U.S. Treasury and IRS approvals, LIPA would be able to continue to finance its non-transmission and distribution assets with low cost, tax-exempt debt following a privatization of the T&D System.
- *Feasibility* – How will the proposed structures be received by the Authority's customers, the PACB, the NYPSC, local governments, and other interested parties and stakeholders?

- While we believe that there are a significant number of positive reasons to consider a Privatization transaction, the ability to enlist stakeholder support will depend on the Authority's ability to develop a compelling economic and business rationale for privatization, particularly since there is no apparent call for change at this time from these constituencies.
- *Union considerations* – How will the workforce be impacted under the new structure?
 - We believe that a privatization can be structured in a way to address the concerns of the union workforce.
- *Timeframe and complexity to accomplish change* – How long will it take to implement the proposed new structures? How hard will it be to obtain any required approvals for such a change, including legislative, bondholder, and IRS approvals, as applicable?
 - We believe that a privatization transaction would take, at a minimum, 15 to 18 months to accomplish and would have the longest timeline of any of the strategic organizational options.

FTI Conclusion with Regard to a Privatization Transaction –

We believe that a Privatization transaction can not be accomplished at this time without a significant increase in customer rates. However, we also believe that a Privatization transaction has significant benefits, as noted above, that should be considered at some time in the future when LIPA's non-Transmission and Distribution costs drop or other cost savings are available, thus providing an opportunity to change ownership at that time without having to raise the then existing rates.

Full Municipalization

Description

In our Full Municipalization model, we have assumed that the existing KeySpan MSA contract would expire and, as it did, the Authority would assume direct responsibility for the operation, maintenance and construction of the electric system on Long Island. The Authority would acquire the required workforce from KeySpan in such a manner as to ensure continuity of existing salaries and benefits for the union and management workforce and in a way that did not

require those acquired employees to become State employees. The Authority would continue to be the branded energy provider on Long Island.

In addition, the Authority would continue to own the T&D System, Nine Mile 2 and the Shoreham-related intangible assets so they will continue to be financed by low cost, tax-exempt debt.

Management and Cost Issues

The rationale for a municipalization would be to achieve cost savings through the elimination of the contractor's profit and overhead. However, LIPA will have to have its own management and overhead and will need to acquire services at current market prices that are currently provided on a historical cost basis. Further, absent the private sector's financial discipline, costs could become higher than necessary. These factors combined may more than offset the anticipated savings from municipalization.

A critical consideration in the Full Municipalization scenario is the ability of the Authority to hire an appropriate number of experienced senior and mid-level utility executives to be responsible for the operations of the T&D System on Long Island. Currently, in its oversight role, the Authority has several experienced utility executives on its Staff and it uses consultants for subject matter expertise to assist those executives. However, if the Authority were to assume complete responsibility for the day-to-day operations and ongoing construction of the T&D System, it would need significantly more in-house expertise. We believe that it would be a challenge for the Authority to readily expand its management ranks because of the limitations on compensation within government and the relatively high cost of living on Long Island. Further, once the executive and management team is assembled, it will take time for the new executives and managers to fully understand the operational nuances of the Long Island T&D System. This learning process will delay the identification and implementation of cost efficiencies and will, we believe, result in near- to mid-term costs that could be higher than those that would otherwise have been billed under the current operating contracts.

Union Considerations

In our meetings with senior union leadership, they indicated a flexibility to consider the effect of the organizational option selected by the Authority and determine how they could work with the Authority to incorporate the union workforce in that option. We believe that before the union could recommend a full municipalization option to its workers, all of the effects this option may have on the unions need to be identified and presented to the unions for

consideration. One significant consideration would be if the union workforce would become State workers and, if so, how all of the terms of the State union contracts compare to the existing union contracts. If the union workforce was to remain independent of the State, the union leadership would need to fully understand all of the issues related to how the union workforce would be dealt with under both its existing and future contracts and the implications of not being State workers. Our preliminary findings are that there would be significant challenges and hurdles to achieving this type of employee structure under either approach.

Organizational Risk

Any time that there is a change in organizational structure, there is a substantial risk in the early years that unforeseen problems will arise and that events will not proceed as originally planned. In a Municipalization, any cost issues that arise as operations are assumed will be borne by customers. Rates on Long Island are already the third highest in the continental United States and there is scant room for additional costs being included in rates. Therefore, the municipalization of the Long Island T&D System will, at least initially, bring added risk to the Authority which risk could increase its cost of borrowing as the market prices that risk into the cost of any new debt that the Authority may issue after a municipalization.

Consistency of the Full Municipalization Organization Structure with the Stated Objectives of this Review

- *Impact on rates* – How will a new organizational structure impact rates in both the short and long-term?
 - We believe that a Full Municipalization organization model could result in an increase in customer rates in the short- to mid-term as the new organization has to obtain new computer information systems and acquire sites for storage yards and operational centers. In addition, a new municipal organization will have to hire a significant number of new managers and key workers to fill positions now occupied by KeySpan employees who may not choose to join the Authority. It will take a period of time for a newly constituted organization to operate at peak efficiency. Since all of the existing transmission and distribution assets are currently financed with tax-exempt municipal debt, a new municipal organization would provide no additional cost of capital savings.

- *Impact on customer service and reliability* – Will customer service and reliability be negatively impacted by a change in organizational structure? Does one governance structure provide these services more efficiently than the others?
 - We believe that a Full Municipalization organization will have no effect one way or the other on the existing levels of customer service or reliability.
- *Consistency with New York State and FERC policies and industry evolution* – Do the proposed new structures fit within current New York State and FERC standards? Can the structure adapt as the industry evolves?
 - We believe that the Full Municipalization organization would be generally consistent with New York State policies (although the Authority spends substantially more on clean energy initiatives than any other electric utility in the State). This organizational model would also be consistent with existing FERC policies and current industry structure. There are large municipal entities (e.g., Los Angeles Department of Water and Power, Sacramento Municipal Utility District, Jacksonville Electric Authority, etc.) that have been able to effectively deal with changes related to evolving electric markets.
- *Ability to manage the regulatory assets* – How will LIPA’s regulatory assets be managed under each of the scenarios? How will the management of these regulatory assets impact current and future rates?
 - Under the Full Municipalization organization, there will be no change in how LIPA manages the regulatory assets.
- *Feasibility* – How will the proposed structures be received by the Authority’s customers, the PACB, the NYPSC, local governments, and other interested parties and stakeholders?
 - We believe that the Full Municipalization model would be difficult to implement since it is expanding the size of government to provide services traditionally provided by the private sector. In addition, if the union employees were in a separate LIPA subsidiary, it would create an unusual organization from a State governance perspective and would probably be unwieldy to administer.
- *Union considerations* – How will the workforce be impacted under the new structure?

- We believe that the manner in which the union workers are employed in the Full Municipalization organization will be critical to the success of that organization. Significant attention will have to be given to working with the unions in this transition.
- *Timeframe and complexity to accomplish change* – How long will it take to implement the proposed new structures? How hard will it be to obtain any required approvals for such a change, including legislative, bondholder, and IRS approvals, as applicable?
 - We anticipate that IRS and bondholder approval should be relatively routine. Overall, however, we believe that a Full Municipalization model would be extremely time consuming and risky to implement, particularly with regard to union workforce issues and the need to hire experienced utility workers and managers.

FTI Conclusion with Regard to the Full Municipalization Organizational Structure –

We don't believe that Full Municipalization is practical. We believe that there will be increased costs in the short- to mid-term that will more than absorb any benefits to this organizational model. Significant effort and cost will be expended to fully municipalize the organization at higher short- to mid-term cost with perhaps some unquantifiable cost savings in the future. There are significant hurdles to overcome with regard to retaining the existing KeySpan union workforce within this model. We see little, if any, benefit for the customers to Full Municipalization. Therefore, we recommend against further consideration of the Full Municipalization of electric transmission and distribution operations on Long Island.

Status Quo

The current public / private partnership between the Authority and KeySpan has served the Authority and its stakeholders well, particularly from a reliability and customer service standpoint. Throughout the public input sessions, participants commented favorably on the current structure, and the resultant transparency of the decision making process. Our interviews with LIPA and KeySpan staff, however, indicated that there are a number of areas in which improvements could be made.

The MSA was the first such contract of its size executed and was subject to very strict and new IRS rules for public / private partnerships. Since that time, the industry and IRS rules have evolved and LIPA has learned a number of

“lessons” regarding the limitations of the MSA. As a result, the continuation of the Status Quo requires modification to ensure that the public / private partnership works in a more efficient manner with lower costs to customers and more transparency for the Authority.

Description –

The current Status Quo organizational model reflects the existing public / private partnership with LIPA providing overall direction and strategy and KeySpan responsible for day to day operation and maintenance of the T&D System.

LIPA currently operates with a staff of approximately 100 people and provides overall direction to, and oversight of, KeySpan. One of the critical services that KeySpan provides under the MSA is the planning function. LIPA reviews the results of the planning performed by KeySpan and augments that information with information supplied by consultants to LIPA that provide assessments related to the planning issues.

Issues and Options Related to a Re-bid of the MSA or a Renegotiation with KeySpan

Because we recommend that the Authority maintain the Status Quo, at least until achievable cost savings are sufficient to offset the higher capital cost of private ownership, a determination as to how best to restructure the MSA going forward needed to be made. Based upon LIPA’s experience over the last seven years, we believe that a new MSA should result in lower costs immediately and over the long-term and simplify the Authority’s oversight and management functions, while still assuring reliable service. This is an extremely critical process for the Authority because it will establish operations and maintenance costs, as well as oversight costs, for an extended period into the future.

The current MSA is basically structured as a cost plus contract with limited risk to KeySpan and limited price predictability and financial and operational transparency for LIPA. The current costs saving incentives in the contract have led to significant disputes and mistrust between LIPA and KeySpan. Any new contract must address these issues.

Re-bid of the MSA

The MSA calls for a re-bid prior to the expiration of the contract on December 31, 2008. Given the pervasive nature of the operating requirements of the MSA, the Authority, through its “MSA Re-Bid Team” is preparing for a process to solicit

bids for a new MSA beginning in the first quarter of 2006 thereby providing a winning bidder two years for a transition.

This re-bid process will absorb significant Authority internal resources and will be the largest contract bid performed by the Authority. The MSA Re-Bid Team has spent months cataloguing the list of all of the services currently performed under the MSA, interviewing potential service providers and visiting other entities that have significant levels of outsourced activity. FTI had discussions with the MSA Re-Bid Team regarding their findings.

There are Significant Risks to a Re-bid in 2006

As noted above, there are a number of critical issues related to a re-bid of the MSA contract in 2006 that we believe make this a much less desirable option than a contract re-negotiation with KeySpan.

There is no assurance that the Authority will be able to achieve near-term cost reductions in a re-bid. Based on discussions with the members of the Re-bid Team, they believed that it was possible that costs under a re-bid contract would be equal to, or more than, the costs currently paid under the existing MSA. Common facilities now provided by KeySpan on a historical cost basis would either have to be duplicated at today's higher costs or leased from KeySpan at market-based lease rates. In either case, it is reasonable to expect that for at least the cost of the common facilities presently used in operations, the costs will rise.

Presumably, a winning bidder(s) would have to arrange for the acquisition of the KeySpan Long Island electric system workforce. This will raise many of the same issues that would occur under a Full Municipalization scenario. Negotiations with the unions will be required, as will negotiations with KeySpan over the transfer of pension and other post retirement benefit obligations. We believe that both sets of negotiations will be time consuming and difficult.

In addition, since we believe that it would be difficult for one entity (other than KeySpan) to assume all of the services provided under the current MSA, multiple contract providers would create "seams" or "intersection" issues. The "seams" or "intersection" issues would arise when required work is not clearly set forth in one of the revised MSA contracts and a dispute arises as to which contractor is responsible for the work. In this situation, we believe that the risk of additional billings for work that should have been completed under one of the contracts winds up being a supplemental bill which then becomes an additional cost to the Authority. Further, a critical goal of the re-bid process is to make the contract easier to administer and having multiple contractors will not achieve that goal; rather it will make it more difficult for the Authority to monitor the contract.

Finally, there may be services that KeySpan currently provides that will be difficult, if not impossible to obtain through a contractor. These services primarily include services provided that involve use of intellectual property created over the life of the existing MSA contact.

For all of the above reasons, we conclude that, at this time, there are significant risks to the Authority in a MSA re-bid, which make a renegotiation with KeySpan the preferred alternative.

Renegotiation with KeySpan

There are contract disputes going back to the early years of the MSA and continuing through the present that need to be settled between the Authority and KeySpan. These contract issues, commonly referred to as the "Global Issues," are of a substantial dollar magnitude and could be settled as a part of the negotiation to extend the MSA with KeySpan. Presently, one of the individual items that constitute portions of the Global Issues is scheduled for arbitration. The outcome of this and any subsequent arbitrations cannot be predicted.

We believe that both the Authority and KeySpan have large economic and social (i.e., workforce) interests in resolving the existing Global Issues and renegotiating the MSA. For the Authority, it would achieve cost reductions earlier than it would in a re-bid scenario, avoid the cost and distractions attendant to a re-bid of the MSA and settle the Global Issues in an expedited manner with less cost and risk. KeySpan would maintain a long-term service contract, settle outstanding financial issues and assure its union workforce that it will have employment stability during the term of the renegotiated MSA. Thus, a successful re-negotiation of the MSA would be beneficial for both parties by resolving a number of economic issues, clarifying and simplifying the contract and maintaining and strengthening the existing relationship between the Authority and KeySpan.

The Authority has significant leverage in a contract renegotiation and we believe renegotiating modifications and an extension to the existing MSA would be the best course of action for the Authority to take. The Authority and KeySpan began discussions on this subject in May 2005, determined that this approach was feasible and successfully reached an Agreement in Principle on those matters in December. As part of those negotiations, the Authority was also able to resolve the global contract issues and obtain a modified generating plant purchase option that is better tailored to the Authority's needs and that will be significantly easier to exercise than the existing GPRA. In addition, the Authority was able to obtain the ability to terminate the new MSA at its option upon

payment of a modest fee to KeySpan, thus giving it the flexibility to change organization structure if and when it believes that such change will provide benefits to its customers.

Summarized below are the critical benefits to the Authority from its Agreement in Principle with KeySpan:

- Achieves significant cost reductions immediately which continue over the life of the new MSA and provides for a predictable cost to LIPA with significant risk shifted to KeySpan. It allows KeySpan to retain cost savings and the benefits of system load growth;
- Settles the Global Issues for a significant payment to the Authority and transfer of unuable tax credits from the Authority to KeySpan;
- Simplifies the MSA and makes it more transparent to administer, including incorporating operating metrics that will facilitate the monitoring of the contract. It allows LIPA to assign one of its executives to KeySpan's Electric Business Unit and two individuals to the KeySpan Planning Group on a full-time basis;
- Replaces the GPRA (which FTI had concluded was of limited benefit to the Authority) with a new purchase option with regard to plant sites that would significantly benefit from re-powering;
- Extends the MSA contract through 2013;
- Gives the Authority, at any time during the contract, the right to terminate the MSA at a relatively modest cost if and when the Authority chooses to pursue a privatization; and
- Eliminates the significant risks and costs inherent in a re-bid of the MSA contract at this time, while providing greater transparency to position LIPA favorably for a re-bid in 2013.

Consistency of the Status Quo option with the stated objectives of this review

- *Impact on rates* – How will a new organizational structure impact rates in both the short and long-term?
 - The settlement produced an annual \$34 million reduction on a net present value basis in operations and maintenance cost from 2005 levels, phased-in over three years.
- *Impact on customer service and reliability* – Will customer service and reliability be negatively impacted by a change in organizational structure? Does one governance structure provide these services more efficiently than the others?

- We do not believe the renegotiated MSA will have a negative impact on existing levels of customer service or on the existing high levels of system reliability.
- *Consistency with New York State and FERC policies and industry evolution* – Do the proposed new structures fit within current New York State and FERC standards? Can the structure adapt as the industry evolves?
 - We believe that the renegotiated MSA is consistent with New York State policies and is also consistent with existing FERC policies and the current state of industry evolution.
- *Ability to manage the regulatory assets* – How will LIPA’s regulatory assets be managed under each of the scenarios? How will the management of these regulatory assets impact current and future rates?
 - Under the contract renegotiation with KeySpan, there will be no change in how LIPA manages the regulatory assets.
- *Feasibility* – How will the proposed structures be received by the Authority’s customers, the PACB, the NYPSC, local governments, and other interested parties and stakeholders?
 - We believe that all of the Authority’s stakeholders should be satisfied with the results of the contract renegotiation.
- *Union considerations* – How will the workforce be impacted under the new structure?
 - We believe that there will be minimal, if any, impact on the union under the contract renegotiation with KeySpan.
- *Timeframe and complexity to accomplish change* – How long will it take to implement the proposed new structures? How hard will it be to obtain any required approvals for such a change, including legislative, bondholder, and IRS approvals, as applicable?
 - We believe that the implementation of the new MSA is relatively straight forward and the necessary approvals should be able to be obtained on an expedited basis. The renegotiated contract should be the simplest of all of the strategic organization options to accomplish.

FTI Conclusion on the Status Quo Organizational Structure –

FTI believes that the contract renegotiation with KeySpan provides the Authority with the optimum economic outcome for its customers at this time. It facilitates the overall monitoring of the new MSA by the Authority by changing the nature of the contract from a cost plus type contract to a fee for service contract. It successfully resolved the Global Issues to the Authority's benefit. It provides the Authority with an option to acquire Long Island generating facilities that are the best candidates for repowering, while preserving the existing GPRA option for later exercise under certain conditions. Finally, it gives the Authority the right to terminate the MSA if and when it becomes beneficial to privatize.

An additional benefit of the amended MSA is that it provides enhanced cost and operational transparency and better positions the Authority to re-bid the contract at the expiration of the current MSA.

Appendix A – Benchmarking of LIPA’s Operations –

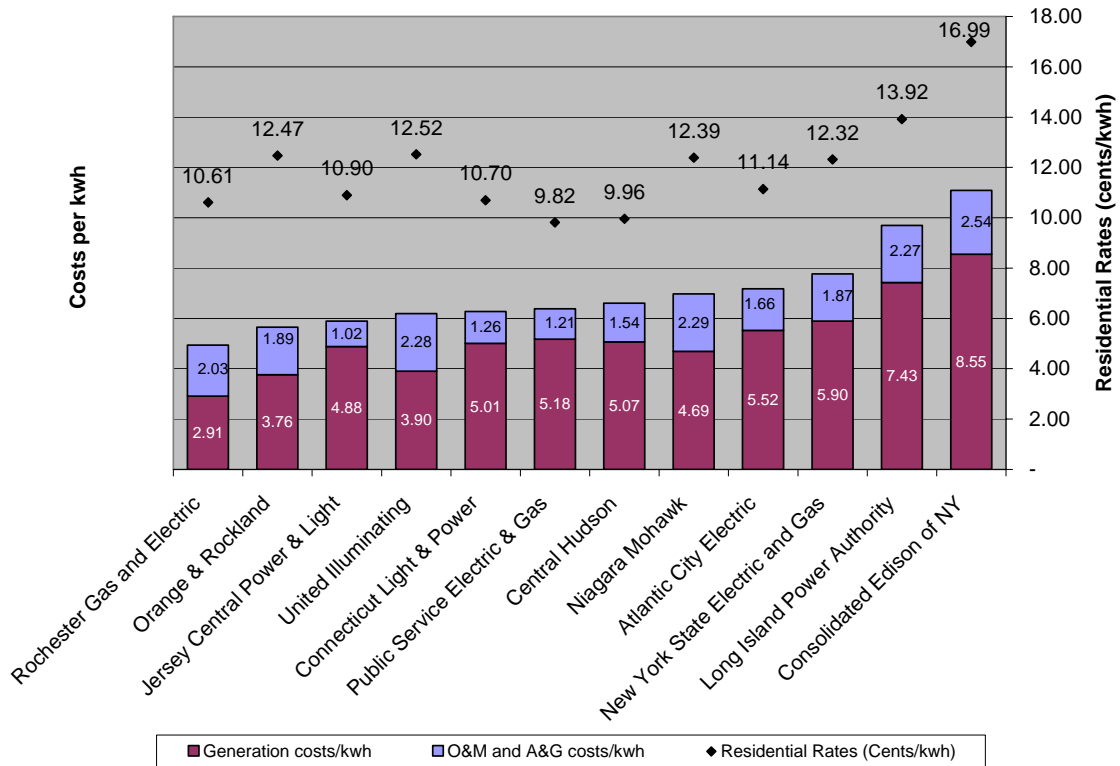
In late 2004, FTI performed a benchmarking analysis of LIPA in which we compared its operating results to some of the larger municipals in the United States or with New York State investor-owned utilities. Since 2004 data was not yet available for this group of companies, we utilized 2002 and 2003 data in our benchmarking analysis. Based on our understanding of cost trends in the electric utility industry, we believe that the use of 2004 data in our benchmarking analysis would produce similar results to the results that we determined using the 2002 and 2003 data and that our conclusions remain valid.

While LIPA has some of the highest retail electric rates in the country, its direct operating and administrative costs, excluding purchased power, are not out of line with other Northeast municipals. Our analysis demonstrates that while LIPA’s transmission and generation operations and maintenance costs are competitive, its administrative and general costs and customer services costs are significantly higher than most other entities in our comparative data base. Because substantially all of these costs are incurred by LIPA under the various operating agreements with KeySpan, we believe that it will be extremely difficult for LIPA to achieve significant cost savings under the existing contract arrangement.

The Authority has a higher proportion of administrative and general and transmission and distribution operating and maintenance costs than all of the other municipals and all but three of eleven investor-owned electric utilities included in our benchmarking sample. This fact has significant implications for the Status Quo scenario because it is unlikely LIPA can realize operating or administrative cost savings unless it renegotiates the current KeySpan contracts or is able to obtain significant savings as it enters into a new MSA in 2009. As noted in the main body of this report, we believe that the ability of the Authority to realize significant cost savings through a contract re-bid has significant risk and that a renegotiation of the MSA with KeySpan is much more likely to produce cost savings for the Authority. Potentially, additional savings would be realized in a merger that is able to achieve significant economies of scale, but such a merger would likely involve the Authority and at least two other companies.

LIPA’s high retail costs are partially driven by Long Island’s high cost of generation. When compared to municipals and regional IOU’s, only Consolidated Edison has higher generation/purchased power costs. Given the constraints of building new generation on Long Island and LIPA’s lack of fuel diversity, it is unlikely that any meaningful savings in purchased power costs can be achieved unless fuel costs subside or additional transmission cables are

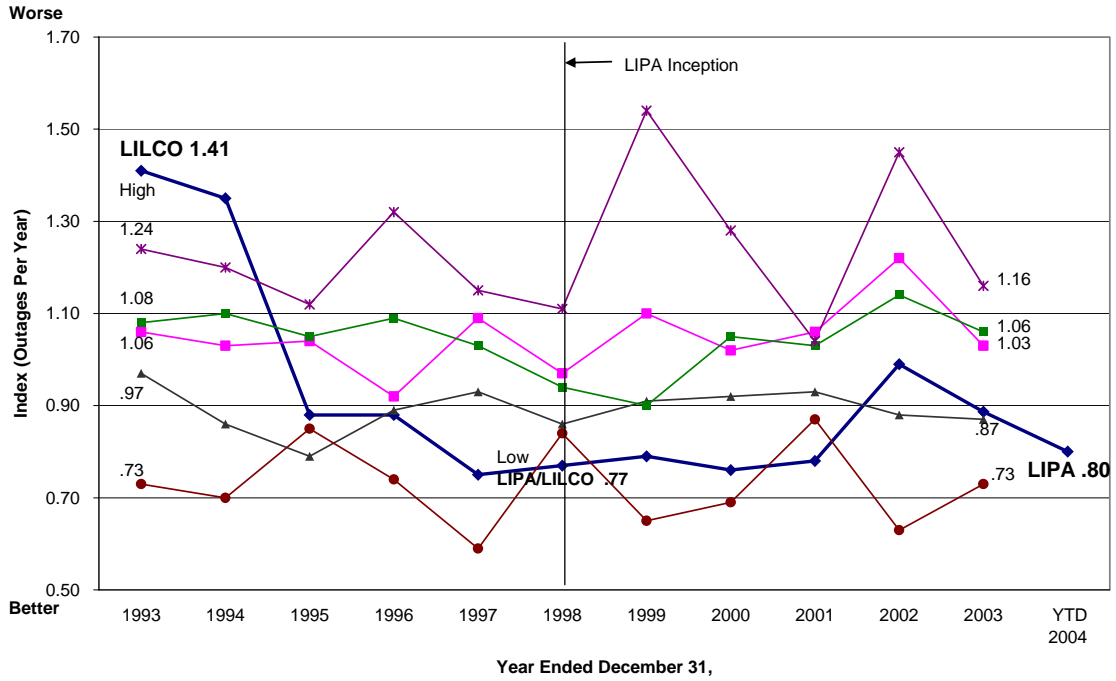
built to connect Long Island with lower-cost regions. The existing PSA with KeySpan is subject to the jurisdiction of the FERC and the rates are determined on a cost-based formula that produces relatively low rates for the capacity cost of the PSA, but the fact that all of the generation in the PSA is either oil or gas fired has resulted in significantly increased bills, particularly in 2005 which has experienced unprecedented increases in oil and gas costs.

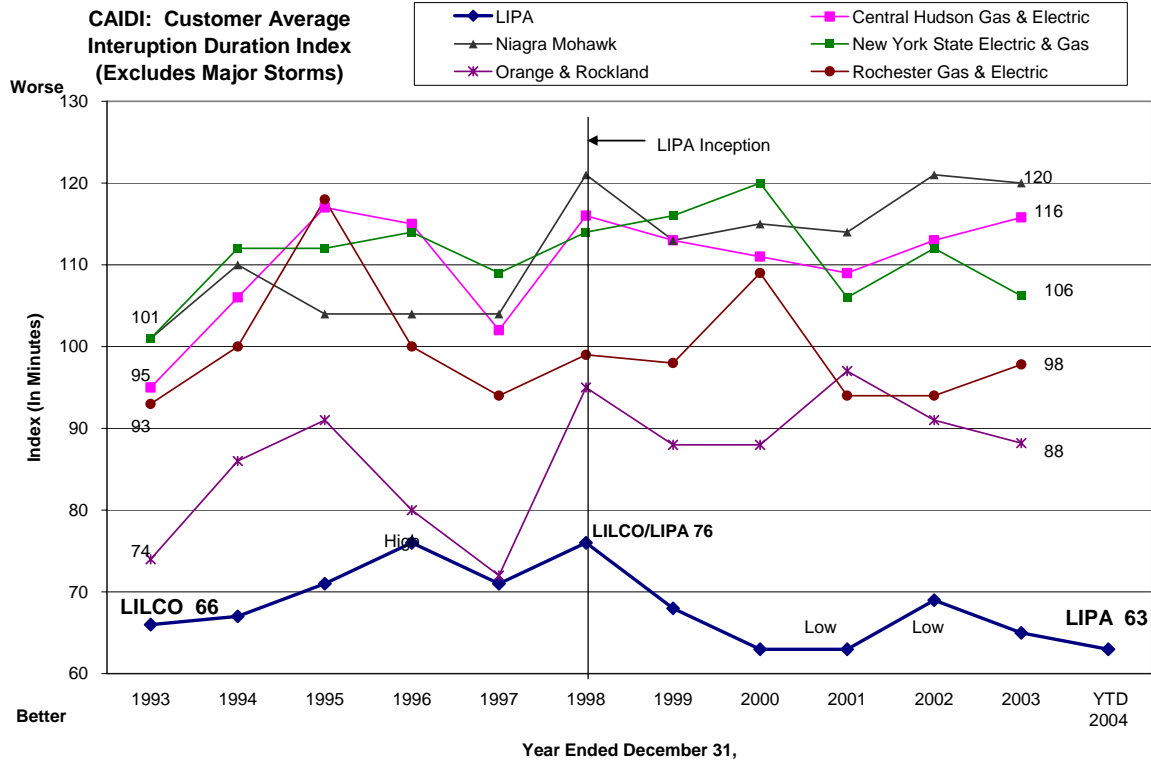


Market realities, such as limited on-island merchant generation and import capabilities, limit the potential success for Long Island Retail Choice. Less than 1% of LIPA’s load has converted to retail choice, compared to 6% of NY state customers which represents 33% of total New York load. The bulk of NY State’s conversions were in the industrial customer base (66% of load converted), which customer base is virtually non-existent on Long Island.

LIPA, on average, spends less on transmission and distribution O&M than other municipals and regional IOU’s, yet LIPA has some of the best reliability statistics for these groups. LIPA’s System Average Interruption Frequency Index (“SAIFI”) and Customer Average Interruption Duration Index (“CAIDI”) results are in the top third nationally. These statistics, when compared to other New York utilities, demonstrate that LIPA has been able to maintain the high reliability levels that were in existence at the time of its takeover of LILCO.

**SAIFI: System Average
Interuption Frequency Index
(Excludes Major Storms)**





Appendix B – Recent Industry Merger Developments

Financial buyers have emerged as major participants in the energy and independent power producer markets. Buyers and energy marketers include investment banks, insurance companies, private energy funds and hedge funds all of which have acted as principals on large acquisition transactions.

In two recent cases, however, attempts by financial buyers to acquire regulated electric utility systems were halted when the state utility regulatory commission denied its approval.

- On March 10, 2005, Texas Pacific Group, a private equity management firm, was denied in its bid to acquire Portland General Electric from the Enron bankruptcy estate. The Oregon Public Utility Commission concluded that (i) the acquired utility would be too heavily leveraged; (ii) the expressed intention of the acquirer to sell the utility within 12 years created disincentives to maintenance and investment; and (iii) the absence of finalized transaction terms presented a risk of rising interest rates that could not be dismissed.
- In December 2004, Saguro Utility Group, a subsidiary of a limited partnership controlled by Kohlberg Kravis Roberts & Co., JP Morgan Chase and Wachovia Bank, was denied the opportunity to acquire UniSource, an Arizona utility whose primary asset is Tucson Electric Power. The Arizona Corporation Commission found no tangible benefit to ratepayers and found detriments and risks including increased leverage, an absence of transparency through the use of a limited partnership governance structure and leadership by a single individual inexperienced in managing regulated entities.

The Exelon / PSE&G merger, announced on December 20, 2004, brings together two substantial utilities with operations in Illinois, Pennsylvania and New Jersey. Exelon, in an all-stock transaction, paid a premium of approximately 8% on the December 17, 2004 PSE&G stock price at the agreed -upon exchange ratio. The companies in their joint merger presentation were predicting \$500 million in synergies by the second year of merged results, on combined revenues of \$27 billion. Only 11% of these synergies were expected to be derived from transmission and distribution activities. Also, 43% of the aggregate synergies were listed as being derived from “staffing” cuts.

Municipalization of private sector electric utility assets has also been proposed and is being seriously pursued in at least two jurisdictions.

- The City of Portland, Oregon has announced its intention to bid for Portland General Electric now that the Texas Pacific Group's bid has been rejected by the Oregon Public Utility Commission. The City issued a request for proposals seeking underwriting services for such an acquisition. The City is willing to purchase the utility for the same \$2.35 billion purchase price that the Texas Pacific Group originally bid and that was deemed acceptable by the Bankruptcy Court handling the Enron bankruptcy. It appears that Enron now believes that the value of Portland General has increased and they are no longer willing to sell at the previously negotiated price. It now appears that Portland General will remain a stand-alone investor-owned utility company.
- In its most recent Official Statement, the Sacramento Municipal Utilities District ("SMUD") has disclosed that it is engaged in a study with three adjacent cities to expand its service territory. If such an expansion receives all of the required approvals, then SMUD or the three municipalities would need to acquire the existing electrical system infrastructure in those cities from the Pacific Gas & Electric Company ("PG&E"), the existing electrical service provider. This transaction will be interesting to watch since PG&E has a significant balance of deferred costs it is currently recovering from customers that are left over from the California energy crisis. We would expect PG&E to seek to recover the amount of the deferred costs allocable to the three cities in the form of an "exit fee" if this transaction goes forward in order to reduce the cost burden on the remaining PG&E customers.

The State of Montana was recently rebuffed twice in its attempts to purchase Northwestern Corporation's transmission and distribution assets in Montana. Northwestern has recently exited bankruptcy and was not looking to sell its operating properties in Montana. However, there continue to be reports of shareholder interest in selling Northwestern's assets. Black Hills Power has made a bid to acquire Northwestern and the State of Montana may be able to use that bid to gain access to Northwestern's books and records to perform due diligence for the state. Whatever happens, it is becoming clearer that Northwestern will be acquired by one of the several parties currently seeking to do so.