

**Long Island Power Authority**

**Biennial Report  
of the  
Consulting Engineer and Rate Consultant  
for the Period  
January 1, 2004 through December 31, 2005**

**August 31, 2006**

**NAVIGANT CONSULTING, INC.**



August 31, 2006

Long Island Power Authority  
Board of Trustees  
333 Earle Ovington Boulevard  
Suite 403  
Uniondale, New York 11553

Chairman and Members of the Board of Trustees:

Navigant Consulting, Inc. ("Navigant Consulting") has been retained by the Long Island Power Authority (the "Authority") as the Authority's Consulting Engineer and Rate Consultant (as such terms are defined in the General Bond Resolution and the General Subordinated Resolution) for the purpose of an examination of, and preparation of a report on, the properties and operations of the System. This report (the "Biennial Report") is to be prepared no less frequently than every other Fiscal Year, commencing with Fiscal Year 1999 (the 12 months ended December 31, 1999) pursuant to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution. Navigant Consulting submits this Biennial Report for the Fiscal-Year 2004 through 2005 period (the "Historical Period") presenting the results of its review and investigations.

In preparation of the Biennial Report, Navigant Consulting has reviewed the operation, maintenance, and repair of the System for the Historical Period and estimated results for the two Fiscal Years ending December 31, 2007. Navigant Consulting has also reviewed the rates, fees, rents, charges, and surcharges of the Authority. For purposes of this assignment, Navigant Consulting has conducted investigations and analyses, held discussions with staff and representatives of the Authority and KeySpan Corporation d/b/a "KeySpan", among others, and performed examinations of reports and projections prepared by consultants and advisors to the Authority, which Navigant Consulting deemed necessary and appropriate to reach its conclusions.

Respectfully submitted,

Patrick S. Hurley  
Managing Director

# Table of Contents

SECTION 1: INTRODUCTION .....	1
SECTION 2: DESCRIPTION OF THE SYSTEM .....	4
SECTION 3: MANAGEMENT AND OPERATION OF THE SYSTEM .....	6
SECTION 4: TRANSMISSION AND DISTRIBUTION SYSTEM .....	10
SECTION 5: NINE MILE POINT NUCLEAR POWER STATION, UNIT 2.....	19
SECTION 6: ADEQUACY OF RATES AND CHARGES.....	22
SECTION 7: FINDINGS.....	29

## Exhibits

EXHIBIT 1: ACTUAL OPERATING RESULTS.....	31
EXHIBIT 2: PROJECTED OPERATING RESULTS.....	33

2

## Appendices

Appendix A: SUMMARY OF CERTAIN PROVISIONS OF THE MANAGEMENT SERVICES AGREEMENT .....	A-1
Appendix B: SUMMARY OF CERTAIN PROVISIONS OF THE AMENDED AND RESTATED MANAGEMENT SERVICES AGREEMENT .....	B-1
Appendix C: SUMMARY OF CERTAIN PROVISIONS OF THE POWER SUPPLY AGREEMENT .....	C-1
Appendix D: SUMMARY OF CERTAIN PROVISIONS OF THE ENERGY MANAGEMENT AGREEMENT.....	D-1

## SECTION 1

### INTRODUCTION

The Long Island Power Authority (the "Authority") is a corporate municipal instrumentality and political subdivision of the State of New York authorized under the Long Island Power Authority Act (the "Act"). The Authority became the retail supplier of electric service in most of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens County (the "Service Area") on May 28, 1998 by acquiring the Long Island Lighting Company ("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, since the early 1900's, 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. For the period prior to the LIPA/LILCO Merger, LILCO is referred to herein as "LILCO" and, for the subsequent period, is referred to herein as "LIPA."

The Authority, through LIPA, owns, among others, the following assets: (i) an electric transmission and distribution system (the "T&D System") serving most of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens County, including assets, facilities, equipment, and contractual arrangements used to provide the transmission and distribution of electrical capacity and energy to electric customers within the Service Area; (ii) an 18 percent ownership interest in the Nine Mile Point 2 Nuclear Power Station ("NMP2") located in upstate New York; and (iii) certain other intangible assets resulting from the LIPA/LILCO Merger. These assets, together with all other assets of the Authority and LIPA used in the furnishing of electric service, are referred to as the "System."

LIPA provides retail electric service to approximately 1.1 million customers within the Service Area. During 2005, the maximum annual peak demand experienced by LIPA totaled approximately 5,115 megawatts ("MW"), inclusive of sales for resale. During this period, LIPA's total annual revenues approximated \$3.28 billion, of which over \$3.26 billion was derived from retail electric sales.

#### **PURPOSE OF THE REPORT**

The Authority had a total of approximately \$7.0 billion of senior lien, subordinate lien, and subsidiary debt outstanding as of December 31, 2005. As of such date, approximately \$5.8 billion of senior lien bonds issued under the Authority's Electric System General Revenue Bond Resolution (the "General Bond Resolution") were outstanding. The Authority also had outstanding approximately \$935 million of subordinate lien bonds, issued under the Authority's Electric System General Subordinated Revenue Bond Resolution (the "General Subordinated Resolution"), \$100 million of commercial paper issued under the Authority's Supplemental Bond Resolution, and approximately \$155.4 million of New York State Energy Research and Development Authority Financing Notes for which it is primarily responsible, and for which LIPA holds a Promissory Note from KeySpan for an equivalent amount. The General Bond Resolution and General Subordinated Resolution contain certain covenants that require the Authority to undertake certain actions on an annual or periodic basis. One such action involves the performance by the Authority's Consulting Engineer and Rate Consultant (as such terms are defined in the General Bond Resolution and the General Subordinated Resolution) of an examination of, and preparation of a report on, the properties and operations of the System. This

report (the "Biennial Report") is to be prepared no less frequently than every other Fiscal Year, commencing with Fiscal Year 1999 (the 12 months ended December 31, 1999).

Pursuant to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution, the Biennial Report is to set forth the following:

- (i) "The Consulting Engineer's advice and recommendations as to the proper operation, maintenance, and repair of the System during the ensuing two Fiscal Years, and an estimate of the amounts of money necessary for such purposes;
- (ii) The Consulting Engineer's advice and recommendations as to improvements which should be made during the ensuing two Fiscal Years, and an estimate of the amounts of money necessary for such purposes, showing the amount projected to be expended during such Fiscal Years from the proceeds of Bonds and Subordinated Indebtedness issued under or pursuant to the Resolution;
- (iii) The Rate Consultant's recommendation as to any necessary or advisable revisions of rates, fees, rents, charges and surcharges and such other advice and recommendation as it may deem desirable; and
- (iv) The Consulting Engineer's findings as to whether the System has been maintained in good repair and sound operating condition, and its estimate of the amount, if any, required to be expended to place such properties in such condition and the details of such expenditures and the approximate time required therefore."

Navigant Consulting, Inc. ("Navigant Consulting") has been retained by the Authority to serve as the Consulting Engineer and the Rate Consultant to perform the examination of the properties and operations of the System, as required by the General Bond Resolution and General Subordinated Resolution, and to render its findings with respect to the above subject matter. This Biennial Report covers the Fiscal-Year 2004 through 2005 period (the "Historical Period") and the Fiscal-Year 2006 through 2007 forecast period (the "Forecast Period"). Information presented herein with respect to LIPA's historical operations is limited to financial and operating results known to have occurred as of December 31, 2005, except as otherwise noted. Additional information and items of a material nature have been included in this Biennial Report based on information available to Navigant Consulting through the date of this Biennial Report. Navigant Consulting's findings with respect to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution can be found in Section 7 of this Biennial Report.

#### **NAVIGANT CONSULTING, INC.**

Navigant Consulting is an internationally recognized firm of engineers, economists, regulatory specialists, and management consultants headquartered in Chicago, Illinois. Navigant Consulting's professionals provide services to various industries, including electric and gas utilities, power producers, fuel suppliers, and power marketers. Typical services include power marketing analysis, transmission and distribution system planning, generation facilities evaluation, rate and pricing studies, environmental assessments, conservation and demand-side management program development and evaluation, strategic planning, marketing studies, and related services.

In addition to serving as the Authority's Consulting Engineer and Rate Consultant, Navigant Consulting provides day-to-day assistance to the Authority on various issues, including operations, management, and expansion of its facilities, power supply resource development,

rates and charges, environmental compliance, financial forecasting, and budget review and development, among other areas.

## SECTION 2

### DESCRIPTION OF THE SYSTEM

The Service Area encompasses the bulk of Long Island in New York State, and is comprised of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens County, an area of approximately 1,230 square miles, excluding areas served by three existing municipal utilities: the villages of Freeport, Greenport, and Rockville Centre. Suffolk County is the easternmost county within the Service Area and covers an area of approximately 911 square miles, followed by Nassau County with a 287 square mile area, and the Rockaway Peninsula with an area of approximately 32 square miles. The Service Area is bounded by the Atlantic Ocean on the south and east, by the Long Island Sound on the north, and by portions of New York City on the west. LIPA estimates the population of the Service Area was approximately 2.83 million people as of December 31, 2005.

#### CLIMATIC FACTORS

Long Island experiences seasonal conditions typical of the northeast United States. Summers are usually hot with high temperatures in excess of 90°F, accompanied by high levels of humidity. Winters include snow and icing conditions that can be damaging to overhead power lines. In addition, the Service Area experiences severe storms, including “nor’easters” and hurricanes, which can be particularly damaging due to Long Island’s coastal location. In response to these conditions, the T&D System has been constructed and maintained to minimize damage from high winds and icing and LIPA has adopted storm response procedures that are designed to restore service expeditiously.

#### CUSTOMER BASE

Approximately 97 percent of LIPA’s total revenues are derived from electric sales to retail customers. As of December 31, 2005, LIPA served approximately 1.1 million retail electric customers, of whom approximately 89 percent were residential users. During the year ending December 31, 2005, residential customers provided approximately 52 percent of LIPA’s annual retail electric revenues and commercial and industrial customers provided approximately 46 percent of annual retail electric revenues. The balance of retail electric revenues is derived from electric sales for public lighting and sales to public authorities.

Although commercial and industrial customers provide a significant portion of annual electric sales revenues, these customers account for only 10 percent of the retail electric customers served by LIPA. In general, individual commercial and industrial customers are relatively small; with approximately 93 percent of these customers having peak demands less than 75 kilowatts (“kW”). Furthermore, the Service Area contains little traditional “industrial” loads, and customers served under this rate classification are primarily large commercial customers. The single largest customer in the Service Area (the Long Island Rail Road) accounted for less than two percent of total electric sales during 2005 and less than two percent of total retail electric revenues during the same period. Overall, the 20 largest electric customers, in aggregate, accounted for approximately eight percent and seven percent of total retail energy sales and revenues, respectively, during 2005.

LIPA also provides electric transmission service to the New York Power Authority (“NYPA”) for the delivery of NYPA capacity and energy to the three municipal utilities and other NYPA-power recipients on Long Island, including the Suffolk County Electrical Agency and the Nassau County Public Utility Agency.

Table 1 provides summary information on annual retail energy sales and retail electric revenues within the Service Area during the 2001 through 2005 period. Included in Table 1 is information on numbers of retail electric customers for this period, as well as annual peak demand for electricity and annual energy requirements.

**TABLE 1  
HISTORICAL STATISTICS<sup>1</sup>**

	2001	2002	2003	2004	2005
Peak Demand (MW) .....	4,781	4,929	4,794	4,581	5,115
Energy (MWh) <sup>2</sup>					
Residential.....	8,351,224	8,791,024	9,010,295	9,182,524	9,705,752
Commercial and Industrial .....	9,449,745	9,613,083	9,593,552	9,904,543	10,106,947
Other .....	427,067	411,615	426,059	439,120	437,367
Total Sales .....	18,228,036	18,815,722	19,029,906	19,526,187	20,250,066
Lost and Unaccounted For <sup>3</sup> .....	1,382,626	1,422,551	1,448,646	1,466,420	1,529,151
Total Energy Requirements ..	19,610,662	20,238,273	20,478,552	20,992,607	21,779,217
System Load Factor (Percent).....	46.8	46.9	48.8	52.3	48.6
Customers <sup>4</sup>					
Residential.....	957,738	965,198	970,746	975,656	981,541
Commercial and Industrial .....	110,606	111,715	112,343	112,817	114,014
Other .....	4,966	5,051	5,023	5,097	5,156
Total Customers .....	1,073,310	1,081,964	1,088,112	1,093,570	1,100,711
Retail Electric Revenues (\$000) <sup>5</sup> .....	\$2,250,223	\$2,432,465	\$2,563,542	\$2,834,948	\$3,257,144

<sup>1</sup> Provided by LIPA. Amounts may not total due to rounding.

<sup>2</sup> Megawatt-hour or MWh. Excludes Sales for Resale.

<sup>3</sup> Includes Company service.

<sup>4</sup> Numbers of meters at year-end.

<sup>5</sup> Excludes Sales for Resale. Includes fuel and purchased power adjustment clause revenues.

#### **TRANSMISSION AND DISTRIBUTION SYSTEM**

The T&D System is an integrated electric system consisting of overhead and underground facilities, vehicles, equipment, land parcels, easements, contractual arrangements, and other assets used to provide the transmission and distribution of electric capacity and energy to and within the Service Area. The T&D System includes six transmission interconnections that link the T&D System to utilities outside the Service Area. These transmission interconnections are owned in part or under contract to LIPA. A more complete description of the T&D System is provided in Section 4 of this Biennial Report.



## SECTION 3

### MANAGEMENT AND OPERATION OF THE SYSTEM

The Authority manages the operations, performance, and costs of the System with a senior management team comprised of engineering, legal, financial, accounting and management professionals. The organization and performance of this senior management team is described below. This section also includes a discussion of the responsibilities of KeySpan Corporation ("KeySpan") under the terms of certain key outsourcing agreements.

#### AUTHORITY MANAGEMENT AND ORGANIZATION

The Authority manages the performance and cost of electric service within the Service Area with a senior management team and organizational structure intended to maintain a small total work force. The Authority staff is responsible for certain on-going functions, including, but not limited to: (i) management and oversight of out-sourcing contracts; (ii) certain system planning activities; (iii) certain power marketing efforts; (iv) demand side management program definition; (v) budget preparation, accounting, and treasury functions; (vi) ratemaking activities; and (vii) financing activities. The Authority uses a combination of: (i) a core group of senior managers; (ii) internal professional and administrative support staff; and (iii) outsourced services by specialists to meet the wide variety of skills and experience required to guide the management of the electric utility.

The day-to-day operation of the System, including LIPA's ownership interest in NMP2, is outsourced principally to KeySpan through the Management Services Agreement (the "MSA"), the Power Supply Agreement (the "PSA"), and the Energy Management Agreement (the "EMA"), using primarily management and other personnel previously performing these functions for LILCO. Summaries of these services and agreements are described more fully in the appendices to this Biennial Report.

The Authority has adopted an organization which includes the following senior management positions: (i) President and Chief Executive Officer; (ii) Senior Vice President and Chief of Staff; (iv) Chief Operating Officer; (v) Chief Financial Officer; (vi) General Counsel; (vii) Vice President of Power Markets; (viii) Vice President of Communications; (ix) Vice President of Retail Services; (ix) Vice President of Operations; and (x) Controller. The Authority employs experienced support personnel to assist the senior management team in its day-to-day activities.

The Authority is governed by a fifteen-member board of Trustees who are required under the Act to be residents of the Service Area. The Governor appoints nine of the Trustees, three trustees are appointed by the Majority Leader of the New York State Senate, and three are appointed by the Speaker of the New York State Assembly. A Chairman of the Trustees is also appointed by and serves at the pleasure of the Governor. Each Trustee serves for a staggered term of four years.

On January 13, 2006, the Governor of New York signed the Public Authorities Accountability Act of 2005 (the "PAAA") which makes changes regarding the operation and governance of New York State public authorities, including the Authority. Among other requirements and restrictions, the PAAA prohibits any board member, including the chairperson, from serving as the chief executive officer, executive director, chief financial officer, comptroller, or hold any other equivalent position while also serving as a member of the board. Prior to passage of the PAAA, the Chairman of the Board of Trustees also served as President and Chief Executive Officer of the Authority. In compliance with the PAAA, the Chairman recently resigned his

positions on the Authority's senior management team. The Authority has initiated a search for a successor President and Chief Executive Officer during 2006.

In addition to its internal staff and resources available through the MSA, PSA, and EMA, the Authority utilizes outside experts for those tasks or functions that require independent resources or, by their nature, are best performed by contractors. Examples of tasks performed through this arrangement include, but are not limited to, the following:

- Review of actual costs incurred under outsourcing agreements, including related incentive/disincentive compensation provisions;
- Review of electricity and fuel procurement practices;
- Review and evaluation of annual operating and capital budgets;
- Solicitation and evaluation of new capacity and energy supplies;
- Review of system dispatch and off-system sales and purchases;
- Review and evaluation of various regional and federal electricity market design proposals; and
- Review of on-going programs to ensure compliance with applicable environmental, health, and safety requirements.

The Authority provides the continuity of policy making, rate setting, financial planning, and management of the T&D System and NMP2 by maintaining capability on its management team and in-house staff, and by making use of outsourced services.

#### **SERVICES PROVIDED BY KEYSpan**

At the time of the LIPA/LILCO Merger, the Authority entered into certain agreements aimed at assisting LIPA with the production, acquisition, and delivery of electricity in the Service Area. These agreements include the MSA, the PSA, and the EMA, as well as certain other related agreements (collectively, the "Agreements"). The Authority entered into the Agreements with separate wholly owned subsidiaries of KeySpan (the "KeySpan Subs") and assigned them to LIPA. The performance of each such KeySpan Sub under the respective Agreements, as well as any payment obligations it may have under such Agreements, are guaranteed by KeySpan. The purpose of the Agreements is to provide the Authority and LIPA with the operating personnel and power supply resources necessary for LIPA to continue to provide electric service in the Service Area.

In addition to providing services to the Authority, KeySpan provides a full range of energy-related services to other parties through operations and investments in selected areas of the energy industry. KeySpan's operations include the natural gas business formerly known as Brooklyn Union Gas, as well as the natural gas operations formerly owned by LILCO. KeySpan reports that its gas operations form the fifth largest gas utility in the United States, with approximately 2.6 million customers in New York City, Long Island, Massachusetts, and New Hampshire. KeySpan also reports that it is the largest electric generator in New York State, with approximately 6,600 megawatts of generating. Of this, approximately 4,000 MW of on-Island capacity is under long-term contract to LIPA through the PSA. An additional 160 MW of generation capacity owned by KeySpan on Long Island is purchased by LIPA under separate long-term agreements. The unregulated business units of KeySpan market energy and provide energy facility design, construction, financing and management, and energy equipment

installation and repair. Through its investments, KeySpan has additional domestic and international interests in natural gas exploration, production, processing, transportation and storage.

In February 2006, KeySpan announced that, subject to certain approvals, it was being acquired by National Grid plc. Please see "Acquisition of KeySpan by National Grid" below for additional information on this transaction.

#### **CHANGES TO THE AGREEMENTS**

The day-to-day operation of the T&D System is provided by KeySpan under the terms of the MSA, which expires December 31, 2008. In January 2006, the Authority entered into definitive agreements to amend the MSA (the "Amended MSA") as well as certain of the other Agreements, subject to certain governmental approvals and other conditions. The Amended MSA would expire December 31, 2013. The Authority also entered into a Settlement Agreement, dated as of January 1, 2006 (the "2006 Settlement Agreement"), with KeySpan and KeySpan Subs to resolve certain outstanding disputes. The Authority has stated it will receive approximately \$120 million in payments or credits pursuant to the 2006 Settlement Agreement. The Authority has announced that it will reserve a portion of such amount to allow it to avoid increasing its electric rates and surcharges through 2007, absent a world-wide energy crisis. In addition, the Authority has stated it expects to pay down approximately \$25 million of its outstanding debt and provide each residential customer with a one-time refund of \$35.

The Authority also announced it entered into an option agreement (the "2006 Option Agreement") with KeySpan Generation LLC ("GENCO") which provides the Authority with an option (the "2006 Purchase Option"), exercisable not later than December 31, 2006, to acquire the Barrett and Far Rockaway plants (as defined in such agreement) from GENCO. LIPA has reported that, in the event it acquires one or more generating units pursuant to the 2006 Purchase Option, it and KeySpan have agreed to enter into an Operation and Maintenance Agreement (the "O&M Agreement") which will provide that a subsidiary of KeySpan, to be designated, will perform the services necessary to operate and maintain such generating unit or units. Such services include fuel management, development of operation and maintenance procedures and a preventive maintenance program, performance of routine repairs and arranging for major maintenance services, the procurement of necessary supplies and services, and making recommendations for capital improvements. The KeySpan subsidiary will be compensated by a fee which has both fixed and variable components and by a fuel management fee. In the event LIPA enters into the O&M Agreement, the amounts payable by LIPA under the operating agreements described above will be reduced so that there will be no incremental cost to LIPA resulting from the O&M Agreement. The O&M Agreement will be subject to certain approvals, as described below, and will have an expiration date of the earlier of the retirement or closure of the unit for repowering or May 28, 2013.

The Authority and KeySpan have announced they separately negotiated and amended the portions of the EMA providing for the purchase and sale of off-system energy to extend the termination date to December 31, 2007. Without such amendment, these portions of the EMA would have expired on May 28, 2006. LIPA has announced it has commenced a competitive procurement process for these services and expects to make a decision on the award of a new contract by the end of 2006.

As reported by the Authority, the above agreements are subject to approval by the New York State Comptroller (the "Comptroller") and, as to form, by the New York State Attorney General

(the "Attorney General"). The amendment to the PSA is also subject to approval by the Federal Energy Regulatory Commission ("FERC"). The O&M Agreement is also subject to approval by the New York Public Authorities Control Board. Each of the 2006 Settlement Agreement, the 2006 Option Agreement, and the Amended MSA must become effective or none will become effective. If such agreements become effective, an option previously granted to LIPA by KeySpan to acquire certain of its generating facilities (the "GPRA Option") will expire. However, if such agreements do not become effective, LIPA will have 90 days to exercise the GPRA Option. The Authority has indicated it does not expect the Comptroller or the Attorney General to take action on this matter until the Authority resolves its concerns with the acquisition of KeySpan by National Grid plc (discussed below).

#### **ACQUISITION OF KEYSpan BY NATIONAL GRID**

On February 27, 2006, KeySpan announced a definitive agreement under which KeySpan would be acquired in early 2007 by an affiliate of National Grid plc, a company organized under the laws of England and Wales. The transaction is subject to the approval of the shareholders of both companies and to various regulatory approvals. Shareholder approval of the transaction was received by both KeySpan and National Grid plc in August 2006. The companies report they have filed, or expect to soon file, for all regulatory approvals from pertinent state and federal agencies.

The Authority is evaluating the acquisition of KeySpan by National Grid plc and its effect on the Authority's agreements with KeySpan and the potential benefits to LIPA's customers of the acquisition. The Authority has begun discussions with National Grid plc and KeySpan regarding the proposed acquisition of KeySpan and such discussions are continuing. In the event there is a change of control of KeySpan, the Authority and LIPA have the option of canceling their contracts with KeySpan and the KeySpan Subs. This option remains in effect whether or not the Amended MSA, the 2006 Option Agreement, or the 2006 Purchase Option become effective.

## SECTION 4

### TRANSMISSION AND DISTRIBUTION SYSTEM

The T&D System is an integrated electric system consisting of overhead and underground facilities, vehicles, equipment, land parcels, easements, contractual arrangements and other assets used to provide the transmission and distribution of electric capacity and energy to and within the Service Area. Key components of the T&D System are summarized below.

#### TRANSMISSION INTERCONNECTIONS

Electricity is transmitted to and from the Service Area over six transmission interconnections that are owned in part or are under contract to LIPA. These interconnections link the T&D System to other utilities and enable delivery of: (i) capacity and energy produced by NMP2; (ii) additional off-system capacity resources needed to meet the peak demands of the electric customers; (iii) favorably-priced energy to supplement or displace generation from on-island generating resources; and (iv) excess generation from on-island generating facilities to off-island purchasers when conditions merit. Table 2 provides summary information on the transmission interconnections.

**TABLE 2  
SERVICE AREA TRANSMISSION INTERCONNECTIONS**

Name	Off System Terminal Locations	Interconnecting Utility <sup>1</sup>	Voltage Level <sup>2</sup>
Dunwoodie to Shore Road .....	Westchester County, NY	Con Edison	345 kV
East Garden City to Sprainbrook.....	Westchester County, NY	NYPA	345 kV
Northport to Norwalk Harbor .....	Norwalk, CT	CL&P <sup>3</sup>	138 kV
Shoreham to New Haven <sup>4</sup> .....	New Haven, CT	UI <sup>5</sup>	150 kV
Jamaica to Lake Success.....	Queens, NY	Con Edison	138 kV
Jamaica to Valley Stream .....	Queens, NY	Con Edison	138 kV

<sup>1</sup> These utilities own the portion of the interconnections not owned by LIPA, except for the interconnection with NYPA, which is entirely owned by NYPA.

<sup>2</sup> Kilovolt or “kV.”

<sup>3</sup> CL&P = Connecticut Light and Power. CL&P is the wholly owned operating subsidiary of Northeast Utilities.

<sup>4</sup> This cable is a +/-150 kV bi-directional high voltage direct current system. Electricity is converted to 138 kV alternating current at LIPA’s Shoreham substation for transmission and delivery to LIPA’s customers.

<sup>5</sup> UI = United Illuminating.

Four submarine cables installed under Long Island Sound form part of the interconnection between the T&D System and other utility systems: (i) Dunwoodie to Shore Road; (ii) East Garden City to Sprainbrook; (iii) Northport to Norwalk Harbor, and (iv) Shoreham to New Haven.

The Dunwoodie to Shore Road line, an 18-mile 345-kilovolt (“kV”) cable designated as the “Y-50” line and placed in operation in August 1978, is jointly owned with Consolidated Edison Company of New York, Inc. (“Con Edison”). This cable is of pipe-type construction in which dielectric fluid is circulated to cool the conductors and maintain the electrical insulation. Between January and May 2002, the Long Island land portion of Y-50 was replaced. On May 18, 2002, the submarine portion of the cable between Davids Island and Pea Island (Con Edison portion) failed. Approximately 0.5 miles of cable were replaced, and the circuit was returned to

operation on July 20, 2002. The cable has been operating at full capacity since 2003 with a rating of 599 MW. On peak load days, the system operator may choose to operate Y-50 in a forced oil circulation mode to increase its capability. Under these conditions, the cable operates with a normal rating of 653 MW and emergency rating of 914 MW.

The East Garden City to Sprainbrook 345 kV interconnection ("Y-49") was installed in 1991 and is approximately 23 miles long. This tie is comprised of a submarine portion and a land-based portion. The submarine portion is constructed of self-contained dielectric fluid-filled cables that operate under high pressure, while the land-based portion is of conventional pipe-type construction. This line is owned entirely by NYPA and is used by LIPA under the terms of a contract with NYPA. LIPA's agreement for use of Y-49 provides that LIPA will reimburse NYPA for the costs it incurs in connection with the line, including, but not limited to, debt service, reserves, and operation and maintenance expenses. LIPA is contractually obligated to pay such costs based on the full capacity of Y-49; however, to the extent that NYPA allocates capacity to other parties, LIPA's payment obligations are proportionately reduced. Failures on Y-49 have generally been limited to equipment at the termination points of the line. In May 2002, a component of a circuit breaker at East Garden City failed. The circuit breaker was repaired and completely overhauled before Summer 2003. Subsequent to the circuit breaker failure at East Garden City, a shunt reactor (an electrical device designed to limit fault currents on the line) failed at the Sprainbrook substation. Additionally, another shunt reactor at Sprainbrook was found to have combustible gas buildup and was removed from service as a precautionary measure. NYPA subsequently ordered two replacement reactors, which were installed in 2005. Consolidated Edison has installed series reactors in the Sprainbrook – West 49<sup>th</sup> Street ("M51" and "M52") and the Dunwoodie-Rainey ("71" and "72") lines. With the M51, M52, 71 and 72 series reactors in service, fault duties at Sprainbrook are reduced, and the 35-ohm series reactor that was installed at Sprainbrook in Summer 1996 will be removed from active service, but will remain in place as a back up to the other series reactors.

The Northport to Norwalk Harbor line (the "NUSCO Cable") is a double circuit 138 kV submarine cable. This tie, installed in 1969, extends approximately 12 miles under the Long Island Sound from the Northport Electric Generating Station ("Northport") in Suffolk County, New York to Norwalk Harbor, Connecticut. LIPA owns that portion of the line from Northport to the New York-Connecticut state boundary, at which ownership is held by Connecticut Light and Power ("CL&P"), a wholly-owned subsidiary of Northeast Utilities. Due to the deteriorated condition of the line, resulting from periodic damage sustained by ship and barge anchors, LIPA and Northeast Utilities are proceeding with the replacement of the submarine cables. LIPA has issued a Request for Proposals and awarded a contract for the removal, construction, installation, and maintenance of the replacement cable. Northeast Utilities is acting as LIPA's agent in overseeing this work. On October 26, 2004, an amended Article VII application for the NUSCO Cable replacement was submitted to the New York Public Service Commission. Permitting activities are proceeding for the cable replacement, with anticipated construction to begin in 2007, with commercial operation for Summer 2008.

The Shoreham to New Haven line (referred to as the "Cross Sound Cable") is a 24-mile, +/- 150 kV bi-directional high voltage direct current system utilizing voltage source converter technology with a capability of 330 MW. The Cross Sound Cable is connected between the converter stations installed adjacent to United Illuminating's 345 kV East Shore substation in Connecticut and at LIPA's Shoreham 138 kV substation. This line was constructed in 2000 pursuant to a lease entered into between LIPA and Cross Sound Cable Company, LLC ("CSC

LLC") pursuant to which LIPA agreed to purchase up to 330 MW of transmission capacity (the "CSC Agreement"). Due to the existence of bedrock underneath the Cross Sound Cable and the inability to remedy such condition, CSC LLC had not been able to comply with the depth requirement of the permit necessary to satisfy a condition of the CSC Agreement between LIPA and CSC LLC. As a result, the Cross Sound Cable did not operate and LIPA was not required to make lease payments. After the August 14, 2003 blackout which affected much of the northeast United States, the United States Secretary of Energy, at LIPA's request, issued an Emergency Order providing for the commercial operation of the Cross Sound Cable. The Emergency Order was rescinded in May 2004. After rescission of the emergency order, LIPA sought an order from FERC requiring operation of the Cross Sound Cable. On June 25, 2004, an agreement was reached between LIPA, the Connecticut Department of Environmental Protection ("CTDEP"), the Connecticut Department of Public Utility Control, CL&P, and CSC LLC that provided for immediate energization and operation of the Cross Sound Cable while CSC LLC sought to come into compliance with the CTDEP permits. In January 2005, CSC LLC completed the work needed to bury the Cross Sound Cable at the depth required by the construction permit.

The Cross Sound Cable is now in operation. Since CSC LLC has not yet provided its legal counsel's opinion that it has received all necessary permits in final form necessary to satisfy the CSC Agreement, CSC LLC is providing transmission service to LIPA pursuant to a temporary Bridge Period Firm Transmission Capacity Purchase Agreement (the "Bridge Agreement"), dated June 27, 2004. The Bridge Agreement expires on June 30, 2007, but can be extended for five annually renewable one year periods if the Date of Initial Commercial Operation, as defined in the CSC Agreement, has not occurred by July 1, 2007. Under the terms of the Bridge Agreement, LIPA is obligated to pay approximately \$18.1 million, annually, escalating to approximately \$21.5 million. During the term of the Bridge Agreement, it is anticipated that CSC LLC will satisfy all remaining conditions in the CSC Agreement. Upon expiration of the Bridge Agreement, the CSC Agreement will become effective. The CSC Agreement provides for up to 330 megawatts of firm transmission capacity and expires 20 years following the Date of Initial Commercial Operation..

In November 2005, Babcock & Brown Infrastructure Ltd ("Babcock & Brown"), an Australian firm, announced an agreement with CSC LLC to acquire the Cross Sound Cable. This transaction closed during the first quarter of 2006 and all agreements between LIPA and CSC LLC have been assigned to Babcock & Brown. LIPA reported that under the terms of the CSC Agreement, it had an opportunity to review the sale and could have made an offer to purchase the cable, but chose not to acquire the facility.

The two remaining Service Area transmission interconnections (Jamaica to Lake Success and Jamaica to Valley Stream) are linked to the Con Edison transmission system in Queens County, New York. LIPA owns these facilities to the border of Nassau and Queens Counties, at which point ownership transfers to Con Edison. These ties are employed primarily for the delivery of power to Con Edison from its portion of energy delivered to Long Island via the Y-50 interconnection.

#### **SYSTEM IMPORT CONSTRAINTS**

The total import capability into Long Island during a typical summer period is approximately 1,460 MW under normal conditions. The maximum emergency import capability into Long Island during peak summer conditions is approximately 2,100 MW for a period of approximately four hours.

In September 2005, LIPA entered into a 20-year contract with Neptune Regional Transmission System LLC ("Neptune") which will permit the Authority to import capacity from the Pennsylvania, New Jersey, Maryland Interconnection ("PJM") over an undersea high-voltage direct current transmission cable which Neptune is constructing. This cable interconnects in PJM at the Sayerville, New Jersey substation and terminates on Long Island at the Newbridge substation. Neptune is constructing high voltage direct current converter stations at Sayerville, New Jersey and New Castle, New York. Neptune is also constructing a 345 kV transmission line from New Castle to the Newbridge Road Substation. This line will initially operate at 138 kV. Interconnection service from PJM will allow the cable to export from PJM up to 660 MW of firm energy (net, delivered to Long Island) and an additional 105 MW of non-firm energy. Construction of the cable is underway and is expected to be completed by early 2007. The Neptune project will increase the maximum import capability to Long Island and provide access to additional power supply resources, including those located in PJM. This new interconnection will increase competition between power supply resources on- and off-Island and provide LIPA with greater resource contracting flexibility.

#### **TRANSMISSION FACILITIES**

The transmission facilities provide for the delivery of capacity and energy from the transmission interconnections and the on-Island generating stations to LIPA's electric distribution system. As of December 31, 2005, LIPA reported the transmission system consisted of approximately 1,290 miles of overhead and underground lines, with voltage levels ranging from 23 kV to 345 kV. This transmission system has been constructed following standards similar to those employed by other major electric utilities in the Northeast and includes wood poles, steel poles, and lattice steel towers. Many of the existing transmission structures support distribution circuits and/or connections for telephone, cable television, or fiber optics.

As of December 31, 2005, there were 176 electric substations in the LIPA system, of which 126 were strictly distribution substations. With very few exceptions, the other 50 substations in the system function as both transmission and distribution substations, with distribution transformers connected to the 138 kV and 69 kV buses. The transmission system includes transformation equipment at 17 generating sites that is used to step up the generation voltage to transmission voltage levels. With the exception of certain facilities (e.g., auxiliary and starting transformers) at generating facilities previously owned by LILCO and now under contract to LIPA, transformation equipment at these sites is owned by LIPA.

#### **DISTRIBUTION FACILITIES**

LIPA reports the distribution system included approximately 13,130 primary circuit miles of overhead and underground line (8,904 miles of overhead line and 4,226 miles of underground line) at December 31, 2005. Approximately 44 percent of the poles on which LIPA's distribution facilities have been installed are owned by Verizon and used by LIPA pursuant to a joint-use agreement.

#### **MANAGEMENT SERVICES AGREEMENT**

LIPA relies on KeySpan (as Manager under the MSA) to operate and maintain the T&D System in accordance with all applicable laws, prudent utility practices, and the policies and procedures established by the Authority. The Manager's responsibilities include, but are not limited to: (i) the day-to-day operation and maintenance of the T&D System, including emergency repairs, customer service, billings, and meter readings; (ii) facility additions and



improvements, including customer connections, procurement of goods and services from third parties, and inventory management; (iii) preparing and monitoring budgets, developing load and energy forecasts, and acquisition, maintenance and use of power resource models and plans; and (iv) maintaining an operation and maintenance manual for the T&D System.

The Authority is responsible for, among other things, (i) setting rates and charges; (ii) establishing line extension policies; (iii) developing service rules and regulations; (iv) approving long-term strategic plans; (v) developing customer service programs; (vi) approving annual operating and capital budgets; (vii) approving the Manager's load forecast and power resource models and plans; (viii) determining all energy efficiency, conservation and load management policies and plans; (ix) managing governmental relations and reporting; (x) managing overall legal responsibilities; (xi) overseeing the Manager's operations and performance; and (xii) managing community and public relations. The Authority also has the right to approve the appointment of key personnel of the Manager.

In exchange for services rendered under the MSA, the Manager is entitled to receive an annual service fee as compensation. The service fee is paid on a monthly basis and is calculated based on five components, consisting of a: (i) fixed direct fee; (ii) third party cost reimbursement component; (iii) variable payment; (iv) cost incentive fee; and (v) non-cost performance component. In addition to the service fee, the Manager is reimbursed for all approved third-party costs and is 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. With respect to operations, \$5 million of the Manager's annual fee of \$15 million is contingent upon achieving a comparable amount of cost savings each year. In addition, the Manager is entitled to payments equal to 50 percent of any savings in excess of this amount, provided that no incentive is payable for savings in excess of 15 percent of the operating budget. To the extent costs exceed the operating budget, excluding the Manager's fee, the Manager must absorb overruns up to a maximum total of \$15 million. With regard to the capital budget, the Manager is entitled to incentive payments for cost savings and penalties for cost overruns equal to 50 percent of all variances between budgeted and actual capital expenditures, provided that no additional incentive payment will be earned, nor penalty incurred, for cost variances in excess of 15 percent of the capital budget.

In addition to cost savings incentives, the Manager is eligible for certain annual non-cost performance incentives, including T&D System reliability, meter reading accuracy, and worker safety. The MSA provides for additional non-cost incentives related to customer call answering, accounts receivable, and payments-in-lieu of taxes ("PILOT"); however, the Authority and the Manager have not agreed to the incentive mechanisms for these areas of performance. The Manager has generally met or exceeded the MSA non-cost performance incentive maximum allowances.

For a more complete description of the Manager's responsibilities under the MSA, including associated incentive provisions, please see Appendix A.

#### **AMENDED MSA**

The Authority has reported that the Amended MSA will provide it with a reduction in costs of approximately \$34 million per year on a net present value basis from the amount paid for such services in 2005. The Amended MSA provides for payment to KeySpan based on a fixed rate per kilowatt-hour ("kWh") of retail electric sales, which is subject to an inflation factor, as well as a

floor and a cap. This fixed rate per kWh replaces the fixed direct fee, the variable payment; the cost incentive fee; and the non-cost performance component. "Pass through expenditures" which include both direct and third party costs, such as capital expenditures and storm restoration costs, will continue to be passed through to LIPA on an actual cost basis. The Amended MSA also eliminates the cost and performance incentives and provides for penalties for failure by KeySpan to perform within 18 specified performance metrics. Total financial penalties payable by KeySpan for failure to meet the performance metrics can reach \$7 million per year.

In the event the required governmental approvals for the Amended MSA are not obtained and the Amended MSA does not become effective, LIPA and KeySpan will continue under the MSA previously in effect. Appendix B to this Biennial Report provides an overview of the terms and conditions associated with the Amended MSA.

#### **THE MANAGER'S PERFORMANCE UNDER THE MSA**

The following sections provide a summary of the Manager's performance in key areas during the Historical Period.

##### **Reliability**

LIPA is continuing and expanding a program that is intended to improve the reliability and quality of electric service within the Service Area. For the distribution system, this program is focused on three major areas: (i) circuit reconfiguration and reinforcement; (ii) pole replacement; and (iii) circuit conversion and reinforcement projects to serve new customer loads. For the transmission system, the improvement program is focused on: (i) transmission system reliability; (ii) substation reliability improvements; (iii) transmission breaker replacements; and (iv) structure inspection program. These program elements are a key part of LIPA's efforts to achieve reductions in both the frequency and duration of customer outages.

Two standard industry criteria for measuring transmission and distribution system reliability are: (i) System Average Interruption Frequency Index ("SAIFI"), which is a measure of the number of times the average customer's service is interrupted in a year; and (ii) Customer Average Interruption Duration Index ("CAIDI"), which is a measure of the average number of minutes required to restore service to a customer whose service has been interrupted. For both SAIFI and CAIDI, a low value is favorable. A low SAIFI value indicates a longer time period between service interruptions, and a low CAIDI value indicates a shorter average duration, less elapsed time, associated with the outages that have occurred. The MSA establishes incentive measures for the Manager to maintain SAIFI and CAIDI indices for the T&D system within prescribed levels. Information on these incentives may be found in Appendix A.

For 2004, the system-wide SAIFI index was 0.83 (or 14.4 months between interruptions), and the CAIDI index was 62.0 minutes. For 2005, the system-wide SAIFI index was 0.849 (or 14.1 months between interruptions), and the CAIDI index was 64.0 minutes. The composition of these reliability indices by LIPA operating district is provided in Table 3.

Over the five-year period 2001 through 2005, LIPA's customers experienced an average of 13.8 months between interruptions and average interruption times of 64.6 minutes. For all New York State utilities (other than Con Edison, whose system is predominately underground), the average time between interruptions during this five-year period was 11.3 months and the average duration of an interruption was 112.0 minutes.

**TABLE 3**  
**T&D SYSTEM RELIABILITY<sup>1,2</sup>**

	MSA Incentive Minimum	Calendar Year	
		2004	2005
<b>SAIFI<sup>3</sup></b>			
Queens.....	1.23	0.60	0.68
Central.....	1.40	1.00	0.89
W. Suffolk.....	1.60	0.85	0.84
E. Suffolk.....	2.10	0.82	0.94
System Average.....		0.83	0.85
<b>CAIDI<sup>4</sup></b>			
Queens.....	67.2	55.0	52.0
Central.....	81.0	70.0	69.8
W. Suffolk.....	72.6	59.0	58.9
E. Suffolk.....	71.4	61.0	60.6
System Average.....		62.0	64.0

<sup>1</sup> Excludes interruptions of less than five minutes and during major storms.

<sup>2</sup> Lower values are more favorable.

<sup>3</sup> System Average Interruption Frequency Index.

<sup>4</sup> Customer Average Interruption Duration Index.

### **Maintenance**

The Manager's substation maintenance group is responsible for the operation and maintenance of the transmission and distribution substations throughout the Service Area. The preventive maintenance program calls for the inspection and major maintenance of over 2,000 individual pieces of substation equipment annually. During the Historical Period, the substation maintenance group completed approximately 99 percent of the scheduled preventive maintenance each year. A completion rate over 90 percent falls within the range of that achieved by other similarly situated utilities.

The Manager uses a computerized maintenance inspection and record-keeping system, known as Maximo, for the substation group. This maintenance system is used for work order management, planning and scheduling, asset management and tracking, resource management, reports and analysis, and integration with the Manager's financial system. The system considers equipment criticality, load, number of operations, age, and test diagnostics. LIPA expects the computerized maintenance system to provide for more targeted maintenance programs in the future.

### **Storm Restoration**

Under the terms of the MSA, the Manager is responsible for storm response and storm restoration programs. During these restoration efforts, the Manager utilizes, as necessary, appropriately trained personnel not normally assigned to field duties, as well as gas and generation department personnel when storm severity warrants, in order to perform electric distribution emergency restoration services. In addition, the Manager may utilize tree trimming or construction vendors to assist in storm restoration and rebuild activities. This utilization of personnel increases the availability of local field forces to restore service to customers affected by the storm damage. The Manager, on behalf of LIPA, also relies on standard electric utility

industry mutual aid programs wherein neighboring and regional utilities provide emergency assistance to one another in the event of widespread outages due to major storms. Table 4 below provides a summary of the total cost of storm damage within the Service Area for the 2001 through 2005 period.

**TABLE 4  
HISTORICAL STORM EXPENDITURES  
FOR THE T&D SYSTEM**

Year	\$000
2001.....	\$7,443
2002.....	17,354
2003.....	12,917
2004.....	6,582
2005.....	14,802 <sup>1</sup>

<sup>1</sup> Estimated.

Under the original MSA, approximately \$4.4 million is included in the annual budget for the Manager to provide storm restoration services. This allowance is intended to cover the cost of direct labor, excluding overtime pay, incurred by the Manager for storm restoration services. In addition to the MSA storm allowance paid to the Manager, the Authority also included in revenue requirements an annual storm allowance of approximately \$7 million over the Historical Period to provide for storm restoration costs other than the Manager’s direct labor costs (resulting in a total allowance for storm restoration of approximately \$12.0 million per year). Annual storm losses in excess of \$12.0 million are funded through any unspent accumulated storm reserve balance. Depending on the extent of damage, the Authority may also be eligible for funds from the Federal Emergency Management Agency. For 2006, the Authority has increased the reserve to \$16 million, reflecting the increased storm activity over the past several years.

Under the Amended MSA, LIPA is responsible for all storm-related costs as a pass-through, and no amount is included in the base per kwh fee.

**Condition of the Facilities**

During the January 2004 through May 2006 period, Navigant Consulting conducted periodic on-site observations of principal and representative facilities comprising the T&D System. These observations consisted of visual examinations of facilities that Navigant Consulting deemed adequate to allow it to assess the general condition of the facilities. In addition to field observations, Navigant Consulting reviewed historical operation and maintenance records for the T&D System to assess past performance levels and examined written maintenance procedures to evaluate the adequacy of existing maintenance practices. Navigant Consulting did not identify any material deficiencies in the condition of the T&D System as a result of these observations or review of historical records.

**Capital Expenditures**

During the 2001 through 2005 period, LIPA reported that an average of approximately \$211 million per year was spent on T&D System capital additions and improvements. Such expenditures included interconnection costs associated with new generating stations on Long

Island, reliability enhancements, capability expansion, new customer connections, facility replacements and public works. LIPA reports that T&D System capital expenditures for 2004 and 2005 were approximately \$206 million and \$218 million, respectively. The variation in capital expenditure levels during the Historical Period was due primarily to differences in the amounts incurred by LIPA for transmission interconnection projects associated with new generating resources. T&D System capital expenditures for 2006 and 2007 are estimated by LIPA to total approximately \$270 million and \$280 million, respectively. The 2006 and 2007 capital expenditure programs provide for a continuation of the historical programs to improve reliability and quality of electric service, as well as expenditures for interconnection facilities to support interconnection of and delivery of 660 MW from PJM over the Neptune project and replacement of the NUSCO cable, capability expansion, new customer connections, facility replacements, reliability enhancements and public work projects that are comparable to historical levels

Amounts reported above for T&D System capital expenditures do not include expenditures for NMP2 or for the Authority's internal administrative and general purposes. NMP2 capital expenditures are discussed in Section 5 of this Biennial Report. The Authority's internal administrative and general capital expenditures have averaged approximately \$2 million per year during the 2001 through 2005 period and are estimated by LIPA to remain at this level during each year of the Forecast Period.

T&D System capital expenditures will continue to be subject to the Authority's annual approval process under the terms of the MSA. LIPA employs a capital planning and review process that takes into account the priority and benefits of individual capital projects relative to alternative investments. This capital planning process allows LIPA to identify, rank, fund, and manage capital investments. The process involves three phases: (i) selection, in which capital projects are screened, ranked, and selected; (ii) control, whereby an ongoing monitoring process manages selected capital projects to ensure that each investment continues to be required and is completed on schedule and within budget; and (iii) evaluation, wherein projects are reviewed upon completion to determine if the capital investment realized its expected mission and business performance goals, and provide feedback to continually improve the capital planning and execution process. The 2006 capital budget was reviewed and approved using an industry-accepted process of ranking projects according to the probability of the occurrence of an outage, the number of customers that would be affected by the outage, and the outage's duration. By utilizing this process, capital investments may be targeted to the most critical projects.

### **Adequacy of Performance**

Operation of the T&D System during the Historical Period was generally consistent with past experience, and no material adverse conditions or occurrences were noted. Such results reflect the relative success of the Manager in operating and maintaining the T&D System under the MSA. LIPA is working with the Manager to implement improvements in several areas of day-to-day operations under the MSA which can be expected to further strengthen the Manager's performance going forward. These include (i) resolution of certain reporting and information issues; (ii) enhanced capital budgeting and system planning procedures; (iii) improvements in LIPA's customer billing system; and (iv) increased attention to prospective conflicts of interest. LIPA believes such improvements would enhance the operation and management of the T&D System, but does not expect them to be critical to the continued financial health or physical condition of the T&D System.

## SECTION 5

### NINE MILE POINT NUCLEAR POWER STATION, UNIT 2

Nine Mile Point Nuclear Power Station, Unit 2 (“NMP2”) is part of a two-unit nuclear power station (“Nine Mile Point”) located on the south shore of Lake Ontario near the Town of Scriba, New York. NMP2 uses a boiling water reactor (“BWR”) and turbine generator supplied by General Electric Corporation. The plant has a rated capacity of 1,148 MW.

NMP2 is the second of two units at the Nine Mile Point site. Unit 1 (“NMP1”) began commercial operation in 1969. NMP1 and NMP2 are operated under different ownership interests. LIPA’s ownership interest is limited to NMP2. The Fitzpatrick Nuclear Power Plant, owned and operated by Entergy, is located on a site adjacent to Nine Mile Point.

NMP2 began commercial operation in April 1988 under a Nuclear Regulatory Commission (“NRC”) license that expires in 2026. In May 2004, Constellation Nuclear LLC (“Constellation”), the majority owner of Nine Mile Point, applied to the NRC for a 20-year extension of the operating licenses for both units. KeySpan has advised Navigant Consulting that NRC approval of the license extension is expected by the end of 2006. LIPA will be eligible to participate in the extended license period.

#### **NMP2 OWNERSHIP AND MANAGEMENT**

LIPA has an undivided 18 percent interest in NMP2. Until November 6, 2001, NMP2 was operated by Niagara Mohawk Power Corporation (“NMPC”). On November 7, 2001, Constellation purchased 100 percent of NMP1 and 82 percent of NMP2 from NMPC, with LIPA retaining its 18 percent interest in NMP2. LIPA’s share of the rated capability of NMP2 is approximately 207 MW.

LIPA has entered into an operating agreement with Constellation for NMP2. Among other things, the agreement provides for a management committee comprised of one representative from each co-tenant. Constellation controls the operating and maintenance decisions of NMP2 in its role as operator. The annual NMP2 business plan and the operating and capital budgets are developed by Constellation and submitted to LIPA for review and approval. LIPA receives output from NMP2 and is responsible for operating and capital costs in proportion to its ownership interest. In addition to its involvement through the management committee, LIPA engages KeySpan personnel to provide on-site support to protect its interests.

#### **NMP2 PERFORMANCE**

Table 5 sets forth capacity factors and generation levels associated with LIPA’s 18 percent share of NMP2 for the period 2001 through 2005. This table also presents comparative industry data for all nuclear generating units in the United States.

Constellation’s goal for NMP2’s 2004 capacity factor was 87.7 percent. That capacity factor target considered a refueling outage during 2004. The refueling outage took longer than planned and the actual capacity factor for 2004 was 85.4. In 2005, NMP2 achieved a capacity factor of 98.6 percent. Historical generation statistics for NMP2 are shown in Table 5 below.

**TABLE 5**  
**HISTORICAL NMP2 PERFORMANCE**

Calendar Year	Annual Net Generation (MWh) <sup>1,2</sup>	Annual Net Capacity Factor <sup>1,3</sup>	Three-Year Average Net Capacity Factor <sup>1,4</sup>	Industry Average Net Capacity Factor <sup>5</sup>
2001 .....	1,598,132	88.1	84.7	90.7
2002 .....	1,519,573	84.0	83.7	91.9
2003 .....	1,721,549	95.2	89.1	89.6
2004 .....	1,548,432	85.4	88.2	90.1
2005 .....	1,784,200	98.6	93.1	89.4

<sup>1</sup> Source: KeySpan.

<sup>2</sup> LIPA's 18 percent share of NMP2 net output. Values reflect scheduled generation through the NYISO, as reported by KeySpan.

<sup>3</sup> Net capacity factor is a measure of the utilization of NMP2's theoretical maximum annual output.

<sup>4</sup> The three-year average smoothes the effects of refueling outages.

<sup>5</sup> Includes all nuclear plants operating during the respective year. Source: Energy Information Administration.

### **NMP2 Maintenance Programs and Condition**

The NRC uses a Reactor Oversight Process to evaluate plant performance in eighteen areas or Performance Indicators. Performance is graded "Green", "White", "Yellow" or "Red". Green signifies satisfactory performance requiring minimal NRC resources for oversight. At the opposite end, Red signifies unsatisfactory performance requiring the most NRC resources for oversight. In 2004 and 2005, both Nine Mile Point units were graded as Green in all areas and the NRC stated that Nine Mile Point had "operated in a manner that preserved public health and safety, and fully met all cornerstone objectives."

The Institute of Nuclear Power Operations ("INPO") is a nuclear industry self-assessment and support organization. In 1999, INPO identified numerous areas needing improvement at Nine Mile Point. In 1999, INPO identified numerous areas needing improvement at NMP2. In response, NMP2 management developed an improvement plan directed at (1) preventive and predictive maintenance optimization; (2) corrective action program enhancements; (3) work management and maintenance planning process improvements; (4) revising the configuration management change process; (5) training improvements; and (6) improving equipment reliability. In 2002, INPO performed another assessment of Nine Mile Point and found that some problems in the above areas had been resolved, but that others remained. Additionally, some problems that had not existed in 1999 were uncovered in 2002. The next INPO plant evaluation was performed in September 2004. This resulted in an evaluation of three on a scale of one to four, one being best. The evaluation identified 20 Areas For Improvement. Based on historically flat trends in several of these areas, INPO placed Nine Mile Point into its Policy 14 program. Policy 14 is a program designed to help plants improve in certain programmatic and process areas. The Policy 14 program involves increased assistance from INPO and peer personnel and is monitored by INPO management on a regular basis. As a Policy 14 plant, Nine Mile Point has been recognized by INPO as showing improvement in areas such as human performance, work control, industrial safety, radiation protection, and management alignment. It is uncertain how long Nine Mile Point will remain a Policy 14 plant. However, the expectation is to be off the Policy 14 Program after the October 2006 INPO evaluation.

Notwithstanding the Policy 14 Program matter, Nine Mile Point is rated in the top decile for the INPO Index of operational and safety parameters. In addition, INPO renewed accreditation of the Operations Training Program on June 16, 2005.

The non-outage corrective maintenance backlog at NMP2 has improved significantly from 45 activities at the end of 2003 to 6 activities in May 2006.

Normal plant inspections were conducted by Constellation during the 2004 and 2006 refueling outages for NMP2. This effort included inspections of the reactor core shroud to assure that the previously identified stress corrosion cracking was within acceptable limits and that the shroud remained safe for plant operations (please see the 2004 Biennial Report for additional information on corrosion of the reactor shroud). Other inspections were performed based on industry experience. Adjustments in water chemistry appear to have resolved the shroud corrosion problem.

### **Capital Expenditures**

NMP2's historical capital expenditure levels vary with the schedule of refueling and maintenance outages for the facility. Major maintenance activities, including replacement of major plant components and facility improvements, are undertaken concurrent with the refueling outages. Nuclear fuel purchases are capitalized and subsequently expensed based on expended heat content of the fuel rods.

During the 2001 through 2005 period, LIPA reported an average of approximately \$11 million per year was spent on its 18 percent share of NMP2 nuclear fuel, capital additions, and improvements. NMP2 capital expenditures for 2004 and 2005 were reported by LIPA to be approximately \$17 million and \$14 million, respectively. LIPA estimates its NMP2 capital expenditures for 2006 and 2007 will total approximately \$7 million and \$18 million, respectively. The 2006 and 2007 estimated annual capital expenditures for NMP2 continue to reflect the cyclical nature of the two-year refueling schedule. A portion of the annual capital expenditures are intended to support projects aimed at maintaining NMP2 in good operating condition and satisfying regulatory requirements.

### **NMP2 Decommissioning Funding**

LIPA is providing for decommissioning costs for NMP2 based on a site-specific study performed in 1995. LIPA's share of the total decommissioning costs for both the contaminated and non-contaminated portions of NMP2 is estimated to be approximately \$145 million in 1996 dollars. LIPA maintains a trust fund for its share of the decommissioning costs of the contaminated portion of NMP2, which at December 31, 2005, had an approximate value of \$49.1 million. LIPA established a separate decommissioning fund for its share of the non-contaminated portion of NMP2, which had a value at December 31, 2005, totaling approximately \$9.9 million. Through continued deposits and investment returns on these trusts, LIPA believes that the value of these trusts will, in 2026, be sufficient to meet the LIPA's decommissioning obligations for NMP2. Should LIPA participate in the NMP2 license extension, the amounts on deposit, plus additional deposits and investment returns, are expected by LIPA to be sufficient to meet the retirement obligations expected in 2046.



## SECTION 6

### ADEQUACY OF RATES AND CHARGES

The Authority's retail rates generally reflect traditional rate designs and include fixed customer charges for all customer classes, seasonal energy rates for all customer classes except lighting, and seasonally differentiated demand charges for the non-residential customer classes (greater than seven kW). Voluntary time-of-use rates are available to all residential and nonresidential customers. Mandatory time-of-use rates apply to nonresidential customers with demands in excess of 145 kW in the summer or 500 kW in the non-summer months. The summer months are June through September, inclusive. Economic development and load retention incentives are provided to a small number of commercial customers.

In addition to the base retail rates, the LIPA Tariff for Electric Service ("Tariff") includes the following adjustments and riders.

#### FUEL AND PURCHASED POWER COST ADJUSTMENT CLAUSE

LIPA's Tariff includes a fuel recovery provision – the Fuel and Purchased Power Cost Adjustment Clause ("FPPCA") that is applicable to all Service Classifications. The FPPCA mechanism is designed to allow LIPA to recover from or return to customers current year fuel and purchased power costs, including certain load reduction program costs, up to an amount sufficient to achieve a targeted level of net income for each year.

During the Historical Period, the FPPCA mechanism was designed to achieve a financial reserve target of \$20 million per year. If the projected financial reserve was expected to fall below this level, the FPPCA was adjusted upward to achieve the targeted financial reserve level. A corresponding downward adjustment would have been made in the FPPCA had the projected financial reserve been expected to exceed \$20 million.

In April 2006, the FPPCA mechanism was modified to achieve a targeted financial reserve of \$75 million per year, with a deadband of \$50 million around this target. The purpose of the deadband is to create some degree of rate stability within the calendar year. So long as the projected financial reserve is greater than \$25 million and less than \$125 million, the FPPCA will remain unchanged and LIPA's projected financial reserve will be impacted accordingly. If the projected financial reserve falls outside the deadband, the FPPCA will be increased or decreased so that the financial reserve will fall within the deadband. Since the lower limit of the financial reserve deadband is now \$25 million, LIPA's financial health is improved compared to the previous financial reserve target of \$20 million.

On June 22, 2006, the Board of Trustees approved a revision to LIPA's base schedule of rates to move substantially all elements of the fuel and purchased power costs previously recovered through base electric rates to the FPPCA. This change was effective for all bills issued on and after July 5, 2006, and substantially consolidates fuel and purchased power costs in the FPPCA. While this restructuring will not affect the level of revenues collected from its customers, LIPA believes the change will provide a clearer indication of the costs incurred to meet the power supply needs of ratepayers in the Service Area.

In 2003, the Authority authorized the deferred recovery of approximately \$365 million in fuel and purchased power costs. These deferred costs are being amortized over ten years and recovered through the FPPCA in equal annual amounts.

To protect its customers from significant market price fluctuations for the purchase of fuel oil, natural gas and electricity, LIPA uses derivative financial instruments which are recorded at their market value. Any unrealized gains and losses derived from these derivatives are deferred as a regulatory asset (or regulatory liability) until realized, at which time they are included in current period results as a component of fuel and purchased power.

#### **SHOREHAM PROPERTY TAX SETTLEMENT RIDER**

The Authority and certain taxing jurisdictions in Suffolk County previously reached an agreement settling various matters related to prior property tax assessments on Shoreham (the "Settlement"). The Settlement results in a rate differential between non-Suffolk County ratepayers (Nassau County and Rockaway Peninsula) and ratepayers in Suffolk County. Under the Settlement, all ratepayers initially received a credit on their monthly electric bills relating to the property tax settlement, with ratepayers in Nassau County and Rockaway Peninsula receiving a greater credit than ratepayers in Suffolk County. Beginning in June 2003, the billing credits were exhausted and a surcharge was added to electric bills for Suffolk County ratepayers.

LIPA's rates include a rider that implements the Settlement. The rider describes the calculation of percentage factors to be applied to bills, including the FPPCA portion thereof. Under this rider, LIPA expects to collect approximately \$35 to \$40 million during each 12-month period for the remaining years of the Settlement from customers residing in Suffolk County. No revenues will be recovered from customers residing in Nassau County and the Rockaway Peninsula under the terms of the Settlement.

#### **PILOT PAYMENT RECOVERY RIDER**

The Authority is obligated to make payments in lieu of taxes ("PILOTs") to municipalities and school districts equal to the property taxes that would have been received by each such jurisdiction from LILCO if the acquisition by the Authority had not occurred, and to make PILOTs for certain State taxes (including gross receipts taxes) and local taxes (including temporary transit station maintenance surcharges charged by the Metropolitan Transportation Authority of New York (the "MTA")) which would otherwise have been imposed on LILCO. LIPA's rates include a PILOT payments recovery rider that allows the Authority to recover the applicable gross receipts tax PILOTs from each ratepayer. This rider also allows for the recovery of the MTA surcharge from each ratepayer. All other PILOTs are recovered in the Authority's base electric rates.

#### **ADEQUACY OF LIPA RETAIL RATES AND CHARGES**

As discussed below, LIPA's currently effective rates and charges, including adjustments and riders, provide for adequate revenue recovery to meet its annual revenue requirements and to satisfy the debt service coverage requirements set forth in the General Bond Resolution, absent the approval of waivers limiting cost recovery.

LIPA's Tariff has kept pace with many of the developments that have affected large investor owned utilities in New York State. A number of minor changes have been made to the Tariff, to keep the terms and conditions of service reasonably comparable to neighboring utilities. LIPA continues to monitor developments at the New York Public Service Commission as well as the major investor owned utilities in New York State and appears to be well positioned to address emerging issues as they arise.

The restructuring of LIPA's rates in July 2006 (described earlier) had no net impact on LIPA's revenue recovery or rate levels. The base rates and the FPPCA were adjusted by exactly the same

amount (in cents per kWh) to maintain rate neutrality and bill neutrality. The restructured rates are, however, more consistent with the rest of the utilities in New York State, which have unbundled their rates and present power supply charges separately from delivery service charges.

LIPA recovers the costs of public policy programs that target energy efficiency, research and development, and the low income sector through base rates. Similarly, LIPA recovers substantially all costs for compliance with the New York State Renewable Portfolio Standards initiatives through the FPPCA mechanism.

#### **OPEN ACCESS TRANSMISSION TARIFF**

On May 13, 1998, the Authority adopted an open access transmission tariff consistent with regulations issued by FERC. On November 18, 1999, the New York Independent System Operator (“NYISO”) officially assumed control of the New York State bulk power system. The NYISO is responsible for the safe and reliable operation of the New York State electric power system and for providing transmission service on a comparable and non-discriminatory basis. In its role as transmission service provider, the NYISO has adopted an open access transmission tariff (“OATT”) for use of the New York State transmission system. Except in the case of “grandfathered” contracts, the NYISO OATT supersedes the transmission tariff adopted by LIPA.

LIPA’s participation does not limit its ability to recover its transmission costs from wholesale customers that use the system. Under the NYISO OATT, LIPA has specified the Transmission Service Charge (“TSC”) based on LIPA’s determination of its transmission revenue requirements. The TSC applies to all wholesale customers that are located in the Service Area, and is not substantially different from the charge that LIPA adopted previously under its own open access transmission tariff. Additional NYISO OATT charges are designed to compensate LIPA for other usage of its transmission system, including interconnections with adjoining service territories.

In 2003, the LIPA Trustees approved a modification to the Open Access Transmission Tariff to authorize the use of a formula rate to update the TSC. As modified, LIPA staff is authorized to update the TSC calculation each year using verifiable financial information. LIPA expects the automatic adjustment process to reduce the administrative burden of the TSC and better match LIPA’s revenues to current expense levels.

#### **FINANCIAL RESULTS – REASONABLENESS OF RATES**

Section 702(b)(iii) of the General Bond Resolution sets forth the duties of the Rate Consultant in preparing its respective portion of the Biennial Report. Specifically, this Section states such report shall contain:

*“(iii) the Rate Consultant’s recommendation as to any necessary or advisable revisions of rates, fees, rents, charges and surcharges and such other advise and recommendation as it may deem desirable;”*

The General Bond Resolution itself however is silent regarding the criteria or standards upon which the recommendations of the Rate Consultant are to be based. As a general matter, Navigant Consulting believes there are many quantitative and qualitative factors to consider when assessing rates, fees, charges, and surcharges including: adequacy of total revenue produced to cover all costs; each rate’s (service classification’s) ability to produce revenue sufficient to cover an appropriate portion of total costs; timeliness of cost recovery; regional competitiveness, understandability; stability; and predictability. Among these, the Navigant Consulting believes the single most important factor is whether the Tariff will produce revenues

that are adequate to cover all costs reasonably expected to be incurred. This is predominately a forward-looking test.

For purposes of the Biennial Report, Navigant Consulting refers to Article VII, Sections 701 and 702 of the General Bond Resolution, which set forth both a minimum standard for assessing the adequacy of Tariff revenue in total and an expectation that the Rate Consultant will, in the preparation of the Biennial Report, make a determination as to whether that minimum standard is satisfied. Furthermore, Navigant Consulting believes that the determinations required by these sections of the General Bond Resolution as to the satisfaction of the minimum standard along with the findings and recommendations of the Rate Consultant are to be measured on both a historical and forward-looking basis. Section 701(a) of the General Bond Resolution states, in part:

*“The Authority shall establish and maintain System fees, rates, rents, charges and surcharges sufficient in each Fiscal Year so that Revenues reasonably expected to be produced in such Fiscal Year, will be at least equal to the sum of (i) 120% (except, after the Authority shall have retired, other than from proceeds of Bonds or Subordinated Indebtedness, an amount equal to 25% of the Acquisition Debt net of the then outstanding balance of the Promissory Notes, 100%) of Debt Service, and amounts under all Parity Contract Obligations, payable by the Authority in such Fiscal Year, (ii) 100% of the Operating Expenses payable in such Fiscal Year, (iii) 100% of the amount necessary to pay all PILOTS payable in such Fiscal Year, and (iv) 100% of the amount necessary to pay other Required Deposits, all other payments required pursuant to the Resolution and the Financing Agreement, and all other payments required for the System, for such Fiscal Year; ...”*

During 2005, the Authority’s cumulative retirement of Acquisition Debt (as defined in the General Bond Resolution) exceeded 25 percent of the original issued amounts. Pursuant to the provision cited above, the Authority’s requirement to establish and set rates equal, among other requirements, to 120 percent of Debt Service has been reduced to 100 percent of Debt Service.

With reference to the expectation that the Rate Consultant will make a determination regarding the requirements of Section 701(a), Section 701(b) states, in part:

*“If ...the report of the Rate Consultant pursuant to Section 702 [Biennial Report], indicates that the rates, fees, rents, charges and surcharges are, or will be, insufficient to meet the requirements of this Section 701 ...”*

For purposes of preparing this portion of the Biennial Report relating to the adequacy of the currently effective system of rates and surcharges, Navigant Consulting, as Rate Consultant, utilized the provisions established in the aforementioned Section 701(a) as the basis of its determinations. Specifically, the test was whether the requirements (minimum standards or Rate Covenants) set forth in Section 701(a) of the General Bond Resolution have been satisfied for the Historical Period and can reasonably be expected to be satisfied for the Forecast Period. In conducting this test, Navigant Consulting utilized the currently effective Tariff in assessing the level of estimated revenues each year of the Forecast Period. To the extent the Trustees have approved waivers of certain provisions of the Tariff during the Historical Period, the effect of these waivers on the reported results and related findings have been recognized in the appropriate year. Navigant Consulting’s analysis for the Forecast Period is based upon the

assumption that no provision of the currently effective Tariff will be waived. To the extent the Trustees approve any waiver of the Tariff that would impact either the amount or timing of the recovery of any incurred expense during the Forecast Period, such waiver would have a direct effect on the results of the revenue adequacy test and the related advice and recommendations derived therefrom. The results of the analyses for the Historical Period and Forecast Period are shown on Exhibits 1 and 2, respectively.

Exhibit 1 sets forth the Authority's annual Statement of Operations for the Historical Period. In accordance with the Authority's accounting practices, annual operating results shown in Exhibit 1 are presented on an accrual basis and include operating expenses, depreciation and amortization, interest income, PILOTs and interest charges, among other expenses.

As shown in Exhibit 1, the actual level of revenues recovered through the Authority's retail electric rates were sufficient during the Historical Period to meet the Authority's operating expenses, PILOTs, and other financial obligations as well as provide debt service coverage levels in excess of 180 percent of debt service payments on outstanding senior lien bonds, parity reimbursement obligations and parity contract obligations.

In conjunction with the preparation of this Biennial Report, Navigant Consulting has reviewed an estimate prepared by the Authority of its annual operating results for the Forecast Period, which is included in Exhibit 2. This estimate is based on numerous assumptions with respect to the Authority's future operations and activities. These assumptions are summarized below.

1. The Amended MSA, the 2006 Settlement Agreement, the 2006 Option Agreement, and the amendments to the EMA and PSA will receive all required approvals and will be effective as of the dates stated in the agreements.
2. The Authority will successfully award and enter into a contract for the purchase and sale of off-system energy to a qualified service provider at costs equal to or less than reflected in Exhibit 2 no later than December 31, 2007.
3. The Authority will issue approximately \$190 million of additional senior lien bonds ("Additional Bonds") to fund capital improvements and other uses during 2006 and approximately \$95 million of Additional Bonds during 2007. Annual debt service payments on the Additional Bonds, along with debt already issued by the Authority, will be as set forth in Exhibit 2.
4. KeySpan and its subsidiaries will carry out their obligations in accordance with the terms of the Agreements.
5. LIPA will fund repairs, renewals, and replacements to the T&D System, and the Manager will make such repairs, renewals, and replacements in accordance with prudent utility practices and the Amended MSA, as may be required, to continue the safe and reliable operation of the T&D System.
6. The Authority will retain staff, advisors, and consultants, as necessary, to carry out its responsibilities for financing, contract administration, planning, public relations, and other matters in connection with the ownership, operation, and maintenance of the System.
7. The Authority will approve capital expenditures by GENCO, and GENCO will make repairs, renewals, and replacements in accordance with prudent utility practice and the

- PSA, as may be required to continue the reliable operation of GENCO's generating facilities.
8. LIPA and Constellation will provide operating and capital funds in a timely manner as needed and required by contract to maintain the reliable, cost effective operation of NMP2 and to meet applicable regulations, including environmental and safety standards.
  9. The Trustees will not waive any provision of the Tariff that would impact the recovery of incurred expenses during the Forecast Period.
  10. Natural gas transportation facilities to deliver gas to and within the Service Area will, during the Forecast Period, be maintained, improved, and expanded to enable operation of the on-island generating facilities as forecast by the Manager in its resource planning calculations as well as for the operation of other power supply resources under contract or available to LIPA.
  11. LIPA will incur fuel and purchased power expenses as set forth in Exhibit 2.
  12. Third party costs, PILOTs, incentive payments, and escalation rates for labor and other costs, as applicable, associated with the Amended MSA, PSA, and EMA will be as reflected in Exhibit 2.
  13. LIPA's share of NMP2 decommissioning costs will increase from estimated 1996 costs at an average rate of no more than 3.0 percent per year and will be funded through annual deposits by LIPA of approximately \$2.7 million and \$1.3 million for the contaminated and non-contaminated portions, respectively, of NMP2. Annual earnings on the decommissioning funds held by or on-behalf of LIPA will average 6.0 percent LIPA will maintain a Rate Stabilization Fund at the levels shown in Exhibit 2 of this Report.
  14. The Rate Stabilization Fund will be used for the purposes and in the amounts shown in Exhibit 2 of this Report for the Forecast Period.
  15. LIPA will realize earnings on its invested funds as reflected in Exhibit 2.
  16. There will be no changes in applicable federal, State, or local laws that will establish new limits on the operation and maintenance of the generating facilities under contract to LIPA during the Forecast Period.
  17. The Authority will maintain regulations, policies, procedures, and rates and charges that will preclude the undue shifting of fixed costs among retail customers or rate classes as a result of individual customers or groups of customers electing to select power suppliers other than LIPA.
  18. There will be no changes in regulations or policies of federal, State, or local agencies with jurisdiction over NMP2 that will cause new capital additions or operation and maintenance costs to exceed the estimated amounts of such costs reflected in Exhibit 2 of this Biennial Report.
  19. All NMP2 performance issues will be successfully addressed within the NMP2 plant modification budget forecast.
  20. NMP2's regulatory performance will be sufficient to make increased NRC regulation of NMP2 unnecessary.

21. Any legislation enacted by the federal government that provides for the restructuring of the electric utility industry will not preclude the use of tax-exempt debt by the Authority for the funding of capital improvements or for other purposes contemplated during the Forecast Period and will not preclude LIPA from owning or operating the System as contemplated in this Biennial Report.
22. There will be no changes in United States Internal Revenue Service regulations that would eliminate or otherwise prohibit the issuance of tax exempt debt by LIPA during the Forecast Period.

As shown on Exhibit 2, the level of revenue estimated to be recovered through the Authority's retail rates are estimated to be sufficient during the Forecast Period to meet the Authority's estimated operating expenses, PILOTs, and other financial obligations and provide debt service coverage levels in excess of 100 percent of debt service payments on outstanding senior lien bonds, parity reimbursement obligations, and parity contract obligations.

## SECTION 7 FINDINGS

The results of the analyses performed in the preparation of this Biennial Report and the findings presented herein are predicated upon the general condition that the assumptions presented herein are reasonable and will continue, as stated, for the period covered by the analyses, without major modification or change except as noted herein. Although Navigant Consulting believes the assumptions made are reasonable, Navigant Consulting makes no representation that the assumed conditions will, in fact, occur. In addition, Navigant Consulting was not permitted to review the INPO plant evaluation reports for NMP2 and therefore offers no assurances as to the conclusions and recommendations contained therein. Furthermore, the waiver of any provision of the Tariff by the Trustees that would impact the recovery of incurred expenses during the Forecast Period could impact the adequacy of LIPA's revenue recovery and, therefore, LIPA's ability to satisfy the requirements of Article VII, Sections 701 and 702 of the General Bond Resolution. Navigant Consulting's studies, analyses, investigations, and projections have been based upon its understanding of certain documents and information provided to Navigant Consulting by the Authority, the Authority's legal, financial, and accounting advisors, KeySpan, and others. While Navigant Consulting believes these sources to be reliable, they have not been independently verified for either accuracy or validity, and no assurances are offered with respect thereto. To the best of Navigant Consulting's knowledge, the data and summaries presented herein accurately reflect the information furnished to Navigant Consulting by the Authority, the Authority's legal, financial, and accounting advisors, KeySpan, and others. Further, Navigant Consulting has assumed that all contracts, agreements, or ordinances that have been relied upon in the conduct of its investigations will be fully enforceable in accordance with their terms and conditions. Navigant Consulting makes no representations or warranties, and provides no opinion concerning the enforceability or legal interpretations of such contractual and legal requirements.

Pursuant to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution, Navigant Consulting's findings are as follows:

### **OPERATION, MAINTENANCE, AND REPAIR OF THE SYSTEM**

1. The Manager has provided services adequate for the operation, maintenance, and repair of the System during the Historical Period.
2. During the Forecast Period, it is reasonable to expect the Manager will provide services adequate for the operation, maintenance, and repair of the System consistent with that experienced during the Historical Period.
3. The amounts included in Exhibit 2 to this Biennial Report for operation, maintenance, and repair expense are expected to be adequate to properly operate, maintain, and repair the System during the Forecast Period.

### **IMPROVEMENTS TO THE SYSTEM**

1. During the Historical Period, LIPA's capital improvement programs: (i) achieved improvements in system reliability and quality of service; and (ii) provided reasonable levels of expenditures for capability expansion, new customer connections, and public works projects.



2. LIPA has approved capital expenditure programs for 2006 (and is expected to approve capital programs for 2007) intended to: (i) maintain system reliability and quality of service; and (ii) provide adequate levels of expenditures for capability expansion, new customer connections, facility replacement, and public works projects, among other purposes.
3. The amounts included in Exhibit 2 and estimated to be available from the proceeds of Bonds during the Forecast Period, together with funds estimated to be available from net revenues of the System, are reasonably expected to be adequate to fund LIPA's identified capital expenditure programs during the Forecast Period.

#### **RATES, FEES, CHARGES, AND SURCHARGES**

1. As of the date of this Biennial Report, LIPA's currently effective system of rates and surcharges (if applied without waiver) are expected to be adequate without change to satisfy during the Forecast Period the requirements of Section 701(a) of the General Bond Resolution and Section 7.01 of the General Subordinated Resolution, which provide that the Authority will establish and maintain rates sufficient to produce revenues at least equal to (i) 100 percent of its annual operating expenses, PILOTs, and other financial obligations; and (ii) 100 percent of annual debt service payments on outstanding senior lien bonds, parity reimbursement obligations, and parity contract obligations.

#### **CONDITION OF THE SYSTEM**

1. As of the date of this Biennial Report, the System is in good repair and sound operating condition to reliably deliver capacity and energy to LIPA's customers.

**EXHIBIT 1**  
**ACTUAL OPERATING RESULTS <sup>1</sup>**  
**STATEMENT OF OPERATIONS**  
**(\$000)**

	<u>2004</u>	<u>2005</u>
<b>Retail Sales of Electricity (MWh)</b> .....	19,526,187	20,250,066
<b>Electric Revenues</b> .....	\$2,853,837	\$3,281,186
<b>Operating Expenses</b>		
Fuel and Purchased Power Costs .....	\$1,386,907	\$1,758,533
Operations and Maintenance.....	691,937	723,774
General and Administrative.....	40,962	43,567
Operating Taxes/Payments In-Lieu of Taxes.....	215,312	222,609
Depreciation and Amortization.....	229,316	237,863
<b>Total Operating Expenses</b> .....	<u>\$2,564,434</u>	<u>\$2,986,346</u>
<b>Operating Income</b> .....	\$289,403	\$294,840
<b>Other Income and Deductions, Net</b> .....	<u>47,248</u>	<u>57,518</u>
<b>Excess of Revenues Over Expenses Before Interest Expense</b> ....	\$336,651	\$352,358
<b>Interest Expense</b> .....	<u>316,651</u>	<u>332,358</u>
<b>Excess of Revenues Over Expenses</b> .....	<u>\$20,000</u>	<u>\$20,000</u>
<b>Debt Service Coverage:</b>		
Senior Lien Debt Service.....	2.16	2.23
Senior Lien and Subordinate Debt Service.....	1.91	1.95
Total Debt Service.....	1.87	1.92

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<sup>1</sup> Source: LIPA.

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(\$000)**

	<u>2006</u>	<u>2007</u>
<b>Retail Sales of Electricity (MWh) <sup>1</sup></b> .....	19,919,995	20,177,259
<b>Electric Revenues <sup>2</sup></b> .....	\$3,735,331	\$3,808,223
<b>Operating Expenses</b>		
Fuel and Purchased Power Costs <sup>3</sup> .....	\$2,085,748	\$2,151,977
Operations and Maintenance <sup>4</sup> .....	761,293	768,546
General and Administrative <sup>5</sup> .....	47,232	46,984
Revenue Taxes <sup>6</sup> .....	56,885	59,969
Payments In-Lieu of Taxes <sup>7</sup> .....	177,043	185,450
Depreciation and Amortization <sup>8</sup> .....	246,495	253,793
<b>Total Operating Expenses</b> .....	<u>\$3,376,696</u>	<u>\$3,466,719</u>
<b>Operating Income</b> .....	\$358,635	\$341,504
<b>Other Income and Deductions, Net <sup>9</sup></b> .....	<u>60,891</u>	<u>66,492</u>
<b>Excess of Revenues Over Expenses Before Interest Expense</b> .....	\$419,526	\$407,996
<b>Interest Expense</b>		
Debt Service Interest Expense <sup>10</sup> .....	\$338,280	\$328,382
Other Interest Expense and Fees <sup>11</sup> .....	<u>14,321</u>	<u>12,689</u>
<b>Subtotal Interest Expense</b> .....	\$352,601	\$341,071
Promissory Notes Receipts <sup>12</sup> .....	<u>(8,075)</u>	<u>(8,075)</u>
<b>Net Interest Expense</b> .....	<u>\$344,526</u>	<u>\$332,996</u>
<b>Excess of Revenues Over Expenses <sup>13</sup></b> .....	<u>\$75,000</u>	<u>\$75,000</u>

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

	<b>2006</b>	<b>2007</b>
<b>CALCULATION OF CASH AVAILABLE FOR DEBT SERVICE</b>		
<b>Excess of Revenues Over Expenses</b> <sup>14</sup> .....	\$ 75,000	\$ 75,000
Plus (Minus) Non-Cash Items:		
Amortization of Deferred Shoreham Property Settlement		
Credits <sup>15</sup> .....	\$ 35,251	\$ 35,936
Carrying Charges on Deferred Shoreham Property Tax		
Settlement Costs <sup>16</sup> .....	(32,439)	(32,178)
Deferred Fuel Cost Reconciliation <sup>17</sup> .....	36,500	36,500
NMP2 Amortized Nuclear Fuel Expense <sup>18</sup> .....	6,744	6,035
Amortization of Prepaid NMP2 Refueling Outage Costs <sup>19</sup> .....	3,149	2,340
O&M Asset Accretion-Asset Retirement Obligation		
(FASB 143) <sup>20</sup> .....	4,345	4,606
Amortization and Prepaid Hedging Costs <sup>21</sup> .....	13,725	15,555
Amortization and Prepaid Mobile Generating Costs.....	10,044	10,044
Depreciation and Amortization <sup>22</sup> .....	246,495	253,793
Other <sup>23</sup> .....	(2,046)	300
Interest Expense <sup>24</sup> .....	353,504	342,555
<b>Subtotal</b> .....	<b>\$750,272</b>	<b>\$750,486</b>
Less:		
Prepaid Fuel Hedging Program Costs <sup>25</sup> .....	\$ 14,000	\$ 12,000
NMP2 Cash Fuel Expense <sup>26</sup> .....	1,813	12,514
Prepaid NMP2 Refueling Outage Costs <sup>27</sup> .....	5,040	180
Funding for NMP2 Decommissioning <sup>28</sup> .....	4,000	4,000
Bank and Related Fees <sup>29</sup> .....	11,152	11,152
<b>Subtotal</b> .....	<b>\$ 36,005</b>	<b>\$ 39,846</b>
<b>Operating Cash Available for Debt Service Coverage</b> .....	<b>\$714,267</b>	<b>\$710,640</b>

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

	<b>2006</b>	<b>2007</b>
<b>RATE COVENANT TEST</b>		
<b>Operating Cash Available for Debt Service and Coverage</b> <sup>30</sup> .....	\$ 714,267	\$ 710,640
Less Debt Service:		
Senior Lien Debt Service <sup>31</sup> .....	\$ 463,914	\$ 473,664
Required Debt Service Coverage <sup>32</sup> .....	-	-
Subordinate Lien Debt Service <sup>33</sup> .....	68,683	65,761
Subsidiary Unsecured Debt Service <sup>34</sup> .....	8,075	8,075
<b>Subtotal</b> .....	<b>\$ 540,672</b>	<b>\$ 547,500</b>
<b>Revenue Excess (Deficiency)</b> .....	\$ 173,595	\$ 163,140
Withdrawals from Rate Stabilization Fund <sup>35</sup> .....	-	-
<b>Revenue Excess (Deficiency) after Transfer</b> .....	<b>\$ 173,595</b>	<b>\$ 163,140</b>
 <b>PRIORITY OF PAYMENT DEBT SERVICE COVERAGE RATIO</b>		
<b>Operating Cash Available for Debt Service and Coverage</b> <sup>36</sup> .....	\$ 173,595	\$ 163,140
Plus:		
Taxes <sup>37</sup> .....	235,928	245,419
Capitalized Leases <sup>38</sup> .....	144,967	190,172
<b>Total Cash Available for Debt Service and Coverage Based on Priority of Payments</b> .....	<b>\$1,095,162</b>	<b>\$1,146,232</b>
Senior Lien Debt Service <sup>39</sup> .....	\$ 463,914	\$ 473,664
<b>Coverage on Senior Lien Debt Service</b> .....	2.36	2.42
Senior Lien and Subordinate Debt Service <sup>40</sup> .....	\$ 532,597	\$ 539,425
<b>Coverage on Senior Lien and Subordinate Debt Service</b> .....	2.06	2.12
Total Debt Service <sup>41</sup> .....	\$ 540,672	\$ 547,500
<b>Coverage on Total Debt Service</b> .....	2.03	2.09

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

	<b>2006</b>	<b>2007</b>
<b>FUNDS PROVIDED FROM:</b>		
<b>Excess of Revenues Over Expenses</b> <sup>42</sup> .....	\$ 75,000	\$ 75,000
Amortization of Deferred Shoreham Property Settlement Credits <sup>43</sup> ...	\$ 35,251	\$ 35,936
Carrying Charges on Deferred Shoreham Property Tax Settlement Costs <sup>44</sup> .....	(32,439)	(32,178)
Deferred Fuel Cost Reconciliation <sup>45</sup> .....	36,500	36,500
NMP2 Amortized Nuclear Fuel Expense <sup>46</sup> .....	6,744	6,035
Amortization of Prepaid NMP2 Refueling Outage Costs <sup>47</sup> .....	3,149	2,340
O&M Asset Accretion-Asset Retirement Obligation (FASB 143) <sup>48</sup> .....	4,345	4,606
Amortization and Prepaid Hedging Costs <sup>49</sup> .....	13,725	15,555
Amortization and Prepaid Mobile Generating Costs .....	10,044	10,044
Depreciation and Amortization <sup>50</sup> .....	246,495	253,793
Other <sup>51</sup> .....	(2,046)	300
Interest Expense <sup>52</sup> .....	353,504	342,555
Proceeds of Bonds, Notes, and Swaps <sup>53</sup> .....	190,000	95,000
<b>Total Sources of Funds</b> .....	<b>\$940,272</b>	<b>\$845,486</b>
 <b>FUNDS USED FOR:</b>		
Prepaid Fuel Hedging Program Costs <sup>54</sup> .....	\$ 14,000	\$ 12,000
NMP2 Cash Fuel Expense <sup>55</sup> .....	1,813	12,514
Prepaid NMP2 Refueling Outage Costs <sup>56</sup> .....	5,040	180
Funding for NMP2 Decommissioning <sup>57</sup> .....	4,000	4,000
Bank and Related Fees <sup>58</sup> .....	11,152	11,152
Debt Service Payments <sup>59</sup> .....	540,672	547,500
Capital Expenditures .....	270,724	259,380
Change in Cash Position Due to Operating, Financing, and Investing Activities <sup>60</sup> .....	92,871	(1,240)
<b>Total Uses of Funds</b> .....	<b>\$940,272</b>	<b>\$845,486</b>

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

	2006	2007
<b>CASH ACCOUNT: FUNDS AVAILABLE FOR OPTIONAL DEFEASED/TENDERED DEBT, WORKING CAPITAL, CAPITAL IMPROVEMENTS, AND OTHER PURPOSES</b>		
<b>Beginning Balance</b> .....	\$ 63,898	\$156,769
Change in Cash Position Due to Operating, Financing, and Investing Activities <sup>61</sup> .....	92,871	(1,240)
Withdrawals from Rate Stabilization Fund .....	-	-
(Deposits to) Rate Stabilization Fund .....	-	-
<b>Ending Balance</b> .....	\$156,769	\$155,529
 <b>RATE STABILIZATION FUND</b>		
<b>Beginning Balance</b> .....	\$250,000	\$250,000
(Withdrawals From).....	-	-
Deposits to.....	-	-
<b>Ending Balance</b> .....	\$250,000	\$250,000
 <b>TOTAL FUNDS</b>		
<b>Beginning Balance</b> <sup>62</sup> .....	\$313,898	\$406,769
Transfers In (Out) <sup>63</sup> .....	92,871	(1,240)
<b>Ending Balance</b> .....	\$406,879	\$405,529
 <b>CAPITAL EXPENDITURE FUNDING</b>		
Internal Funding <sup>64</sup> .....	\$ 80,724	\$164,380
Bond Proceeds <sup>65</sup> .....	190,000	95,000
<b>Total Capital Expenditures</b> <sup>66</sup> .....	\$270,724	\$259,380

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

**FOOTNOTES:**

- <sup>1</sup> Includes bundled and Long Island Choice electric sales. Developed by KeySpan.
- <sup>2</sup> Includes revenues from bundled services, Long Island Choice services, Shoreham property tax settlement surcharge, and recoverable fuel and purchased power costs. Also includes revenues from sales for resale, transmission of electricity for others (“wheeling”), pole attachment fees, late payment charges, service activation charges, and other miscellaneous revenues. Please see LIPA’s 2005 Audited Financial Statement for additional information on the Shoreham property tax settlement surcharge and associated regulatory asset.
- <sup>3</sup> Includes LIPA’s cost for fossil and nuclear fuel, cost of purchased capacity and energy, wheeling charges, independent system operator charges, hedging costs, and deferred fuel cost recovery. Developed based on information provided by KeySpan.
- <sup>4</sup> Includes costs in accordance with the MSA and PSA, NMP2 operation and maintenance expenses and accretion of the asset retirement obligation, Clean Energy and Energy Efficiency Programs costs, assessments, research and development, storm damage reserve, uncollectible accounts, customer service economic development, postage-paid envelopes, and other miscellaneous expenses.
- <sup>5</sup> Includes employee salaries and benefits, utilities, rent, legal and professional services fees, and similar administrative and general costs.
- <sup>6</sup> Payments for gross receipts taxes.
- <sup>7</sup> Includes payments in lieu of property taxes to various taxing jurisdictions for the T&D System, NMP2, and merchant power plants.
- <sup>8</sup> Consists of amortization of the acquisition adjustment and depreciation of plant-in-service.
- <sup>9</sup> Includes interest earned on investments from available cash balances and the Nuclear Decommissioning Trust Fund. Also includes carrying charges related to the Shoreham property tax settlement regulatory asset and income from the sales of emission credits.
- <sup>10</sup> Interest expense on senior lien bonds, subordinate indebtedness, commercial paper, debentures, and certain financing notes. Includes accretion of capital appreciation bonds and amortized interest expense. Also includes amortization of upfront swap payments on derivative financial transactions.
- <sup>11</sup> Bank and letter of credit fees, debt administration costs, interest on customer deposits, amortization of costs associated with bond issuance and redemptions, and reduction for capitalized interest.
- <sup>12</sup> Receipts from KeySpan for certain promissory notes held by LIPA for repayment of certain assumed debt. LIPA’s Audited Financial Statements reflect these receipts as an offset to interest expense.
- <sup>13</sup> LIPA’s FPPCA mechanism will set recoveries of fuel costs so that LIPA achieves \$75 million of revenues in excess of expenses for each calendar year. The fuel recovery will not exceed the fuel cost recovery allowance calculated according to FPPCA rider to LIPA’s tariffs.
- <sup>14</sup> From Exhibit 2, Page 1.
- <sup>15</sup> Equal to the Shoreham property tax settlement surcharge.
- <sup>16</sup> Annual carrying charges recorded on the Shoreham property tax settlement regulatory asset.
- <sup>17</sup> Recognition of deferred fuel costs as an expense in the year during which the corresponding fuel and purchased power costs are billed to retail customers. Equals deferred fuel and purchased power costs from 2003 amortized over a 10-year period.
- <sup>18</sup> Amortization of prepaid NMP2 fuel costs based on NMP2 generation during the year.
- <sup>19</sup> Amortization of non-fuel and capital costs incurred during refueling outages.
- <sup>20</sup> Amortization of operations and maintenance assets, including accretion of the asset retirement obligation.
- <sup>21</sup> Amortization of fuel hedging costs in the year of the contract’s settlement date.
- <sup>22</sup> See Note 8.



**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

**FOOTNOTES:**

- <sup>23</sup> Includes true-ups and adjustments to reserve accounts.
- <sup>24</sup> Debt Service Interest Expense (Note 10), Other Interest Expense (Note 11), and Promissory Notes Receipts (Note 12).
- <sup>25</sup> Cash outlays for hedging contracts.
- <sup>26</sup> Cash outlays for NMP2 nuclear fuel
- <sup>27</sup> Incremental operating and maintenance costs attributable to refueling outages, other than nuclear fuel and capital projects. Includes costs of specialty contractors, skilled craft outside labor, incremental onsite labor associated with the outage, materials and supplies, and benefits and taxes.
- <sup>28</sup> Deposits to the NMP2 decommissioning fund.
- <sup>29</sup> Bank fees, letter of credit fees, bond administration costs, and interest on customer deposits.
- <sup>30</sup> From Exhibit 2, Page 2.
- <sup>31</sup> Debt service on bonds.
- <sup>32</sup> The General Bond Resolution requires rates to be set to produce revenues at least sufficient to provide Debt Service Coverage equal to 20 percent of Senior Lien Bond principal and interest payments. At such time that LIPA retires 25 percent of the Acquisition Debt net of the then outstanding balance of KeySpan Promissory Notes, the Debt Service Coverage requirement is eliminated. LIPA achieved the 25 percent retirement level during 2005; therefore the 20 percent coverage requirement is no longer applicable. Please see the General Bond Resolution for additional information related to the Debt Service Coverage requirement, including the meaning of the above defined terms.
- <sup>33</sup> Debt service on subordinated indebtedness. Subordinated indebtedness consists of variable rate debt and commercial paper.
- <sup>34</sup> Debt service on debentures and certain financing notes.
- <sup>35</sup> Transfers from the Rate Stabilization Fund to satisfy any deficiency in Revenues.
- <sup>36</sup> From Exhibit 2, Page 2.
- <sup>37</sup> Revenue Taxes and Payments In-Lieu of Taxes. From Exhibit 2, Page 1. See Notes 6 and 7.
- <sup>38</sup> Capacity payments for power supply agreements that satisfy the conditions for capital leases.
- <sup>39</sup> See Note 30.
- <sup>40</sup> See Notes 30 and 32.
- <sup>41</sup> See Notes 30, 32, and 33.
- <sup>42</sup> From Exhibit 2, Page 1.
- <sup>43</sup> See Note 15.
- <sup>44</sup> See Note 16.
- <sup>45</sup> See Note 17.
- <sup>46</sup> See Note 18.
- <sup>47</sup> See Note 19.
- <sup>48</sup> See Note 20.
- <sup>49</sup> See Note 21.
- <sup>50</sup> See Note 8.
- <sup>51</sup> See Note 23.
- <sup>52</sup> See Note 24.
- <sup>53</sup> Proceeds of bonds and notes for capital projects and upfront payments for swap transactions.
- <sup>54</sup> See Note 25.
- <sup>55</sup> See Note 26.
- <sup>56</sup> See Note 27.
- <sup>57</sup> See Note 28.

**EXHIBIT 2**  
**ESTIMATED OPERATING RESULTS**  
**STATEMENT OF OPERATIONS**  
**(CONTINUED)**  
**(\$000)**

**FOOTNOTES:**

<sup>58</sup> See Note 29.

<sup>59</sup> Senior Lien Debt Service (Note 30), Debt Service Coverage (Note 31), Subordinate Lien Debt Service (Note 32), and Subsidiary Unsecured Debt Service (Note 33).

<sup>60</sup> Changes in LIPA's cash position.

<sup>61</sup> From Exhibit 2, page 4.

<sup>62</sup> Beginning balance in Cash Account plus beginning balance in Rate Stabilization Fund.

<sup>63</sup> Change in Cash Position plus change in Rate Stabilization fund.

<sup>64</sup> Internal LIPA funds used for capital improvements.

<sup>65</sup> Proceeds of bonds and notes, net of financing costs, used for capital improvements.

<sup>66</sup> Total amount expended for capital improvements.

Note: Sums may not add due to rounding.

## Appendix A

### SUMMARY OF CERTAIN PROVISIONS OF THE MANAGEMENT SERVICES AGREEMENT <sup>1</sup>

The following is a brief summary of certain provisions of the Management Services Agreement. The summary does not purport to be complete or definitive and is qualified in its entirety by reference to the Management Services Agreement, a copy of which is on file with the Trustee.

#### **General**

The Management Services Agreement establishes the terms and conditions under which the Authority has contracted with KeySpan and its subsidiaries (the “Manager”) for the purpose of providing the Operation and Maintenance Services and the Construction Work relating to the T&D System in a manner consistent with policies established by LIPA in order to assure the continued delivery of electric energy to the customers of the T&D System.

#### **Ownership of the T&D System**

The Agreement provides that the Manager will not have any ownership or leasehold interest in the T&D System. LIPA has engaged the Manager as an independent contractor to furnish the services described in the Agreement.

The Agreement provides that the Manager will not, without LIPA’s prior written consent, create or permit to be created or to remain, and will promptly discharge at its expense, any Encumbrance on the T&D System, other than (1) Encumbrances existing as of the date of the Agreement, or (2) any Lien affecting the T&D System (i) resulting solely from any action or failure to act by LIPA or anyone claiming by, through or under LIPA; or (ii) created by Subcontractors that are promptly discharged or bonded against by the Manager. The Agreement provides that nothing in the Agreement will be deemed to create any Lien or Encumbrance in favor of the Manager on any asset of LIPA as security for the obligations of LIPA under the Agreement.

#### **Operation of the T&D System**

*General.* The Agreement provides that the Manager will not transmit or distribute Power and Energy other than Power and Energy obtained by, on behalf of, or with the approval of LIPA, and will not use the T&D System for any purpose other than the purposes contemplated by the Agreement or to serve or benefit any person other than LIPA and its customers in the Service Area.

*Operation and Maintenance.* The Agreement provides that, commencing on the LIPA/LILCO Merger Closing Date, the Manager will provide Operation and Maintenance Services and Construction Work for the T&D System on behalf of LIPA in accordance with the Contract Standards. The Manager will be responsible for the safe and reliable operation and maintenance of the T&D System, management and/or performance of construction of improvements thereto and delivery of Power and Energy to LIPA’s customers and will be responsible for the following tasks and services, among others: (a) day-to-day operation and maintenance of the T&D System; (b) construction activities performed by the Manager’s work force; (c) supervision of routine and major

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<sup>1</sup> The Authority and KeySpan have entered into an amended Management Services Agreement which will not take effect unless certain governmental approvals are obtained and certain other conditions are satisfied. A summary of certain provisions of the Amended Management Service Agreement is attached as Appendix B.

capital improvements; (d) preparation of recommended and monitoring of approved annual capital and operating expenditure budgets, load and energy forecasts and long and short range system and strategic plans; (e) preparation of long and short range transmission and distribution planning analyses; (f) performance of accounting and tax and payment in lieu of tax reporting functions and preparation of monthly reports concerning the T&D System; (g) operation of the T&D System in compliance with applicable provisions of the bond resolutions, and with other requirements pertaining to qualification of the bonds for tax-exemption under the Code; (h) other actions necessary to safely and reliably operate the T&D System in accordance with Prudent Utility Practice; (i) administration and management, at the direction of LIPA, of LIPA's interest in NMP2; and (j) billing and collection, in accordance with LIPA's direction, of all fees and charges in connection with the use or availability of the T&D System for wheeling services.

*Maintenance and Repair of T&D System.* The Agreement provides that the Manager will maintain the T&D System, the T&D System Site and the Common Facilities in good working order and repair and in a neat and orderly condition, and will conduct periodic, corrective, and preventive maintenance and repair of the T&D System consistent with the Contract Standards for the purpose of, among other things, mitigating and preventing abnormal wear, tear and usage.

The Agreement provides that all additions to the T&D System purchased in conjunction or for the use with any part of the T&D System during the term of the Agreement shall be the property of LIPA, except those which are leased or constitute part of the Common Facilities.

*Performance Guarantees.* The Agreement provides that, commencing on the LIPA/LILCO Merger Closing Date, the Manager will at all times comply with the Performance Guarantees, except to the extent excused by Uncontrollable Circumstances or LIPA Fault. If the Manager fails to comply with any Performance Guarantee, the Manager shall, without relief under any other Performance Guarantee under the Agreement, (1) promptly notify LIPA of any such noncompliance, (2) promptly provide LIPA with copies of any notices sent to or received from any Governmental Body having regulatory jurisdiction with respect to any violations of Applicable Law, (3) promptly make any applicable payments provided for in the Agreement, and (4) at its own cost and expense to the extent required under the Agreement, promptly take any action necessary in order to comply with such Performance Guarantee, continue or resume performance under the Agreement and eliminate the cause of, and avoid or prevent recurrence of noncompliance with such Performance Guarantee.

*Rights and Responsibilities of LIPA.* The Agreement provides that LIPA will retain the ultimate authority and control over the assets and operations of the T&D System and the right to direct the Manager in connection with the performance of the Manager's obligations under the Agreement. Without limiting the generality of the foregoing, LIPA's specific rights and responsibilities with respect to the T&D System include: (a) the right to determine all T&D System rates and charges, line extension policies and service rules and regulations applicable to the T&D System and System Power Supply; (b) the right to determine and to change from time to time, in its sole discretion, all policies and procedures for the T&D System consistent with Applicable Law and Prudent Utility Practice; (c) the right to review, amend as appropriate and approve annual capital and operating expenditure budgets pursuant to the procedures outlined in the Agreement and approve or in its discretion, develop, all long-range strategic plans for the T&D System and System Power Supply; and (d) to the extent the Manager acts as the representative of LIPA in connection with the North American Electric Reliability Council, Northeast Power Coordinating Council, the New York Power Pool, the ISO and any other similar institutions or organizations, the right to direct the Manager's actions with respect thereto.

*Customer Services, Rates and Rules of Service.* The Agreement provides that the Manager shall perform normal and customary customer services in a manner designed to achieve the highest level of customer service, including, but not limited to: customer account service and maintenance; service

restorations account inquiry work; customer assistance, credit and collection services; cashiering; account connection and disconnection; and conservation advice.

The Agreement provides that the Manager shall, unless otherwise directed by LIPA, read the meters of electric commercial, industrial, residential heating and residential multiple rate period customers on a monthly basis and all other electric customer meters on a bi-monthly basis. The Manager shall, according to the schedule of rates, tariffs and policies (the "Schedule of Rates") then in effect, render bills to all T&D System customers in the name of LIPA for electric service delivered on behalf of LIPA and in the format determined by LIPA. To the extent directed by LIPA, such bills will also reflect electric services provided to T&D System customers by other parties. LIPA may implement changes to such rates, rules of service, regulations and procedures by giving written notice to the Manager not later than sixty (60) days prior to the effective date of such change to the extent practicable given the nature of the change. The Manager will maintain customer bills and records as LIPA reasonably requests.

The Manager will use best efforts to collect on a timely basis (1) all amounts due LIPA for service provided to customers, and for other services, in accordance with the Schedule of Rates for the periods in which services were provided, and (2) other monies owed to LIPA pursuant to the operation of the T&D System. The Manager's responsibilities will also include the institution of legal proceedings in LIPA's name to collect utility billings and other monies owed LIPA related to the T&D System. All monies collected by the Manager or its Subcontractors will be the property of LIPA and will be deposited by the Manager daily in an account of LIPA specified pursuant to the Agreement. In collecting such monies, the Manager and any Subcontractor will act solely as an agent for LIPA and will have no right or claim to such moneys and, without limiting the generality of the foregoing, will have no right to assert a claim of set-off, recoupment, abatement, counterclaim or deduction for any amounts which may be owed to the Manager under the Agreement or with respect to any other matter in dispute thereunder.

It is expected that gas customers of Manager's Affiliate and the T&D System electric customers will be billed in a single statement. In the event any electric customer who is also a gas customer will pay less than the total amount due at any time under a single statement, the amounts collected will be applied pro rata between the amounts owed by such customer with respect to electric service and gas service. To the extent moneys are collected for any power supply services provided by any unrelated party, amounts collected will be allocated in accordance with the directions of LIPA. The Manager may elect to bill gas customers separately, provided that the Manager will bear all incremental costs arising by reason of any such election. (Note: Effective January 1, 2003, the Authority, at its expense, began the process of separating the electric and gas customer bills.)

*Licenses, Permits and Approvals.* The Manager will identify for LIPA, prepare, and with LIPA approval, make and prosecute all filings, applications and reports necessary to obtain and maintain all permits, licenses and approvals required to be made, obtained or maintained by each under Applicable Law in order to operate the T&D System.

*Operating Period Insurance.* During the term of the Agreement, the Manager will obtain and maintain, the Required Operating Period Insurance as specified in accordance with the Agreement and will comply with all applicable Insurance Requirements.

### **Manager's Reporting Requirements**

*Monthly Reports.* The Manager will provide LIPA and the Consulting Engineer with monthly reports no later than 15 Business Days after the end of each month, which include the following data: (1) on a monthly and year-to-date basis, the actual T&D System costs versus the Annual T&D Budget and the prior year's costs at such time, (2) a description and explanation of significant variations (at least \$1,000,000 and 3%) from the Annual T&D Budget or the prior year's results, (3) a description

of partial or total shutdowns for maintenance and repairs during the prior month and anticipated during the current month, (4) any known or anticipated adverse conditions which may be expected to arise during the next 30 day period that may affect the ability of the Manager to transmit and distribute Power and Energy in accordance with the Performance Guarantees and the annual operating plan established for the T&D System, (5) identification of those costs which are classified as capital versus operating in sufficient detail in order to allow LIPA to determine which costs qualify for bonding under the Resolution and which are to be recovered through T&D System rates, and (6) any other information or statement which is requested by LIPA and which may be reasonably produced from records maintained by the Manager in the normal course of business. The Manager will also provide a quarterly forecast of projected expenditures by line item through year-end.

*Semi-Annual Reports.* The Manager will, on a semi-annual basis within 60 days after the end of each half of the Contract Year, provide LIPA and the Consulting Engineer with a report of actual Direct Costs and Third Party Costs together with identification of any material Direct Costs projects or Third Party Costs projects which were included in the Direct Cost Budget or the Third Party Cost Budget from the previous Contract Year which were deferred to the current Contract Year or proposed to be deferred to a subsequent Contract Year, or such costs in the current Contract Year which the Manager proposes deferring beyond the current Contract Year.

*Other Costs Reports.* The Manager will promptly notify LIPA when an event occurs, or is anticipated to occur, that the Manager believes qualifies for treatment as an Other Cost.

*Annual Reports.* The Manager will furnish LIPA and the Consulting Engineer with the Annual Settlement Statement, an annual summary of the statistical data provided in the monthly reports, certified by the Manager and the Manager's independent public accountants.

*Operations Reports.* The Manager will prepare appropriate reports concerning matters reasonably related to the operation of or planning for the T&D System, including, but not limited to: source of Power and Energy supply; revenues and unit sales of Power and Energy supplied to customers in the aggregate and by customer class; environmental requirements and compliance; compliance with Applicable Law; safety requirements and compliance; and reports relating to any incentive and penalty provisions set forth in the Agreement.

*Fiscal Affairs, Accounting and Record Keeping.* The Manager will maintain possession of operating equipment, buildings, materials and supplies, maps, plans, specifications, and customer billing records during the term of the Agreement in accordance with the Manager's customary practices or in such manner as LIPA may reasonably require. The Manager also will maintain LIPA's fixed asset books and records for those activities performed by the Manager in general conformity with municipal electric utility accounting standards or such other standards as reasonably requested by LIPA.

All cash held by the Manager for the account of LIPA and all cash collected by the Manager for the account of LIPA after the LIPA/LILCO Merger Closing Date will be deposited on each business day in bank accounts in such bank as LIPA may direct and upon such terms and conditions as may be specified by LIPA.

*Purchase of Equipment, Materials and Services.* The Agreement provides that the Manager will arrange for the purchase or rental for the account of LIPA of equipment, materials, and supplies and services which are not purchased directly by LIPA or other items necessary to properly operate and maintain the T&D System and to maintain the records of LIPA, and to make such additions and extensions to the T&D System, all as may be required by LIPA. Subcontractors will be subject to approval by LIPA in accordance with the Agreement.

*Other Services.* The Manager will timely pay all bills related to the T&D System which are proper, appropriate and not otherwise disputed and which it has authority to pay and will assure that,

to the extent within the Manager's control, no mechanic's or similar liens are filed against any portion of the T&D System.

### **Major Capital Improvements**

*Major Capital Improvements Generally.* The Major Capital Plan and Budget provided for in the Agreement is intended to provide for the implementation of major repairs and replacements not constituting routine maintenance of the T&D System. In addition, the Major Capital Plan and Budget is intended to recognize that it will be necessary or desirable from time to time during the term of the Agreement to modify, alter or improve the T&D System from its then-current condition. All such projects which constitute Major Capital Improvements will be made in accordance with the Agreement and will be owned by LIPA. The Manager will not make a Major Capital Improvement without notifying LIPA and receiving written consent from LIPA unless such Major Capital Improvement is included in the then current annual Major Capital Plan and Budget. LIPA will have the right, when the Manager has materially exceeded the Major Capital Plan and Budget as of an interim date, to require the Manager to defer specific Major Capital Improvements planned for the remainder of the year.

*Major Capital Plan and Budget.* Contemporaneously with the preparation of the Annual T&D Budget, the Manager is obligated to prepare a proposed annual and five year Major Capital Plan and Budget concerning planned Major Capital Improvement projects.

The annual Major Capital Plan and Budget will be approved by LIPA before or contemporaneously with the adoption of the Annual T&D Budget, provided that in the event the Major Capital Plan and Budget has not been adopted by LIPA as of the beginning of a Contract Year, the Manager may undertake such Major Capital Improvements as reasonably approved by LIPA on a project-by-project basis.

*Cost Determination.* Major Capital Improvements, except those awarded to the Manager as a result of the competitive procurement procedures established pursuant to the Agreement, will be performed at the cost of the service without any multiplier fee or mark-up.

The Manager will be entitled to incentive payments for cost savings and disincentive payments for cost overruns and delays in scheduled completion of approved Major Capital Improvements equal to 50% of all variances from the approved Major Capital Plan and Budget; provided, however, that no such incentive or disincentive will be payable for cost variances in excess of 15% of the approved Major Capital Plan and Budget. Incentives and disincentives will be trued-up upon the closing and acceptance by LIPA of approved capital projects.

*Public Works Improvements.* The Agreement provides that the budget for each Public Works Improvement will be subject to LIPA approval and the Manager will not undertake any Public Works Improvement until the budget therefor has been adopted.

Public Works Improvements will be performed at the cost of the service without any multiplier fee or mark-up; provided, however, that such costs will be reduced by all reimbursements or payments received from the applicable Governmental Body for the planning, engineering, procurement and completion of the Public Works Improvement. The Manager will be entitled to certain incentive payments for cost savings and disincentives for cost overruns and delays in scheduled completion that result in incremental costs for approved Public Works Improvement.

*Major Capital Improvements for which Manager is Responsible.* If the T&D System is damaged or destroyed by reason of circumstances for which the Manager is responsible described below under the heading "Allocation of Risks of Certain Costs and Liabilities", the Manager shall promptly proceed to make or cause to be made all Major Capital Improvements reasonably necessary to permit the Manager to perform its obligations under this Agreement. All such Major Capital Improvements

for which the Manager is responsible as described under the heading “Allocation of Risks of Certain Costs and Liabilities” shall be made at the Manager’s sole cost and expense, and the Manager shall not be entitled to any compensation from LIPA as a result thereof.

### Compensation and Budgets

*Service Fee Formula.* Commencing with the first Billing Period and for each Billing Period during the term of the Agreement, LIPA will pay the Manager a Service Fee for the services provided by the Manager under the terms of the Agreement in accordance with the following formula:

$$\text{SF} = \text{FDF} + \text{TPC} + \text{VP} + \text{CIF} + \text{NCPI}$$

Where

SF = Service Fee

FDF = Fixed Direct Fee

TPC = Third Party Costs

VP = Variable Payment

CIF = Cost Incentive Fee

NCPI = Non-cost Performance Incentives and Disincentives

Each component of the Service Fee will be computed in accordance with the Agreement and may be adjusted from time to time as provided in the Agreement. In addition to the Service Fee, Manager will be entitled to payment for cost overruns as and to the extent as discussed below.

*Fixed Direct Fee.* LIPA will make a monthly payment to the Manager equal to ninety percent (90%) of the approved annual Direct Cost Budget (the “Fixed Direct Fee”).

*Third Party Costs.* LIPA will make a monthly payment to the Manager for the monthly allocation of the approved annual Third Party Cost Budget.

*Variable Payment.* The Manager will be entitled to a Variable Payment equal to the lesser of (a) the difference between actual Total Costs (the sum of the actual Direct Costs and the actual Third Party Costs), less the sum of the Fixed Direct Fee and the lesser of actual or budgeted Third Party Costs or (b) the difference between the approved Total Cost Budget (the sum of the Direct Cost Budget and the Third Party Cost Budget) less the sum of the Fixed Direct Fee and the lesser of the actual or budgeted Third Party Costs. Monthly allocation of such payment will be determined by the parties based on historical monthly trends to minimize working capital costs.

*Management Fee, Cost Incentive Fee and Non-cost Performance Incentives and Disincentives.* To the extent actual Total Costs are less than the approved Total Cost Budget for the year, the Manager will be paid the portion of its Management Fee, described within the definition of Direct Costs as discussed below under the heading “Annual T&D Budget and Five Year Planning Budget” (relating to cost savings), in an amount equal to such cost savings up to a maximum of \$5 million. Beyond such \$5 million level, the Manager will be paid a Cost Incentive Fee equal to 50% of such additional savings, provided that no incentive will be paid for savings in excess of 15% of the Total Cost Budget. All savings above this cap will be for the benefit of LIPA.

*Cost Overruns.* To the extent actual Total Costs, excluding the Management Fee, are greater than the Total Cost Budget, excluding the net Management Fee, for the applicable Contract Year, the Manager will absorb the first dollars of such overruns, up to a maximum total of \$15 million in each Contract Year. For cost overruns in excess of this amount, the Manager will be entitled to a payment through the Annual Settlement Statement equal to the amount of such excess overruns (the “Overrun Payment”).



*Limitations.* The Agreement provides that the ratio of (1) the sum of the Variable Payment plus the Cost Incentive Fee plus the sum of the Non-cost Performance Incentives and Disincentives (as discussed below under the heading “Non-Cost Performance Incentives and Disincentives”) plus the Overrun Payment divided by (2) the sum of (a) the amounts described in (1) above and (b) the Fixed Direct Fee, will not be greater than twenty percent (20%) in any Contract Year.

### **Annual T&D Budget and Five Year Planning Budget Process**

*General.* The Agreement provides that the Annual T&D Budget and the Five-Year Planning Budget will be established in the manner described below and will provide for the determination and payment of the Manager’s costs of operating and maintaining the T&D System and performing its obligations under the Agreement, inclusive of fees paid to the Manager. The Annual T&D Budget and the Five-Year Planning Budget will be comprised of two broad categories: Direct Costs and Third Party Costs. These categories of costs will exclude Incremental Internal Costs and additional Third Party Costs relating to Major Capital Improvements, Public Works Improvements, and Other Costs.

In establishing the Direct Cost Budget for the initial Annual T&D Budget under the Agreement, the Direct Cost Budget will include (1) amounts to compensate the Manager for Operation and Maintenance Services costs anticipated to be reasonably predictable and incurred by the Manager through the utilization of either its work force, or its owned assets, in carrying out its responsibilities under the Agreement and (2) the Manager’s fee.

The Third Party Cost Budget will include amounts for reimbursement of, on a dollar for dollar basis, all recurring capital or operating costs incurred by the Manager in carrying out its responsibilities under the Agreement and paid to parties other than the Manager, its parent or affiliates, and any of their employees.

The Manager will be entitled to receive Cost Incentive Fees, as discussed above under the heading “Service Fee”, for costs savings from the amounts included for Direct Costs and Third Party Costs in the approved Annual T&D Budget.

*Annual T&D Budget Preparation.* The Agreement provides that no later than six months prior to the end of each Contract Year, the Manager will prepare a recommended annual budget for the operation and maintenance, including routine capital projects not constituting Major Capital Improvements or Public Works Improvements, of the T&D System and a recommended annual budget for total revenue requirements, inclusive of LIPA’s own costs, with the costs that will be paid by LIPA to Manager under the Agreement specifically and separately identified (together, the “Annual T&D Budget”). The recommended Annual T&D Budget will be accompanied by the Five-Year Planning Budget. The Authority will hold at least one hearing to solicit public input on the initial budgets.

LIPA has established an initial Direct Cost Budget. Subsequent annual Direct Cost Budgets will be calculated based upon the initial Direct Cost Budget, subject to adjustments for the “Direct Cost Budget Indices” described in an appendix to the Agreement.

The Agreement provides that the Annual T&D Budget and Five-Year Planning Budget prepared by the Manager and submitted to LIPA for review and approval will be accompanied by any Manager-recommended rate adjustments for the upcoming year at least six months before the beginning of each subsequent Contract Year. The Agreement provides that LIPA will have 60 days to review the proposed Annual T&D Budget and Five-Year Planning Budget and any rate adjustments and to propose modifications as it deems appropriate, so as to have the Annual T&D Budget and the Five-Year Planning Budget adopted at least two months before the beginning of the next Contract Year. All rate proposals will be subject to public hearings prior to approval by LIPA.

*Other Costs.* The Agreement provides that “Other Costs” are those costs which cannot reasonably be anticipated and will include those costs the Manager and LIPA agree are not included in the Direct Cost Budget, Third Party Cost Budget or Major Capital Plan and Budget (“Other Costs”). Other Costs include the Incremental Internal Costs and additional Third Party Costs incurred by the Manager as a result of events (including but not limited to major storms and extreme weather) that the Manager and LIPA agree have caused costs to be incurred by the Manager to respond to significant (i) damage to or adverse affects on the T&D System, (ii) changes in the level of required maintenance or operation of the T&D System, or (iii) tasks which are necessary for safety reasons.

Although Other Costs will not be budgeted, the Manager will recommend, and LIPA will adopt, an annual reserve level for Other Costs for each Annual T&D Budget and Five-Year Planning Budget to enable estimation of total “System Revenue Requirements,” consisting of the sum of the annual Service Fee, plus an estimate of other costs plus debt service requirements on the Authority’s Revenue Bonds plus the Authority’s costs as reported to the Manager pursuant to the Agreement. The Manager will be reimbursed for reasonably incurred Other Costs.

*Non-Cost Performance Incentives and Disincentives.* In addition to the cost saving incentives discussed above under the heading “Annual T&D Budget and Five Year Planning Budget Process,” the Manager will be eligible for incentives for performance above certain threshold target levels of performance standards (“Non-cost Performance Incentives”) and subject to disincentives for performance below certain other threshold minimum performance standard levels (“Non-cost Performance Disincentives”), with an intermediate band of performance in which neither incentives nor disincentives will apply, for reliability, worker safety, and customer service, all as provided in or established pursuant to the Agreement.

In any Contract Year in no event will the total of the Non-cost Performance Incentives, net of any applicable Non-cost Performance Disincentives, together with the System Power Supply Performance Incentive/Disincentive, be greater than \$7.5 million, nor will the total Non-cost Performance Disincentives, net of any applicable Non-cost Performance Incentives together with the System Power Supply Performance Incentive/Disincentive be greater than \$7.5 million.

*LIPA Non-Performance.* If caused by an event the costs of which LIPA is responsible for as discussed below under the heading “Allocation of Risk of Certain Costs and Liabilities,” there will be an increase in the Manager’s cost of Construction Work or Operation and Maintenance Services, the amount of any such incremental cost increase will be borne by LIPA to the extent it is responsible therefor and will not be considered for purposes of calculating any incentive or disincentive thereunder.

If at any time the T&D System is damaged or destroyed due to an event for which LIPA is responsible, LIPA will pay all Major Capital Improvement Costs and adjustments as are required to be made by LIPA pursuant to applicable provisions of the Agreement.

*Manager Non-Performance.* If due to an event for which the Manager is responsible as discussed below under the heading “Allocation of Risk of Certain Costs and Liabilities,” there will be an increase in the Manager’s cost of Construction Work or Operation and Maintenance Services, or in LIPA’s costs associated with performing obligations under the Agreement, the amount of any such incremental cost increase will be borne by the Manager to the extent it is responsible therefor.

*Annual Settlement.* The Agreement provides that the Manager will deliver to LIPA within 60 days after the end of each Contract Year, an Annual Settlement Statement, setting forth the actual aggregate Service Fee payable with respect to such Contract Year and a reconciliation of such amount with the amounts actually paid by LIPA pursuant to the billing statements. The Annual Settlement Statement will also include an accounting of any incentives or disincentives accrued during the applicable Contract Year which LIPA will have an opportunity to review prior to payment.

During the first quarter of the following Contract Year, the monthly payments made to the Manager by LIPA will be (i) reduced by any overpayment by LIPA or (ii) increased to reflect any Non-Cost Performance Incentive earned by the Manager during the previous year and/or any Overrun Payment due.

*LIPA's Payment Obligations.* The Agreement provides that amounts payable to the Manager under the Agreement will be paid from T&D System revenues and other funds of LIPA available for such purposes in accordance with the terms of the Resolution.

The Agreement contemplates that if any billing disputes cannot be resolved within 30 days, either party may refer such dispute for resolution as discussed below under the heading "Non-Binding Mediation; Arbitration."

*Allocation of Risks of Certain Costs and Liabilities.* The Agreement provides that except to the extent due to Subsidiary Fault (as determined by either a final non-appealable order or judgment of a court of competent jurisdiction (including administrative tribunals) or a final non-appealable binding arbitration decision), the Manager will be responsible and liable to LIPA for, and will not be entitled to reimbursement from LIPA for any Loss-and-Expense incurred by the Manager or LIPA,

(a) due to any gross negligence or willful misconduct by the Manager during the period commencing six months prior to the LIPA/LILCO Merger Closing Date to the extent LILCO knew or should have known of such gross negligence or willful misconduct and during the term of the Agreement in carrying out its obligations thereunder,

(b) due to any violation of or failure of compliance with Applicable Law by the Manager (except as provided below) during the period commencing six months prior to the LIPA/LILCO Merger Closing Date to the extent LILCO knew or should have known of such violation or failure of compliance and during the term of the Agreement which materially and adversely affects

(i) the condition or operations of the T&D System,

(ii) the financial condition of LIPA,

(iii) the performance or ability of the Manager to perform its obligations under the Agreement, or

(iv) the cost of providing electric service to the customers of the T&D System, provided, however, that Manager will not be responsible and liable to LIPA under the provisions of the Agreement described in this clause (b) with respect to any violation of, failure of compliance with, or liability under, Environmental Laws (as defined in the LIPA/LILCO Merger Agreement) for which LIPA or the Manager may be strictly liable provided that Manager (or for actions prior to the LIPA/LILCO Merger Closing Date, LILCO) acted in a manner consistent with Prudent Utility Practice. Notwithstanding the foregoing, Manager will in all events be liable for any fine or penalty arising by reason of any violation of or failure of compliance with Applicable Law for acts or omissions of the Manager not consistent with Prudent Utility Practice,

(c) due to any criminal violation of Applicable Law by the Manager (or for actions prior to the LIPA/LILCO Merger Closing Date, LILCO), or

(d) due to an event which gives rise to a cost not included in the Direct Cost Budget or Third Party Cost Budget or a cost incurred with respect to Major Capital Improvements or Public Works Improvements, that is incurred by reason of actions or omissions of the Manager not consistent with Prudent Utility Practice.

## **Default, Termination For Cause And Dispute Resolution**

*Remedies for Breach.* Subject to the provisions of the Agreement described below under the heading “Non-Binding Mediation; Arbitration,” in the event that either party breaches any other obligation under the Agreement or any representation made by either party under the Agreement is untrue in any material respect, the other party will have the right to take any action at law or in equity it may have to enforce the payment of any damages or the performance of such other obligation under the Agreement and such right to recover damages or to be reimbursed as provided therein will ordinarily constitute an adequate remedy for any breach of such other obligation or any material untruth in any such representation. Either party may enforce by an action for specific performance the other party’s obligations under the Agreement in the event a material breach thereof has occurred and is continuing. Neither party will have the right to terminate the Agreement for cause except after an Event of Default determined in accordance with the provisions of the Agreement has occurred.

### **Events of Default by the Manager**

(1) *Events of Default Not Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of the Manager for which LIPA may terminate the Agreement without any requirement of cure opportunity:

(a) *Change of Control.* Change of Control of the Manager, the Parent or the Guarantor; provided, however, that the combination effectuated under the BUG/LILCO Agreement or the LIPA/LILCO Merger Agreement shall not constitute a Change of Control of the Manager for purposes of this provision.

(b) *Worker Safety/Customer Service.* Failure for two out of three consecutive years, for reasons other than major storms or extreme weather, to achieve the “Minimum Worker Safety Standard” or “Minimum Customer Service Standard,” as such standards are established in accordance with appendices to the Agreement.

(c) *Bankruptcy.* Certain voluntary or involuntary events relating to bankruptcy affecting the Manager, the Parent or the Guarantor.

(d) *Credit Enhancement.* Failure of the Manager to supply, maintain, renew, extend or replace the credit enhancement required under the Agreement (see “General—Credit Enhancement in Certain Circumstances” below).

(e) *Letter of Credit Draw.* Failure of the Manager to supplement, replace or cause to be reinstated the letter of credit as described in the Agreement (see “General—Credit Enhancement in Certain Circumstances” below) within 30 days following draws equal to, in the aggregate, 50% of the face value thereof.

(2) *Events of Default Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of the Manager for which LIPA may terminate the Agreement upon compliance with the notice and cure provisions set forth below:

(a) *System Reliability.* Failure to achieve, for two out of three consecutive years, the “Minimum Reliability Standard” specified in the Agreement.

(b) *Failure to Pay or Credit.* Failure of the Manager to pay or credit undisputed amounts owed to LIPA under the Agreement within 90 days following the applicable due date.

(c) *Failure to Comply with Agreement or Guaranty.* The failure or refusal of the Manager to perform any material obligation under the Agreement, or the failure of the Guarantor to comply with any of its material obligations under the Guaranty unless such failure or refusal is excused by an Uncontrollable Circumstance or Subsidiary Fault; except

that no such failure or refusal in clause (b) or (c) will constitute an Event of Default giving LIPA the right to terminate the Agreement for cause unless LIPA has given prior written notice to the Manager or the Guarantor and the Manager or the Guarantor, as applicable, has neither challenged in an appropriate forum LIPA's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from receipt of the notice (but if the Manager or the Guarantor shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as the Manager or the Guarantor is continuing to take such steps to correct such default).

*Events of Default by LIPA.* Each of the following shall constitute an Event of Default on the part of LIPA for which the Manager may terminate the Agreement upon compliance with the notice and cure provisions set forth below:

(a) *Failure to Pay.* The failure of LIPA to pay undisputed amounts owed to the Manager under the Agreement within 90 days following the due date for such payment.

(b) *Failure to Comply with Agreement.* The failure or refusal by LIPA to perform any material obligation under the Agreement unless such failure or refusal is excused by an Uncontrollable Circumstance or Manager Fault; except that no such failure or refusal will constitute an Event of Default giving the Manager the right to terminate the Agreement for cause unless the Manager has given prior written notice to LIPA and LIPA has neither challenged in an appropriate forum the Manager's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from the date of the notice (but if LIPA shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as LIPA is continuing to take such steps to correct such default).

(c) *Change of Control of LIPA.* A change of control of LIPA which results in ownership control of LIPA by other than a state public benefit corporation, authority, political subdivision or other instrumentality of the State or any political subdivision thereof.

*Procedure for Termination for Cause.* If any party has a right of termination for cause, the right may be exercised by giving a notice of termination for cause to the party in default at least two years prior to (or, in the case of a bankruptcy or insolvency default or a Change of Control, simultaneously with, or, in the case of an Event of Default as discussed above under the heading "Events of Default by LIPA," six months) the date of termination specified in such notice (the "Termination Date").

### **Non-Binding Mediation; Arbitration**

The Agreement provides that any dispute arising out of or relating to the Agreement will be resolved in accordance with the mediation and arbitration procedures for the resolution of such disputes established by the Agreement, which shall constitute the sole and exclusive procedures for the resolution of such disputes.

Either party may, without prejudice to any negotiation, mediation, or arbitration procedures, proceed in any court to obtain provisional judicial relief if, in such party's sole discretion, such action is necessary to avoid imminent irreparable harm, to provide uninterrupted electrical and other services, or to preserve the status quo pending the conclusion of the dispute procedures specified in the Agreement.

### **Provisional Relief**

*LIPA Emergency Powers.* The Agreement provides that if the Manager, due to Uncontrollable Circumstances or any other reason whatsoever, fails to provide any Operation and Maintenance Services and Construction Work contemplated by the Agreement and LIPA or any Governmental

Body finds that such failure endangers or menaces the public health, safety or welfare, then LIPA will have the right, upon notice to the Manager, during the period of such emergency, to take possession of and use any or all of the Operating Assets necessary to transmit and distribute Power and Energy which the Manager would otherwise be obligated to transmit and distribute. The Manager will fully cooperate with LIPA to effect such a temporary transfer of possession of the Operating Assets for LIPA's use of the same.

## **Term**

*Term of Agreement.* The Agreement commenced on June 26, 1997 and will continue in effect until May 28, 2006, unless earlier terminated in accordance with its terms.

*Mandatory Competitive Selection of Future Managers.* LIPA will conduct a competitive procurement for T&D System management services following May 28, 2003. The Manager will have the right or be ineligible to submit a bid in such procurement on the same basis as other bidders unless the Agreement is terminated due to an Event of Default of the Manager. The Manager is obligated to cooperate with LIPA during such procurement process.

## **Miscellaneous Provisions**

*Affiliate.* Pursuant to the Agreement, the Manager has agreed to remain an Affiliate of the Guarantor.

*Credit Enhancement in Certain Circumstances.* The Agreement provides that if the Guarantor's credit rating declines below investment grade, then the Manager shall provide credit enhancement of its obligations under the Agreement in the form of either (i) an unconditional guarantee of all of GENCO's obligations under the Power Supply Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, provided by a corporation or financial institution whose long-term senior debt is or would be rated investment grade, or (ii) an irrevocable letter of credit securing GENCO's obligations under the Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, in a face amount of \$60,000,000 provided by a financial institution whose long-term senior debt is rated investment grade. The amount of such letter of credit shall be reduced by \$30,000,000 if the Energy Management Agreement has theretofore been or is thereafter terminated and by \$4,000,000 if the Power Supply Agreement has theretofore been or is thereafter terminated, such obligation to continue until the expiration or termination of the Agreement, the Power Supply Agreement and the Energy Management Agreement.

*Uncontrollable Circumstances Generally.* Except as otherwise specifically provided in the Agreement, neither LIPA nor the Manager will be liable to the other for any failure or delay in performance of any obligation under the Agreement to the extent due to the occurrence of an Uncontrollable Circumstance.

*Indemnification.* The Agreement provides that the Manager, to the extent permitted by law, will protect, indemnify and hold harmless LIPA and its respective representatives, Trustees, officers, employees and subcontractors (as applicable in the circumstances), (the "LIPA Indemnified Parties") from and against (and pay the full amount of) any Loss-and-Expense and will defend LIPA Indemnified Parties in any suit, including appeals, for personal injury to, or death of, any person, or loss or damage to property arising out of any matter for which the Manager is responsible under the caption "Allocation of Risk of Certain Costs and Liabilities" in the Agreement and LIPA, to the extent permitted by law, will protect, indemnify and hold harmless the Manager Indemnified Parties from and against (and pay the full amount of) any Loss-and-Expense, and will defend the Manager Indemnified Parties in any suit, including appeals, for personal injury to, or death of, any person, or

loss or damage to property arising out of any matter for which LIPA is responsible under the caption "Allocation of Risk of Certain Costs and Liabilities" in the Agreement. The foregoing indemnifications are subject to certain exceptions, including the negligence or other wrongful conduct of any indemnified party and any Uncontrollable Circumstance.

*Assignment and Transfer.* The Agreement may be assigned by either party only with the prior written consent of the other party, except that without the consent of the other party (1) LIPA may make such assignments, create such security interests in its rights thereunder and pledge such monies receivable thereunder as may be required in connection with issuance of Revenue Bonds; (2) LIPA may assign its rights, obligations and interests thereunder, or transfer such rights and obligations by operation of law, to any other governmental entity or to a subsidiary of LIPA provided that the successor entity gives reasonable assurances to the Manager that it will be able to fulfill LIPA's obligations thereunder; and (3) the Manager may assign its rights, obligations and interests thereunder to the Parent or any Affiliate thereof except that the Manager may not, without the consent of LIPA, make any assignment or other transfer to any person of its rights and obligations under the Agreement unless the Guaranty is and remains in full force and effect and unless the Guarantor or a majority-owned direct or indirect subsidiary of the Guarantor will have control of and responsibility for the Operation and Maintenance Services and any Construction Work. The Authority may assign its rights, obligations and interests under the Agreement to LILCO (then a wholly-owned subsidiary of the Authority) and the Manager shall assign all of its rights, obligations and interests under the Agreement to the Parent or any Affiliate thereof.

## **Appendix B**

### **SUMMARY OF CERTAIN PROVISIONS OF THE AMENDED AND RESTATED MANAGEMENT SERVICES AGREEMENT**

The following is a brief summary of certain provisions of the Amended and Restated Management Services Agreement.

The summary does not purport to be complete or definitive and is qualified in its entirety by reference to the Amended and Restated Management Services Agreement, a copy of which is on file with the Authority.

#### **General**

The Authority (acting through LIPA) and KeySpan Electric Services LLC (the “Manager”) have entered into an Amended and Restated Management Services Agreement (the “Agreement”), which becomes effective pending the approval of the New York State Attorney General (as to form) and the approval of the New York State Comptroller.

The Amended and Restated Management Services Agreement establishes the terms and conditions under which the Authority has contracted with the Manager for the purpose of providing the Operation and Maintenance Services and the Construction Work relating to the T&D System in a manner consistent with policies established by LIPA in order to assure the continued delivery of electric energy to the customers of the T&D System.

#### **Ownership of the T&D System**

The Agreement provides that the Manager does not and will not have any ownership or leasehold interest in the T&D System. LIPA has engaged the Manager as an independent contractor to furnish the services described in the Agreement.

The Agreement provides that the Manager will not, without LIPA’s prior written consent, create or permit to be created or to remain, and will promptly discharge at its expense, any Encumbrance on the T&D System, other than (1) Encumbrances existing as of the date of the Agreement, or (2) any Lien affecting the T&D System (i) resulting solely from any action or failure to act by LIPA or anyone claiming by, through or under LIPA; or (ii) created by Subcontractors that are promptly discharged or bonded against by the Manager. The Agreement provides that nothing in the Agreement will be deemed to create any Lien or Encumbrance in favor of the Manager on any asset of LIPA as security for the obligations of LIPA under the Agreement.

The Agreement provides that the Manager will provide LIPA with unrestricted access to the T&D System. The Manager will provide LIPA and its consultants and designees with a dedicated on-site office space located at the Manager’s current headquarters building or another mutually agreed site and a separate work space adequate to enable LIPA to exercise its oversight rights and responsibilities under this Agreement. LIPA has the right to designate up to four LIPA employees (each a “LIPA Designee”) to be located at the Manager’s offices. One such LIPA Designee will fully participate with the senior executives of the Manager and its Affiliates who are responsible for the provision of electric service, up to two LIPA Designees will fully participate with the senior management of the Manager’s Electric Planning Organization for the T&D System and with respect to electric resource



planning work performed by such organization, and one such LIPA Designee will fully participate with the Manager's combined Electric Sales and Marketing Organization.

### **Operation of the T&D System**

*General.* The Agreement provides that the Manager will not transmit or distribute Power and Energy other than Power and Energy obtained by, on behalf of, or with the approval of LIPA, and will not use the T&D System for any purpose other than, the purposes contemplated by the Agreement or to serve or benefit any person other than LIPA and its customers in the Service Area.

*Operation and Maintenance.* The Agreement provides that the Manager will provide Operation and Maintenance Services and Construction Work for the T&D System on behalf of LIPA at all times in accordance with the Contract Standards. The scope of services to be provided by the Manager is subject to modification during the Term of the Agreement to reflect changes in Prevalent Utility Services. The Manager will be responsible for all electric transmission, distribution, and load serving activities the safe and reliable operation and maintenance of the T&D System, management and/or performance of construction of improvements thereto and delivery of Power and Energy to LIPA's customers and will be responsible for the following tasks and services, among others: (a) day-to-day operation and maintenance of the T&D System; (b) engineering activities; (c) asset management; (d) identification and assistance in the development and administration of third-party research and development; (e) contract administration of third party generation and transmission and interface with daily operation; (f) preparation of recommended and monitoring of the approved Capital Plan and Budget, load and energy forecasts and long and short range system and strategic plans; (g) preparation of long and short range transmission and distribution planning analyses and forecasts; (h) monitoring the regulatory environment for changes or trends that could impact LIPA and recommending appropriate courses of action; (i) performance of accounting and tax and payment in lieu of tax reporting functions; (j) representation of LIPA before, among others, NYISO, NY State Reliability Counsel and ISO-NE, if requested by LIPA; (k) administration and management, at the direction of LIPA, of LIPA's interest in NMP2; (l) billing and collection, in accordance with LIPA's direction, of all fees and charges in connection with the use or availability of the T&D System for wheeling services; (m) under LIPA's direction, assistance in the administration, development and/or implementation of energy conservation and load management programs for the T&D System and its customers; (n) performance of Capital Improvements including customer connections and disconnections and supervision; (o) repair or modification activities required due to Public Works Improvements; (p) reasonable cooperation with third parties providing services to LIPA with respect to the provision of electric service; (q) other activities necessary, appropriate or advisable to safely, reliably and efficiently operate and maintain the T&D System in accordance with the Contract Standards and Prevalent Utility Services.

The Manager will be responsible for implementation of customer service functions related to the provision of electric service, including, but not limited to, the following: (a) maintaining customer contact through call centers with toll free service numbers, customer offices, authorized payment centers, maintaining and overseeing customer portion of LIPA's Web Site, co-management of customer loyalty and satisfaction programs, customer services field operations, and customer care and institutional communications and responding to customer inquiries regarding LIPA provided services; (b) development and maintenance of all necessary information and accounting systems and controls relating to the provision and reporting of customer services, and updating customer records in the financial and customer information system; (c) marketing and sales for retail system expansion, retail customer retention, and customer care and service programs, including all aspects of marketing, promotion and communications; market research; account relationship management; economic development, field sales; trade ally relations; demand response programs; and participating in and

complying with LIPA's clean energy initiatives; (d) planning and managing the design of customer meter reading and billing systems, reading of customer meters, issuance of accurate and timely customer bills, and collection of customer payments and timely investigation of customer bill inquiries, all in accordance with the Contract Standards and unusual or unmetered usage, unbilled revenues and theft of services; (e) auditing, on a timely basis, of adjustments for billing errors, and seeking refunds and interest payments from customers; (f) collection of reliability, meter reading, call answering, collection and customer satisfaction performance data; (g) inclusion of communications to customers requested and approved by LIPA in customer bills; (h) identification, assistance in the development of, and administration of third party produced research and development to provide solutions to fulfill customer needs and expectations, renewable technologies and clean energy initiatives; and (i) other activities necessary, appropriate or advisable to implement LIPA's customer service programs in accordance with the Contract Standards and Prevalent Utility Services.

The Manager is responsible for (a) the preparation of recommended revenue requirements for the management of the T&D System; (b) the preparation of recommended rate classification and designs for the T&D System; (c) at LIPA's request, public presentation of recommended rate and capital expenditure adjustments at LIPA rate hearings; (d) cost of service and planning; (e) tariff development, administration, and enforcement; (f) regulatory monitoring; and (vii) load research and forecasting.

The Manager is responsible for the following other activities with respect to the provision of electric service to customers of the T&D System: (a) assisting LIPA in developing and maintaining System Policies and Procedures and training the Manager's work force in accordance therewith; (b) assigning and supervising the Manager's and its Subcontractor's work force consistent with the day-to-day requirements of the Agreement; (c) assigning and allocating physical resources consistent with the day-to-day operational requirements of the Agreement; (d) recruiting, retaining, deploying, and supervising subcontract labor and resources; (e) determining, acquiring, deploying, and maintaining tools, equipment, and information systems necessary to perform all activities under the Agreement; (f) preparing and delivering cost and budget input data for LIPA's annual budgeting processes; (g) accounting for and documenting the costs and revenues resulting from the Manager's performance under the Agreement in accordance with GAAP, GASB, FERC and /or NYSPSC requirements as necessary; (h) developing safety programs, safety reports, and written procedures and practices for the Manager's staff; (i) producing and delivering information as may be necessary to determine the Manager's performance under the Agreement; (j) contracting for and maintaining services, including utilities, communication systems, and internet and intranet services, necessary for the Manager's office facilities and to fulfill the Manager's obligations under the Agreement; (k) monitoring industry advancements and technological changes in the provision of transmission and distribution services by electric utilities and recommending improvements in current programs and practices for LIPA's consideration; (l) in accordance with current practices of the Manager, staffing public events and presenting workshops, seminars, and similar activities during normal business hours, evenings, weekends, and holidays, as may be required from time to time by LIPA; and (m) providing vehicle and refueling operations.

The Manager is responsible for developing and implementing business continuity, disaster recovery and emergency response plans, and all necessary emergency response and reporting relating to the T&D System, and coordinating such plans with LIPA's plans and the plans of LIPA's other service providers for business continuity and disaster recovery.

If requested by LIPA, the Manager will perform additional services reasonably related to the T&D System and not included within the Manager's scope of services based upon terms and conditions (including compensation) agreed to by the parties. The Manager's scope of services does

not include (a) operation, maintenance and repair of transmission or distribution facilities which are owned in whole or in part by third parties, other than certain specified cables or (b) operation, maintenance and repair of transmission or distribution facilities located outside of the Long Island Control Area owned by LIPA which are constructed or acquired after the date of delivery of the Agreement (the “Contract Date”).

*Maintenance and Repair of T&D System.* The Agreement provides that the Manager will maintain the T&D System, the T&D System Site and the Common Facilities in good working order and repair and in a neat and orderly condition, and will conduct periodic, corrective, and preventive maintenance and repair of the T&D System consistent with the Contract Standards for the purpose of, among other things, mitigating and preventing abnormal wear, tear and usage.

All additions to the T&D System purchased in conjunction or for the use with any part of the T&D System during the term of the Agreement shall be the property of LIPA, except those which are leased or constitute part of the Common Facilities.

*Performance Metrics.* The Agreement provides that the Manager will monitor and report to LIPA with respect to the Manager’s performance during each month under the following operational and customer service performance metrics: Actual Meter Read Rate, Billing Accuracy, Customer Satisfaction Index, Days Sales Outstanding, Bad Debt Ratio, Expanded Electronic Transactions, Call Answer Rate & Average Speed of Call Answer, First Call Resolution, Workplan Completion Index, Capital Cost Per Customer, Multiple Customer Outages, System Average Interruption Duration Index, System Average Interruption Frequency Index, Customer Average Interruption Duration Index, Storm Customer Average Interruption Duration Index, Worker Safety, Planned Substation Maintenance, and Primary Cable Faults, as set forth in Appendix 5 to the Agreement (the “Performance Metrics”). The Manager’s performance in meeting the Performance Metrics will determine the extent, if any, to which the Manager will be assessed performance penalties, which penalties shall in no event exceed either (i) Seven Million Dollars (\$7,000,000) in the aggregate during any one Contract Year for such Performance Metrics, or (ii) an amount which would result in the Manager receiving less than the Minimum Compensation amount for such Contract Year. The deviation from the agreed upon level of performance with respect to the metrics, and the associated penalty amount, are set forth in Appendix 5 to the Agreement.

*Rights and Responsibilities of LIPA.* The Agreement provides that LIPA will retain the ultimate authority and control over the assets and operations of the T&D System and the right, consistent with Applicable Law, Prudent Utility Practices, Prevalent Utility Services, subject to the Agreement, to direct the Manager, in connection with the performance of the Manager’s obligations under the Agreement. Without limiting the generality of the foregoing, LIPA’s specific rights and responsibilities with respect to the T&D System include: (a) the right to determine all T&D System rates and charges, line extension policies and service rules and regulations applicable to the T&D System and System Power Supply; (b) the right to determine and to change from time to time, in its sole discretion, all policies and procedures for the T&D System; (c) the right to review, amend as appropriate and approve the annual Capital Plan and Budget pursuant to the procedures outlined in the Agreement and approve or in its discretion, develop, all long-range strategic plans for the T&D System and System Power Supply; and (d) to the extent the Manager acts as the representative of LIPA in connection with the NERC, NPCC, the NYISO, the NYSPSC, the ISO-NE, PJM and any other similar institutions or organizations, the right to direct the Manager’s actions with respect thereto.

*Customer Services, Rates and Rules of Service.* The Agreement provides that the Manager will perform normal and customary customer services in a manner designed to achieve the highest level of

customer service, including, but not limited to: customer account service and maintenance; service restorations account inquiry work; customer assistance, credit and collection services; cashiering; account connection and disconnection; and conservation advice.

The Agreement provides that the Manager will, unless otherwise directed, by LIPA, read the meters of electric commercial, “industrial”, residential heating and residential multiple rate period customers on a monthly basis and all other electric customer meters on a bi-monthly basis. The Manager will, according to the schedule of rates, tariffs and policies (the “Schedule of Rates”) then in effect, render bills to all T&D System customers in the name of LIPA for electric service delivered on behalf of LIPA and in the formal determined by LIPA. To the extent directed by LIPA, such bills will also reflect electric services provided to T&D System customers by other parties. LIPA may implement changes to such rates, rules of service, regulations and procedures by giving written notice to the Manager not later than sixty (60) days prior to the effective date of such change to the extent practicable given the nature of the change. The Manager will maintain customer bills and records as LIPA reasonably requests.

The Manager will use best efforts to collect on a timely basis (1) all amounts due LIPA for service provided to customers, and for other services; in accordance with the Schedule of Rates for the periods in which services were provided, and (2) other monies owed to LIPA pursuant to the operation of the T&D System. The Manager’s responsibilities will also include the institution of legal proceedings in LIPA’s name to collect utility, billings and other monies owed LIPA related to the T&D System. All monies collected by the Manager or its Subcontractors will be the property of LIPA and will be deposited by the Manager daily in an account or LIPA specified pursuant to the Agreement. In collecting such monies, the Manager and any Subcontractor will act solely as an agent for LIPA and will have no right or Claim to such moneys and, without limiting the generality of the foregoing, will have no right to assert a claim of set-off, recoupment, abatement, counterclaim or deduction for any amounts which may be owed to the Manager under the Agreement or with respect to any other matter in dispute thereunder.

To the extent moneys are collected for any power supply services provided by any unrelated party, amounts collected will be allocated in accordance with the directions of LIPA.

*Licenses, Permits and Approvals.* The Manager will identify for LIPA, prepare, and with LIPA approval, make and prosecute all filings, applications and reports necessary to obtain and maintain all permits, licenses and approvals required to be made, obtained or maintained by each under Applicable Law in order to operate the T&D System.

*Operating Period Insurance.* During the term of the Agreement, the Manager will obtain and maintain the Required Operating Period Insurance to the extent that such insurance remains available on commercially reasonable terms. If, as a result of material changes in the market for insurance products, one or more Required Operating Period Insurance policies is or are not generally available or available only on terms not considered to be commercially reasonable, the Manager will so notify LIPA. If such insurance is not generally available, LIPA will be entitled to an equitable adjustment in the Minimum Compensation for the Scope of Services. If such insurance is available, but only at a cost that Manager considers to be commercially unreasonable, Manager will advise LIPA of such cost. If, after consultation, the parties are unable to agree on whether the Manager should procure such insurance at such additional cost, LIPA may either obtain such insurance at its own cost or determine to forego such insurance coverage. In either event, LIPA will be entitled to an equitable reduction in the Minimum Compensation for the Scope of Services. LIPA has the right, upon ninety days’ notice to the Manager, at any time at its expense to cancel or replace and obtain independently all or any portion of the Required Operating Period Insurance, in which case LIPA will be entitled to

an equitable reduction in the Base Fee for the Scope of Services. If the Manager obtains additional insurance not set forth on Appendix 4 at LIPA's request, LIPA will reimburse the Manager for the costs thereof as an Additional Service.

### **Manager's Reporting Requirements**

*Monthly Reports.* The Manager will provide LIPA and the Consulting Engineer with monthly reports no later than 15 Business Days after the end of each month (except for (i) item (1) below, which will be provided no later than 20 Business Days after the end of each month, provided that Manager agrees, not later than 6 months after the Contract Date, it will examine its reporting practices with an objective of accelerating the reporting of item (1) below so it can be provided no later than 15 Business Days after the end of each month, and (ii) item (3) below, which will be provided no later than 30 Business Days after the end of each month), including the following data: (1) on a monthly and year-to-date basis, the actual Capital Costs, pensions and OPEBs, and Storm Events (collectively, "Reported Costs") versus the budget for Reported Costs, with variance explanations, and the prior year's Reported Costs at such time; (2) a capital budget adjustment report; (3) a System Operating Report substantially in the form provided by the Manager as of the Contract Date, together with a report of the Manager's performance with respect to the Performance Metrics; (4) a reasonably detailed list of the results of any environmental or other tests or monitoring procedure conducted by or at the direction of any federal, State or local environmental or other regulatory agency during the prior monthly period, and at LIPA's request copies thereof and copies of any reports or other submittals made to or received from any such agency (it being understood that LIPA will in any event have complete access to the foregoing); (5) a description of partial or total shutdowns for maintenance and repairs during the prior month and anticipated during the current month, any known or anticipated adverse conditions which may be expected to arise during the next 30 day period that may affect the ability of the Manager to transmit and distribute Power and Energy, the results of any regulatory or insurance inspections or tests conducted during the prior month, and identification of those costs which are classified as Capital Costs versus operating in sufficient detail in order to allow LIPA to determine which costs qualify for bonding under the Bond Resolution and which are to be recovered through T&D System rates; and (6) any other documents, reports, data, and other information or statement which LIPA may reasonably request (as to time and format) and which may be reasonably produced from records maintained by the Manager hereunder or pursuant to the Original MSA in the normal course of business consistent with the provisions of the Agreement with respect to record retention.

The Manager will provide LIPA on a monthly basis updated year-end projections of Pass-Through Expenditures beginning in April of each Contract Year.

*Semi-Annual Reports.* The Manager will, on a semi-annual basis within 60 days after the end of each half of the Contract Year, provide LIPA and the Consulting Engineer with a report of actual Direct Costs and Third Party. Costs together with identification of any material Direct Costs projects or Third Party Costs projects which were included in the Direct Cost Budget or the Third Party Cost Budget from the previous Contract Year which were deferred to the current Contract Year or proposed to be deferred to a subsequent Contract Year, or such costs in the current Contract Year which the Manager proposes deferring beyond the current Contract Year.

*Other Costs Reports.* The Manager will promptly notify LIPA when an event occurs, or is anticipated to occur, that the Manager believes qualifies for treatment as an Other Cost.

*Annual Reports.* The Manager will furnish LIPA and the Consulting Engineer with an annual settlement reconciling actual costs for Reported Costs and the budget for Reported Costs (the "Annual Settlement Statement for Reported Costs"), certified by the Manager and the Guarantor's

internal auditor and chief financial officer. The Manager will continue to have its independent auditors certify the Manager's internal controls in accordance with Section 404 of the Sarbanes-Oxley Act.

*Books and Records.* The Manager will prepare and maintain and make available to LIPA upon its reasonable (as to time and format) request, distinct, proper, accurate and complete books, records, and accounts regarding the operations and financial or other transactions related to the T&D System to the extent necessary: (1) to enable LIPA to prepare financial statements, regarding the operations of the T&D System, certified in accordance with GAAP and GASB, (2) to verify data with respect to any operations or transactions in which LIPA has a financial or other material interest hereunder, (3) to prepare periodic performance reports and statements of the T&D System, which will be submitted by the Manager to LIPA, and (4) as may be required by Applicable Law or applicable regulatory authority.

*Additional Reports.* The Manager will provide LIPA with access to reports currently used by the Manager in daily operation of the T&D System. In addition, the Manager and LIPA will develop the scope for the operations management dashboard, consistent with the budget determined by the IT Steering Committee, not later than March 31, 2006 and the Manager will implement such operations management dashboard not later than December 31, 2006. The Manager and LIPA will also develop the scope for the financial data mart and operations data mart, consistent with the budget determined by the IT Steering Committee, not later than March 31, 2006 and the Manager will implement such financial data mart and operations data mart not later than December 31, 2006.

*Fiscal Affairs, Accounting and Record Keeping.* The Manager will maintain possession of operating equipment, buildings, materials and supplies, maps, plans, specifications, and customer billing records during the term of the Agreement in accordance with the Manager's customary practices or in such manner as LIPA may reasonably require. The Manager also will maintain LIPA's fixed asset books and records for those activities performed by the Manager in general conformity with municipal electric utility accounting standards or such other standards as reasonably requested by LIPA.

All cash held by the Manager for the account of LIPA and all cash collected by the Manager for the account of LIPA will be deposited on each business day in bank accounts in such bank as LIPA may direct and upon such terms and conditions as may be specified by LIPA.

*Purchase of Equipment, Materials and Services.* The Agreement provides that the Manager will arrange for the purchase or rental for the account of LIPA of equipment, materials, and supplies and services which are not purchased directly by LIPA or other items necessary to properly operate and maintain the T&D System and to maintain the records of LIPA, and to make such additions and extensions to the T&D System, all as may be required by LIPA. Subcontractors will be subject to approval by LIPA in accordance with the Agreement.

*Other Services.* The Manager will timely pay all bills related to the T&D System which are proper, appropriate and not otherwise disputed and which it has authority to pay and will assure that, to the extent within the Manager's control, no mechanic's or similar liens are filed against any portion of the T&D System.

## **Capital Improvements**

*Capital Improvements Generally.* From time to time it will be necessary to make repairs and replacements to the T&D System which do not constitute routine maintenance and it will be

necessary or desirable from time to time during the term of the Agreement to modify, alter or improve the T&D System from its then current condition. All such projects which constitute Capital Improvements will be made in accordance with the Agreement and will be owned by LIPA. The Manager will not make a Capital Improvement without notifying LIPA and receiving written consent from LIPA unless such Capital Improvement is included in the then current annual Capital Plan and Budget. LIPA will have the right, when the Manager has materially exceeded the Capital Plan and Budget as of an interim date, to require the Manager to defer specific Capital Improvements planned for the remainder of the year.

*Capital Plan and Budget.* The Manager is obligated to prepare a proposed annual, two and five year Capital Plan and Budget concerning planned Capital Improvement projects.

The annual Capital Plan and Budget will be approved by LIPA prior to or contemporaneously with the adoption of any rate adjustment by LIPA, provided that in the event the Capital Plan and Budget has not been adopted by LIPA as of the beginning of a Contract Year, the Manager may undertake such Capital Improvements as reasonably approved by LIPA on a project-by-project basis.

*Cost Determination.* Capital Improvements will be performed at the cost of the service without any multiplier fee or mark-up. With respect to any Capital Improvement estimated to cost in excess of \$2,000,000, after conferring with the Manager, LIPA, at its sole discretion, may (a) conduct an independent procurement, (b) direct the Manager to competitively bid the Capital Improvement, or (c) direct the Manager to complete the work. In that regard, LIPA will give due consideration to the efficient utilization of the Manager's workforce.

*Capital Improvements for which Manager is Responsible.* If the T&D System is damaged or destroyed by reason of circumstances for which the Manager is responsible, described below under the heading "Allocation of Risks of Certain Costs and Liabilities", the Manager will promptly proceed to make or cause to be made all Capital Improvements reasonably necessary to permit the Manager to perform its obligations under the Agreement. All such Capital Improvements for which the Manager is responsible as described under the heading "Allocation of Risks of Certain Costs and Liabilities" will be made at the Manager's sole cost and expense, and the Manager will not be entitled to any compensation from LIPA as a result thereof.

## **Compensation and Budgets**

*Manager Compensation.* Commencing with the Initial Contract Year and for each Contract Year during the term of the Agreement, LIPA will pay the Manager a fee for the Scope of Services provided by the Manager under the terms of the Agreement in an amount equal to the lesser of (i) the Minimum Compensation plus the Variable Compensation and (ii) the Minimum Compensation divided by 80%.

"Minimum Compensation" is equal to Two Hundred Twenty Four Million Dollars (\$224,000,000.00) for the first three Contract Years. For each subsequent Contract Year, Minimum Compensation will be equal to the prior Contract Year Minimum Compensation multiplied by 1.017, multiplied by the change in the Consumer Price Index (all Urban Consumers) for the New York-Northern New Jersey-Long Island region (Series ID #CUURA101SA0) as published by the United States Department of Labor Bureau of Labor Statistics ("New York Region CPI") for the twelve month period ending September 30th of the prior Contract Year.

“Variable Compensation” is equal to the total kilowatt hours of LIPA’s billed sales for the Contract Year less “Base Kilowatt Hours,” multiplied by the “Variable Price Per KWh” for the Contract Year.

“Base Kilowatt Hours” is equal to 16,558,000,000 kilowatt hours for the Initial Contract Year. For each subsequent Contract Year, Base Kilowatt Hours will be set at the prior Contract Year’s Base Kilowatt Hours multiplied by 1.017.

“Variable Price Per KWh” is equal to 1.3377 cents per kilowatt hour (\$0.013377/KWh) for the Initial Contract Year. For the second Contract Year, the Variable Price Per KWh will be equal to 1.2870 cents per kilowatt hour (\$0.012870/KWh) multiplied by the change in the New York Region CPI for the twelve month period ending September 30, 2006 as compared to September 30, 2005. For the third Contract Year, the Variable Price Per KWh will be equal to 1.2363 cents per kilowatt hour (\$0.012363/KWh) multiplied by the change in the New York Region CPI for the twelve month period ended September 30, 2006 multiplied by the change in the New York Region CPI for the twelve month period ended September 30, 2007. For each subsequent Contract Year, the Variable Price Per KWh will be set at the Variable Price Per KWh for the prior Contract Year multiplied by the change in the New York Region CPI for the twelve month period ended on September 30th of the prior Contract Year.

*Payment Schedule.* LIPA will pay to the Manager the Minimum Compensation in monthly installments based on LIPA’s forecasted sales pattern as set forth below:

January	8.4%
February	7.4%
March	7.9%
April	7.0%
May	7.6%
June	9.0%
July	10.5%
August	10.4%
September	8.5%
October	7.7%
November	7.4%
December	8.2%

*Pass-Through Expenditures.* The Agreement provides that LIPA will reimburse the Manager for all Pass-Through Expenditures in the manner set forth therein. “Pass-Through Expenditures” are those expenditures incurred by the Manager with respect to the following items: (1) Capital Costs; (2) claims, lawsuits, litigations, losses, costs and expenses, judgments, liens, settlement, disbursements and similar expense (including, without limitation, external attorney’s fees) (collectively, “Claims”), incurred in connection with each such Claim or related Claims which exceeds \$25,000 in the aggregate; (3) Storm Events; (4) LIPA’s return postage; (5) real property taxes, special franchise taxes, other taxes and any payments in lieu of taxes (PILOTS) related to LIPA-owned assets or revenues (collectively, “Taxes”); (6) customer refunds; (7) completion of repairs and remediation related to E.F. Barrett to Valley Stream 138kV cable leak (circuit no 138-291) identified in the fall of 2005; (8) incremental substation maintenance for Contract Year 2006, in an amount up to \$2,000,000; (9) third party conservation and third party research and development costs; (10) repair costs for any damage to the submerged portion of any marine cable; and (11) increases in the annual cost of Long Island Railroad easements above \$1,265,000 (which amount will be escalated annually by 1.017



multiplied by the change in the New York Region CPI for the twelve month period ending September 30th of the prior Contract Year).

*Exogenous Cost Adjustments.* The Agreement provides that LIPA will reimburse the Manager. The Manager is required to credit to LIPA's account any Exogenous Costs which the Manager incurs during a Contract Year to the extent that the Manager incurs net Exogenous Costs for that Contract Year in excess of \$3,000,000 in the aggregate. "Exogenous Costs" are those costs which result in either a positive or negative change in the Manager's costs of providing services hereunder within the Scope of Services which are (i) outside of the Manager's control and (ii) not otherwise reflected in the New York Region CPI, and which directly result from one or more of the following: (1) Change in Law (including tax law, except with respect to the Manager's income tax), regulation or GAAP, but only if and to the extent that such changes are applicable to electric utilities operating in New York State, (2) change in the New York Public Service Law or NYSPSC regulation, but only if and to the extent that such change relates to the safety and reliability of the operation of the T&D System and are adopted as part of the System Policies and Procedures and (3) acts of terrorism.

*Storm Costs.* LIPA will reimburse the Manager, as a Pass-Through Expenditure, for costs incurred by the Manager in connection with a Storm Event. Such costs will be charged against the Storm Reserve which LIPA will establish and replenish from time to time in the amounts and in the manner set forth in the Agreement.

*Mutual Aid Costs.* The Manager must obtain authorization from LIPA prior to the release of any internal or third-party crews to assist a utility either within or outside New York State for storm recovery ("Mutual Aid"). The Manager will track all costs related to such Mutual Aid on a segregated basis and will prepare the documentation necessary for cost reimbursement by LIPA. Any and all reimbursement which the Manager receives from the Mutual Aid recipient or third party for such Mutual Aid assistance will accrue to LIPA's account.

*LIPA Non-Performance.* If due to the occurrence of an event for which LIPA is responsible for as discussed below under the heading "Allocation of Risk of Certain Costs and Liabilities," there will be an increase in the Manager's cost of Construction Work or Operation and Maintenance Services, the amount of any such incremental cost increase will be borne by LIPA to the extent it is responsible therefor.

If at any time the T&D System is damaged or destroyed due to an event for which LIPA is responsible, LIPA will pay all Capital Improvement Costs and adjustments as are required to be made by LIPA pursuant to applicable provisions of the Agreement.

*Manager Non-Performance.* If due to an event for which the Manager is responsible as discussed below under the heading "Allocation of Risk of Certain Costs and Liabilities;" there will be an increase in the Manager's cost of Construction Work or Operation and Maintenance Services, or in LIPA's costs associated with performing obligations under the Agreement, the amount of any such incremental cost increase will be borne by the Manager to the extent it is responsible therefor.

*LIPA's Payment Obligations.* The Agreement provides that amounts payable to the Manager under the Agreement will be paid from T&D System revenues and other funds of LIPA available for such purposes in accordance with the terms of the Resolution.

The Agreement contemplates that if any billing disputes cannot be resolved within 30 days, either party may refer such dispute for resolution as discussed below under the heading "Non-Binding Mediation; Arbitration."

*Allocation of Risks of Certain Costs and Liabilities.* The Agreement provides that except to the extent due to Subsidiary Fault (as determined by either a final non-appealable order or judgment of a court of competent jurisdiction (including administrative tribunals) or a final non-appealable binding arbitration decision), the Manager will be responsible and liable to LIPA for, and will not be entitled to reimbursement from LIPA for any Loss-and-Expense incurred by the Manager or LIPA,

1. due to any gross negligence or willful misconduct by the Manager during the term of the Agreement in carrying out its obligations thereunder,

2. due to any violation of or failure of compliance with Applicable Law by the Manager (except as provided below) which materially and adversely affects

a. the condition or operations of the T&D System,

b. the financial condition of LIPA,

c. the performance or ability of the Manager to perform its obligations under the Agreement, or

d. the cost of providing electric service to the customers of the T&D System, provided, however, that Manager will not be responsible and liable to LIPA under the provisions of the Agreement described in this clause (b) with respect to any violation of, failure of compliance with, or liability under, Environmental Laws (as defined in the LIPA/LILCO Merger Agreement) for which LIPA or the Manager may be strictly liable provided that Manager acted in a manner consistent with Prudent Utility Practice. Notwithstanding the foregoing, Manager will in all events be liable for any fine or penalty arising by reason of any violation of or failure of compliance with Applicable Law for acts or omissions of the Manager not consistent with Prudent Utility Practice,

3. due to any criminal violation of Applicable Law by the Manager,

4. due to an event which gives rise to a cost incurred with respect to Capital Improvements that is incurred by reason of actions or omissions of the Manager not consistent with Prudent Utility Practice, or

5. due to any claim that (a) the Manager's use of any Manager Owned Property or Manager Licensed IP in connection with the performance of its services under the Agreement or (b) LIPA's use of any Manager Owned Property, Manager Licensed IP, or LIPA Owned Property created or developed by the Manager or Manager's Related Parties and not provided by or on behalf of LIPA or LIPA's Related Parties, in each case in accordance with the Agreement, infringes or otherwise violates Intellectual Property Rights or other proprietary rights of any third party.

#### *Default, Termination For Cause And Dispute Resolution*

*Remedies for Breach.* Subject to the provisions of the Agreement described below under the heading "Non-Binding Mediation; Arbitration," in the event that either party breaches any other obligation under the Agreement or any representation made by either party under the Agreement is untrue in any material respect, the other party will have the right to take any action at law or in equity it may have to enforce the payment of any damages or the performance of such other obligation under

the Agreement and such right to recover damages or to be reimbursed as provided therein will ordinarily constitute an adequate remedy for any breach of such other obligation or any material untruth in any such representation. Either party may enforce by an action for specific performance the other party's obligations under the Agreement in the event a material breach thereof has occurred and is continuing. Neither party will have the right to terminate the Agreement for cause except after an Event of Default determined in accordance with the provisions of the Agreement has occurred.

*Events of Default by the Manager*

1. *Events of Default Not Requiring Cure Opportunity for Termination.* Each of the following will constitute an Event of Default on the part of the Manager for which LIPA may terminate the Agreement without any requirement of cure opportunity:

a. *Change of Control.* Change of Control of the Manager or the Guarantor.

b. *Bankruptcy.* Certain voluntary or involuntary events relating to bankruptcy affecting the Manager or the Guarantor.

c. *Credit Enhancement.* Failure of the Manager to supply, maintain, renew, extend or replace the credit enhancement required under the Agreement (see "General—Credit Enhancement in Certain Circumstances" below).

d. *Letter of Credit Draw.* Failure of the Manager to supplement, replace or cause to be reinstated the letter of credit as described in the Agreement (see "General—Credit Enhancement in Certain Circumstances" below) within 30 days following draws equal to, in the aggregate, 50% of the face value thereof.

e. *Performance Metrics.* Failure of the Manager to meet the minimum Performance Metrics for either (i) customer satisfaction for three (3) consecutive Contract Years, or (ii) SAIDI for two (2) out of three (3) consecutive Contract Years; provided, however, that such Event of Default by the Manager will be excused to the extent of a Force Majeure event, strike, work stoppage or other labor dispute with respect to the Manager's work force that prevents or delays the Manager's performance of such metric.

2. *Events of Default Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of the Manager for which LIPA may terminate the Agreement upon compliance with the notice and cure provisions set forth below:

a. *Failure to Pay or Credit.* Failure of the Manager to pay or credit undisputed amounts owed to LIPA under the Agreement within 90 days following the applicable due date.

b. *Failure to Comply with Agreement or Guaranty.* The failure or refusal of the Manager to perform any material obligation under the Agreement, or the failure of the Guarantor to comply with any of its material obligations under the Guaranty unless such failure or refusal is excused by a Force Majeure or LIPA Fault; except that no such failure or refusal in clause (a) or (b) will constitute, an Event of Default giving LIPA the right to terminate the Agreement for cause unless LIPA has given prior written notice to the Manager or the Guarantor and the Manager or the Guarantor, as applicable, has neither challenged in an appropriate forum LIPA's

conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from receipt of the notice (but if the Manager or the Guarantor shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as the Manager or the Guarantor cures such default within 270 days from its receipt of such notice).

*Events of Default by LIPA.* Each of the following shall constitute an Event of Default on the part of LIPA for which the Manager may terminate the Agreement upon compliance with the notice and cure provisions set forth below:

1. *Failure to Pay.* The failure of LIPA to pay undisputed amounts owed to the Manager under the Agreement within 90 days following the due date for such payment.

2. *Failure to Comply with Agreement.* The failure or refusal by LIPA to perform any material obligation under the Agreement unless such failure or refusal is excused by a Force Majeure or Manager Fault; except that no such failure or refusal will constitute an Event of Default giving the Manager the right to terminate the Agreement for cause unless the Manager has given prior written notice to LIPA and LIPA has neither challenged in an appropriate forum the Manager's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from the date of the notice (but if LIPA shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as LIPA corrects such default within 270 days from its receipt of such notice).

3. *Change of Control.* A change of control of LIPA or the Authority which results in ownership control of LIPA or the Authority by other than a state public benefit corporation, authority, political subdivision or other instrumentality of the State or any political subdivision thereof.

*Procedure for Termination for Cause.* If any party has a right of termination for cause, the right may be exercised by giving a notice of termination for cause to the party in default at least two years prior to (or, in the case of a bankruptcy or insolvency default, a Change of Control or an Event of Default specified in clause (e) above under the heading "Events of Default Not Requiring Cure Opportunity for Termination," simultaneously with, or, in the case of an Event of Default as discussed in clause (c) and (d) above under the heading "Events of Default Not Requiring Cure Opportunity for Termination," six months) the date of termination specified in such notice (the "Termination Date").

#### *Non-Binding Mediation; Arbitration*

The Agreement provides that any dispute arising out of or relating to the Agreement will be resolved in accordance with the negotiation, mediation and arbitration procedures for the resolution of such disputes established by the Agreement, which shall constitute the sole and exclusive procedures for the resolution of such disputes.

#### *Provisional Relief*

Either party may, without prejudice to any negotiation, mediation, or arbitration procedures, proceed in the NY State Supreme Court, Nassau County, to obtain provisional judicial relief if, in such party's sole discretion, such action is necessary to avoid imminent irreparable harm, to provide

uninterrupted electrical and other services, or to preserve the status quo pending the conclusion of such negotiation, mediation or arbitration.

*LIPA Emergency Powers.* The Agreement provides that if the Manager, due to a Force Majeure event or any other reason whatsoever, fails to provide any Operation and Maintenance Services and Construction Work contemplated by the Agreement and LIPA or any Governmental Body finds that such failure endangers or menaces the public health, safety or welfare, then LIPA will have the right, upon notice to the Manager, during the period of such emergency, to take possession of and use any or all of the Operating Assets necessary to transmit and distribute Power and Energy which the Manager would otherwise be obligated to transmit and distribute. The Manager will fully cooperate with LIPA to effect such a temporary transfer of possession of the Operating Assets for LIPA's use of the same.

## **Term**

*Term of Agreement.* The Agreement will continue in effect until December 31, 2013, unless earlier terminated in accordance with its terms.

*Selection of Future Managers.* LIPA may conduct a procurement for T&D System management services to be provided following the expiration or earlier termination of the Agreement. The Manager will have the right or be ineligible to submit a bid in such procurement on the same basis as other bidders unless the Agreement is terminated due to an Event of Default of the Manager. The Manager is obligated to cooperate with LIPA during such procurement process.

## **Miscellaneous Provisions**

*Affiliate.* Pursuant to the Agreement, the Manager has agreed to remain an Affiliate of the Guarantor.

*Credit Enhancement in Certain Circumstances.* The Agreement provides that if the Guarantor's credit rating declines below investment grade, then the Manager will provide credit enhancement of its obligations under the Agreement in the form of either (i) an unconditional guarantee of all of GENCO's obligations under the Power Supply Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, provided by a corporation or financial institution whose long-term senior debt is or would be rated investment grade, or (ii) an irrevocable letter of credit securing GENCO's obligations under the Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, in a face amount of \$60,000,000 provided by a financial institution whose long-term senior debt is rated investment grade. The amount of such letter of credit will be reduced by \$30,000,000 if the Energy Management Agreement has theretofore been or is thereafter terminated and by \$4,000,000 if the Power Supply Agreement has theretofore been or is thereafter terminated, such obligation to continue until the expiration or termination of the Agreement, the Power Supply Agreement and the Energy Management Agreement.

*Force Majeure Generally.* Except as otherwise specifically provided in the Agreement, neither LIPA nor the Manager will be liable to the other for any failure or delay in performance of any obligation under the Agreement, including any obligations with respect to the Performance Metrics, to the extent due to the occurrence of a Force Majeure event.

*Indemnification.* The Agreement provides that the Manager, to the extent permitted by law, will protect, indemnify and hold harmless LIPA and its respective representatives, trustees, directors, officers, employees and subcontractors (as applicable in the circumstances) (the “LIPA Indemnified Parties”) from and against (and pay the full amount of) any Loss-and-Expense and will defend LIPA Indemnified Parties in any suit, including appeals, for personal injury to, or death of, any person; or loss or damage to property arising out of any matter for which the Manager is responsible under the caption “Allocation of Risk of Certain Costs and Liabilities” in the Agreement and LIPA, to the extent permitted by law, will protect, indemnify and hold harmless the Manager Indemnified Parties from and against (and pay the full amount of) any Loss-and-Expense, and will defend the Manager Indemnified Parties in any suit, including appeals, for personal injury to, or death of, any person, or loss or damage to property arising out of (i) any matter for which LIPA is responsible under the caption “Allocation of Risk of Certain Costs and Liabilities” in the Agreement and (ii) any claim that (a) LIPA’s use of any LIPA Owned Property or any LIPA Licensed IP, (b) the Manager’s use of any LIPA Owned Property provided by or on behalf of LIPA or LIPA’s Related Parties or LIPA Licensed IP in accordance with the Agreement, or (c) the Manager’s use of the LIPA Marks in accordance with the Agreement, infringes or otherwise violates Intellectual Property Rights or other proprietary rights of any third party. The foregoing indemnifications are subject to certain exceptions, including the negligence or other wrongful conduct of any indemnified party and any Force Majeure event.

*Assignment and Transfer.*

*General.* The Agreement may be assigned by either party only with the prior written consent of the other party, except that without the consent of the other party (1) LIPA may make such assignments, create such security interests in its rights thereunder and pledge such monies receivable thereunder as may be required in connection with issuance of Revenue Bonds; (2) LIPA may assign its rights, obligations and interests thereunder, or transfer such rights and obligations by operation of law, to any other governmental entity or to a subsidiary of LIPA provided that the successor entity gives reasonable assurances to the Manager that it will be able to fulfill LIPA’s obligations thereunder; and (3) the Manager may assign its rights, obligations and interests thereunder to the Parent or any Affiliate thereof except that the Manager may not, without the consent of LIPA, make any assignment or other transfer to any person of its rights and obligations under the Agreement unless the Guaranty is and remains in full force and effect and unless the Guarantor or a majority-owned direct or indirect subsidiary of the Guarantor will have control of and responsibility for the Operation and Maintenance Services and any Construction Work.

*T&D System Sale or Transfer.* During the Term of the Agreement, LIPA may, without the Manager’s consent, sell, assign or transfer in whole or in part the T&D System to a federal, state or municipal governmental entity; provided, however, that any such sale, assignment or transfer shall be subject to the Manager’s rights under the Agreement. LIPA may, during the Term of the Agreement, also sell, assign or transfer the T&D System to a private entity, in which event LIPA will have the right to terminate (upon not less than 6 months prior written notice to the Manager) the Agreement effective upon the closing of such sale, assignment or transfer (the “Early Termination Date”); provided, however, that on the Early Termination Date, LIPA pays to the Manager (1) a termination fee of (x) \$28,000,000 if the Early Termination Date occurs on or before December 31, 2009, and (y) \$20,000,000 if the Early Termination Date occurs after December 31, 2009, and (2) the Manager’s reasonable and actual transition costs related to activities directed by LIPA or the new T&D System owner. In addition, with respect to contracts in the Manager’s name with a term extending for 3 years or more beyond the Early Termination Date that are not assigned (without material cost) to LIPA or the new T&D System owner, on the Early Termination Date LIPA will pay to the Manager its actual and reasonable cost to terminate such contracts up to \$2,000,000 in the aggregate.

## Appendix C

### SUMMARY OF CERTAIN PROVISIONS OF THE POWER SUPPLY AGREEMENT

The following is a brief summary of certain provisions of the Power Supply Agreement. The summary does not purport to be complete or definitive and is qualified in its entirety by reference to the Power Supply Agreement, a copy of which is on file with the Trustee.

#### General

The Power Supply Agreement sets forth the terms and conditions for the sale and delivery of electric capacity and energy by BL Holding Corp. and its subsidiaries (“GENCO”) to LIPA.

#### Power Supply

*Delivery of Power.* The Agreement provides that during the term of the Agreement GENCO shall sell and deliver to LIPA, and LIPA shall purchase and accept delivery from GENCO of, (i) all the capacity from the GENCO Generating Facilities, and (ii) all the energy that GENCO produces from the GENCO Generating Facilities, in accordance with the Agreement, that LIPA requests to meet the electricity requirements of its retail and wholesale electricity customers (regardless of whether located inside or outside the Service Area). The Agreement also provides that GENCO will provide the various Ancillary Services as required by LIPA, and LIPA shall pay for any associated costs not otherwise compensated by LIPA.

*Sale or Assignment of Generating Units.* The Agreement provides that GENCO shall not sell or otherwise assign any interest in any of its generating units (as set forth in an appendix to the Agreement) except for (i) liens securing bona fide debt or other encumbrances incurred in the ordinary course of business, (ii) capital leases, or (iii) sales or assignments made with LIPA’s prior written consent, which consent shall be deemed to have been given in respect of certain easements specified in the Agreement.

*Transmission Requirements.* The Agreement provides that LIPA is responsible for all transmission reinforcements required in conformance with Prudent Utility Practice for any new generation, including any new interconnections and other T&D System requirements regardless of their location, sufficient to maintain the delivery of electricity from the GENCO Generating Facilities onto the T&D System. The additional costs charged to GENCO for such transmission reinforcements will not be greater than if such costs were allocated to all of the LIPA Electricity Customers and transmission service customers on an average system basis.

#### Purchase Price and Payment

The Agreement provides that during the term of the Agreement LIPA will pay to GENCO monthly an amount equal to the aggregate of the following components:

- (i) a capacity charge to compensate GENCO for its fixed costs of generating electricity from the GENCO Generating Facilities,
- (ii) a variable charge based on the variable operation and maintenance costs as established by the Agreement, multiplied by the actual megawatt-hour (“MWh”) of operation of the GENCO Generating Facilities,
- (iii) a charge for any costs incurred by GENCO in providing certain Ancillary Services to LIPA, if any such services are required by LIPA which are not otherwise compensated by the charges described in items (i) and (ii) above,
- (iv) a charge for non-variable related expenses net of insurance proceeds, that cannot be planned for with any certainty and are outside the control of GENCO, and

(v) certain other miscellaneous charges as specified in the Agreement.

## **Budgets**

Pursuant to the Agreement, GENCO and LIPA have agreed to an initial five-year plan which provides details on the fixed and variable costs of operating the GENCO Generating Facilities. The budget establishes the monthly capacity charge and the monthly variable charge for the first year of the five-year period, which forms the basis for adjustment for subsequent years in such period in accordance with the terms of the Agreement.

The Agreement provides that prior to the commencement of each successive five-year period during the term of the Agreement, GENCO shall prepare and submit to LIPA for review and approval a proposed five-year budget plan. If GENCO and LIPA are unable to reach agreement concerning the budget plan, those portions that are in dispute shall be resolved in a proceeding before the FERC.

The Agreement also provides that GENCO shall annually prepare and submit to LIPA a rolling Five Year Capital Improvement Budget for incremental capital expenditures and associated rate adjustments for LIPA's review and approval.

## **Capacity Ramp Down Option**

The Agreement provides that, commencing in the seventh year of the Agreement, LIPA may determine to reduce the amount of capacity purchased from GENCO. In any such an event, LIPA shall immediately reimburse GENCO for the capacity charges in the amount set forth in the Agreement that would have been recovered from LIPA over the remaining portion of the original term of the Agreement. The Agreement provides that such reduction may not be greater than 1500 MW.

## **Term and Termination**

*Term.* The Agreement commenced on May 28, 1998 for an initial term of fifteen (15) years. The Agreement provides that it shall terminate upon the purchase of the GENCO Generating Facilities by LIPA as provided for under the Generation Purchase Right Agreement attached to the LIPA/LILCO Merger Agreement.

*Termination for Cause by GENCO.* The Agreement provides that GENCO shall have the right to terminate the Agreement for cause if one of the following events shall have occurred:

(1) *Failure to Pay.* The failure of LIPA to pay undisputed amounts owed to GENCO under the Agreement within 90 days of such amounts having become due.

(2) *Failure to Comply with Agreement.* The failure or refusal by LIPA substantially to perform any material obligation under the Agreement unless such failure or refusal is excused by force majeure (as defined in the Agreement), except that the Agreement further provides that no such failure or refusal to pay or perform as referenced in these clauses (1) and (2) shall constitute an Event of Default giving GENCO the right to terminate the Agreement for cause unless GENCO has given prior written notice to LIPA stating that a specified failure or refusal to perform exists and LIPA has neither challenged in an appropriate forum GENCO's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from the date of the notice (but if LIPA shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as LIPA is continuing to take such steps to correct such default).



*Termination For Cause by LIPA.* The Agreement provides that LIPA shall have the right to terminate the Agreement for cause after one of the following Events of Default as determined in accordance with the provisions of the Agreement shall have occurred:

(1) *Events of Default Not Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of GENCO for which LIPA may terminate the Agreement without any requirement of cure opportunity:

(a) *Change of Control of GENCO.* Change of Control of GENCO or the Guarantor has occurred; provided, however, that the combination effectuated under the LIPA/LILCO Merger Agreement shall not constitute a Change of Control of GENCO for purposes of this provision.

(b) *Bankruptcy.* Certain voluntary or involuntary events relating to bankruptcy affecting GENCO or the Guarantor.

(c) *Credit Enhancement.* Failure of GENCO to supply, maintain, renew, extend or replace the credit enhancement required under the Agreement (see below, "Credit Enhancement in Certain Circumstances" below).

(d) *Letter of Credit Draw.* Failure of GENCO to supplement, replace or cause to be reinstated the letter of credit as described in the Agreement (see "Credit Enhancement in Certain Circumstances" below) within 30 days following draws equal to, in the aggregate, 50% of the face value thereof.

(2) *Events of Default Requiring Cure Opportunity for Termination.* Each of the following shall constitute an Event of Default on the part of GENCO for which LIPA may terminate the Agreement upon compliance with the notice and cure provisions of the Agreement described below:

(a) *Failure to Comply with Agreement.* The failure or refusal by GENCO to substantially perform any material obligation under the Agreement, except that no such failure or refusal shall constitute an Event of Default giving LIPA the right to terminate the Agreement for cause unless LIPA has given prior written notice to GENCO or the Guarantor, as applicable, stating that a specified failure or refusal to perform exists and GENCO or the Guarantor, as applicable, has neither challenged in an appropriate forum LIPA's conclusion nor corrected or diligently taken steps to correct such default within a reasonable period of time, but not more than 60 days, from receipt of the notice (but if GENCO or the Guarantor shall have diligently taken steps to correct such default within a reasonable period of time, the same shall not constitute an Event of Default for as long as GENCO or the Guarantor is continuing to take such steps to correct such default).

*Procedure for Termination for Cause.* If either GENCO or LIPA shall have a right of termination for cause in accordance with the provisions of the Agreement outlined above, the same may be exercised by notice of termination given to the party in default at least two years prior to (or, in the case of a bankruptcy or insolvency default or a Change of Control, simultaneously with or, in the case of an event of default described in clauses (1)(c) or (1)(d) above, six months) the date of termination specified in such notice.

### **Non-binding Mediation; Arbitration**

The Agreement provides that any dispute arising out of or relating to the Agreement shall be resolved in accordance with the mediation and arbitration procedures for the resolution of such disputes established by the Agreement which shall constitute the sole and exclusive procedures for the resolution of such disputes.

**Affiliate**

Pursuant to the Agreement, GENCO has agreed to remain an Affiliate of the Guarantor.

**Credit Enhancement in Certain Circumstances**

The Agreement provides that if the Guarantor's credit rating declines below investment grade, then GENCO shall provide credit enhancement of its obligations under the Agreement at its sole cost and expense in the form of either (i) an unconditional guarantee of all of GENCO's obligations under the Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, provided by a corporation or financial institution whose long-term senior debt is or would be rated investment grade, or (ii) an irrevocable letter of credit securing GENCO's obligations under the Agreement, the Manager's obligations under the Management Services Agreement, and the Energy Manager's obligations under the Energy Management Agreement, in a face amount of \$60,000,000 provided by a financial institution whose long-term senior debt is rated investment grade.

**Allocation of Risk of Certain Costs and Liabilities**

The Agreement contains provisions relating to the allocation of risks and liabilities that are substantially the same as the provisions of the Management Services Agreement described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Compensation and Budgets—Allocation of Risks of Certain Costs and Liabilities."

## Appendix D

### SUMMARY OF CERTAIN PROVISIONS OF THE ENERGY MANAGEMENT AGREEMENT

The following is a brief summary of the Energy Management Agreement. The summary does not purport to be complete or definitive and is qualified in its entirety by reference to the Energy Management Agreement, a copy of which is on file with the Trustee.

#### **General**

The Energy Management Agreement establishes the terms and conditions for the management by the KeySpan subsidiary party thereto (the “Energy Manager”) of fuel supplies used at the GENCO Generating Facilities to produce electric energy for delivery to LIPA, and for management and administration of the System Power Supply on behalf of LIPA in a manner consistent with policies established by LIPA.

#### **Scope of Energy Management Services**

As described in the Agreement, the Energy Manager is responsible for (a) fuel procurement, delivery, storage, and management for GENCO Generating Facilities to meet the energy generation requirements of the Electricity Customers, (b) the dispatch of all System Power Supply available to LIPA to meet total capacity and energy requirements of the Electricity Customers and Off-System Sales, (c) the purchase, on behalf of LIPA, of all capacity and energy to meet the needs of the Electricity Customers and (d) the sale, on behalf of LIPA, of Electricity owned by, or under contract to, LIPA which is not otherwise required to meet the needs of the Electricity Customers. The Agreement provides that all such responsibilities will be discharged in a manner consistent with Prudent Utility Practice, the System Policies and Procedures and New York State Public Service Commission policies and procedures pertaining to retail gas customer service. In discharging all such functions, the Energy Manager is obligated to use best efforts to obtain the least-cost fuel and least-cost capacity and energy for the benefit of the Electricity Customers.

The Energy Manager agrees to establish policies and procedures satisfactory to LIPA designed to assure that the Energy Manager’s responsibilities are performed without consideration of the ownership or economic return to the Energy Manager or its Affiliates, except for the incentive provisions of the Agreement (described below at “Fuel Management—Fuel Management Compensation—Fuel Purchase Performance Incentives/Disincentive Payments”), and comply with such policies and procedures.

The Agreement provides that in no event will the Energy Manager take title to Electricity being purchased or sold thereunder.

#### **Fuel Management**

*Fuel Management Services.* The Agreement provides that the Energy Manager will manage all aspects of the Fuel supply for the GENCO Generating Facilities, including determinations regarding the type of Fuel used for operating the GENCO Generating Facilities and the source of such Fuel supply taking into account the purchase of alternate sources of Electricity in lieu of Electricity from the GENCO Generating Facilities when economic. LIPA agrees to compensate the Energy Manager for such Fuel management services, including a Fuel Purchase Performance Incentive/ Disincentive Payment, in accordance with the terms of the Agreement (see “Fuel Management—Fuel Purchase Performance Incentives/Disincentive Payments” below). The Energy Manager will not contract for additional firm assets specifically for use in the GENCO Generating Facilities unless LIPA and the Energy Manager agree to the contract.

*Fuel Management Compensation.* During the term of the Agreement, LIPA will make monthly payments to the Energy Manager consisting of an amount equal to the sum of: (i) the Monthly Fuel Management Fee, plus (ii) the Monthly Fuel Payment, plus or minus (iii) the Fuel Purchase Performance Incentive/Disincentive.

*Fuel Management Fee.* The Energy Manager will be paid an annual Fuel Management Fee in consideration for the Energy Manager's performance of the Fuel Services contemplated in the Agreement. The Agreement provides that the cost-related component of the initial Fuel Management Fee, once established and approved by LIPA, will be indexed in the same manner as the Direct Cost Budget under the Management Services Agreement until the termination of the Management Services Agreement and thereafter will be subject to mutually agreeable adjustments. LIPA is obligated to pay the Fuel Management Fee to the Energy Manager in twelve equal monthly installments.

*Monthly Fuel Payment.* LIPA will, in accordance with the provisions discussed below at "Fuel Management—Payment," pay the total monthly cost of all Fuel for use in the GENCO Generating Facilities that are under contract to LIPA pursuant to the Power Supply Agreement, including but not limited to any current or future fuel related taxes or other fuel related fees or costs reasonably incurred by the Energy Manager. This cost will be based upon (a) the actual variable cost of gas delivered to the delivery points for such fuel plus (i) any incremental Firm Gas Supply costs which are incurred based on use of Firm Gas Supplies in the operation of the GENCO Generating Facilities, (ii) any costs the Energy Manager incurs based on non-use of gas it has otherwise contracted to purchase for use in the operation of the GENCO Generating Facilities, and (iii) the Local Transportation Charge and (b) the delivered cost of oil for use in GENCO's Generating Facilities.

*Fuel Purchase Performance Incentives/Disincentive Payments.* The Energy Manager will receive a Fuel Purchase Performance Incentive/Disincentive Payment, which will be calculated at the end of each month, with the results reflected in the following month's invoice. The total Fuel Purchase Performance Incentive/Disincentive Payment will not exceed \$5.0 million on an annual basis.

*Payment.* The Energy Manager will submit monthly invoices to LIPA for the Monthly Fuel Management Fee and the Fuel Purchase Performance Incentive/Disincentive Payment by the tenth (10th) Business Day following the month of service, consistent with the provisions in this description of "Fuel Management." Payment of all invoiced amounts will be due and payable by LIPA within fifteen (15) Business Days of LIPA receiving such invoices.

*Minimization of Costs.* In providing the Fuel, Energy Manager shall use best efforts to minimize Fuel costs for the GENCO Generating Facilities, such efforts being consistent with (i) all applicable insurance policies, (ii) all applicable prudent industry practices and standards, including Prudent Utility Practice, (iii) all applicable operating and contract constraints for Fuel delivery, (iv) Energy Manager's collective bargaining agreements and (v) Applicable Law.

## **Off-System Sales**

The Agreement provides that the Energy Manager will use best efforts to market to Off-System Sales customers, on LIPA's behalf, Electricity from the System Power Supply that is not otherwise needed by the Electricity Customers in a manner which will reduce the net cost of Electricity provided to the Electricity Customers. The Energy Manager will receive 33 percent of the revenue net of incremental costs from Off-System Sales of Electricity from the System Power Supply and LIPA will receive 67 percent of the revenue net of incremental costs from these Off-System Sales of Electricity from the System Power Supply. The incremental costs for such Off-System Sales will be based upon the incremental cost of energy for such Electricity sales including any other costs or charges (including applicable taxes) incurred to produce and deliver the Electricity and/or Ancillary Services for sale by the Energy Manager. The incremental costs associated with capacity sales will

include the cost of replacement capacity incurred as a result of the sale, if any, and any other costs or charges related to the sale, including startup, no-load operation, transmission, and applicable taxes.

Notwithstanding any of the above, the Energy Manager will only attempt to sell excess Electricity to the extent that, in GENCO's judgment, such Electricity sales do not jeopardize any of GENCO's tax-exempt debt and to the extent that, in LIPA's judgment, such Electricity sales do not jeopardize the tax-exempt status of any of the Authority's debt. Each party will furnish the other an appropriately detailed description of the constraints imposed on such sales and will update such description from time to time to reflect any applicable changes in law or regulation.

### **System Power Supply Management**

*Lowest Cost Electricity.* In connection with the purchase and management of the System Power Supply, on LIPA's behalf, the Energy Manager is obligated to use best efforts to provide the lowest cost Electricity to the T&D System and the Electricity Customers, given (i) the transmission and distribution limitations unique and/or external to the T&D System; (ii) the terms of the Existing Power Supply Agreements; (iii) availability of power through the New York Power Pool or its successor; (iv) regulatory and reliability council requirements, including, but not limited to system safety and reliability; and (v) System Policies and Procedures, including environmental policies contained therein.

*Specific Energy Manager Responsibilities.* In implementing its System Power Supply responsibilities, the Energy Manager will, subject to the transmission, contractual and reliability constraints referred to in the preceding paragraph:

- (i) schedule deliveries of and Dispatch energy from the System Power Supply;
- (ii) arrange for LIPA's purchase of Electricity to the extent the System Power Supply is insufficient to meet the requirements of the T&D System;
- (iii) continually monitor the market for LIPA's sale and purchase of wholesale Electricity and purchase Electricity, on LIPA's behalf, on the wholesale market to displace System Power Supply if such purchases, including the cost of transmission services to deliver such Electricity, will reduce total power supply costs;
- (iv) sell Electricity on LIPA's behalf from the System Power Supply that is surplus to the requirements of the T&D System whenever such sales, including consideration of any incremental cost of Transmission for delivery of such sales, are advantageous to LIPA;
- (v) arrange for such additional transmission services and capacity as will be necessary for the purchase or sale of Electricity by LIPA; and
- (vi) with the prior written consent of LIPA, subcontract with power marketers or brokers, or similar entities, to assist in the acquisition of Electricity and the marketing and sale of excess Electricity.

All contracts for the purchase or sale of Electricity will be entered into by LIPA or by the Energy Manager as agent for LIPA. The Agreement provides that no contract for the purchase or sale of Electricity for a term in excess of three months will be entered into without the prior written consent of LIPA.

*System Power Supply Management Compensation.* Except as otherwise provided in the Agreement, the payments LIPA will make to the Energy Manager pursuant to the Agreement with respect to System Power Supply Services other than Off-System Sales will be calculated as set forth in the Agreement and as summarized below. During the term of the Agreement, LIPA will make monthly payments to the Energy Manager consisting of an amount equal to the sum of: (i) the System

Power Supply Management Fee, plus or minus (ii) the System Power Supply Performance Incentive/Disincentive.

*System Power Supply Management Fee.* The Energy Manager will be paid an annual System Power Supply Management Fee, in consideration for the Energy Manager's performance of the System Power Supply management services contemplated in the Agreement. The amount of such System Power Supply Management Fee includes a fee of \$750,000 and an allowance for certain costs which, for 1998, has been established at \$868,000. Such allowance for costs will be indexed during the term of the Agreement in the same manner as the Direct Cost Budget under the Management Services Agreement. LIPA will pay the System Power Supply Management Fee to the Energy Manager in twelve equal monthly installments.

*System Power Supply Performance Incentives/Disincentive.* The Energy Manager will receive a System Power Supply Performance Incentive/Disincentive, calculated in accordance with the Agreement which will not exceed \$2 million on an annual basis.

*Payment.* The Energy Manager will submit monthly invoices to LIPA for the Monthly System Power Supply Management Fee and the System Power Supply Performance Incentive/Disincentive Payments and Off-System Sales compensation by the tenth (10th) Business Day following the month of service. Such invoices will show separately amounts payable with respect to Off System Sales and System Power Supply Management. Payment of all invoiced amounts will be due and payable by LIPA within fifteen (15) Business Days of LIPA receiving such invoices.

## **Records; Information**

### **Account Records; Collection of Monies; Availability of Energy Manager**

*Account Records.* The Energy Manager is obligated to maintain such records as LIPA reasonably requests setting forth in accurate and reasonable detail the information relating to the purchase and sale of Fuel and Electricity under the Agreement requested by LIPA.

*Collection of Monies.* The Energy Manager will use best efforts to collect on a timely basis (1) all amounts due LIPA for Off-System Sales, and (2) any other monies owed to LIPA in connection with System Power Supply and other matters within the purview of the Energy Manager. The Energy Manager will provide current and historical billing information concerning Fuel and System Power Supply to LIPA monthly in such form as reasonably requested by LIPA. All such monies collected by the Energy Manager or any Subcontractor thereto will be the property of LIPA and will be deposited by the Energy Manager daily into such accounts and in the manner as LIPA may from time to time designate. The Energy Manager is unconditionally and absolutely obligated to pay or deposit such moneys as directed by LIPA.

*Compliance with Applicable Law.* The Energy Manager is obligated to perform all of its obligations under the Agreement in accordance with Applicable Law.

*Information.* The Agreement requires the Energy Manager to establish and maintain an information system to provide storage and real time retrieval for LIPA review and copying of operating data relating to (i) cost and quantities of Fuel Supply and Power Purchases, (ii) revenues from and quantities of Off-System Sales and (iii) the performance by the Energy Manager of its obligations under the Agreement, including, but not limited to, all information necessary to verify calculations made pursuant to the Agreement.

*Books and Records.* The Energy Manager will prepare and maintain proper, accurate and complete books, records and accounts regarding Fuel and System Power Supply to the extent necessary (1) to enable LIPA to prepare LIPA's financial statements in accordance with generally accepted accounting principles, (2) to verify data with respect to any operations or transactions in which LIPA has a financial or other material interest under the Agreement, (3) to prepare periodic

performance reports and statements relating to purchase of Fuel and System Power Supply, which will be submitted by the Energy Manager to LIPA and (4) to enable LIPA to administer any fuel adjustment clause or similar provision applicable to Electricity sales. The Energy Manager will, upon notice and demand from LIPA, produce for examination and copying by representatives of LIPA, any documents showing all acts and transactions relating to the Agreement, any Subcontract or any transactions in which LIPA has or may have a financial or other material interest under the Agreement, and will produce such operation books and records for examination and copying in connection with the costs for which LIPA may be responsible under the Agreement.

### **Fiscal Affairs, Accounting and Record Keeping**

*General.* The Energy Manager will maintain possession of equipment, materials and supplies, maps, plans and specifications, and Fuel and System Power Supply billing records during the term of the Agreement and will duly account to LIPA for such items.

*Bank Deposits.* All cash held by the Energy Manager for the account of LIPA and all cash collected by the Energy Manager for the account of LIPA after the LIPA/LILCO Merger Closing Date will be deposited on each Business Day in bank accounts in such bank or banks as LIPA may direct and upon such terms and conditions as may be specified by LIPA.

*Bill Payments.* The Energy Manager will timely pay all bills related to Fuel which are proper and appropriate and which it has authority to pay and will assure that, to the extent within the Energy Manager's control, no liens are filed against any portion of the assets or revenues of LIPA.

### **Allocation of Risk of Certain Costs and Liabilities**

The Agreement contains provisions relating to the allocation of risks and liabilities that are substantially the same as the provisions of the Management Services Agreement described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Compensation and Budgets—Allocation of Risks of Certain Costs and Liabilities."

### **Term; Events of Default**

*Term.* The term of the Agreement commenced on May 28, 1998 and, except as otherwise provided, will remain in full force and effect for an initial term of (i) fifteen (15) years from such date with respect to the Fuel Services and (ii) eight (8) years from such date with respect to System Power Supply Services. The Authority and KeySpan have entered into an agreement to extend the term of the System Power Supply Services until December 31, 2006 and thereafter on a month-to-month basis subject to termination by the Authority on sixty days notice, but in no event later than December 31, 2007.

### **Events of Default; Procedures for Termination**

The Agreement contains provisions relating to Events of Default by the Energy Manager or LIPA and the procedures for termination that are substantially the same as the provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Compensation and Budget—Events of Default by the Manager—Events of Default by LIPA" and "—Procedure for Termination for Cause."

*LIPA Emergency Assumption of Fuel and System Power Supply Management Services.* Should the Energy Manager, due to Uncontrollable Circumstances or any other reason whatsoever, fail, refuse or be unable to provide any or all Fuel and System Power Supply Services contemplated hereby and LIPA or any Governmental Body finds that such failure endangers or menaces the public health, safety or welfare, then, in any of those events and to the extent of such failure, LIPA will have the right, upon notice to the Energy Manager, during the period of such emergency, to perform the services which the Energy Manager would otherwise be obligated to perform under the Agreement.

The Energy Manager agrees that in such event it will fully cooperate with LIPA to effect such a temporary assumption. The Energy Manager agrees that, in such event, LIPA may take and use any or all of the operating assets of the Energy Manager necessary for the above-mentioned purposes without paying the Energy Manager or any other person any additional charges or compensation whatsoever for such possession and use; provided, however, that if such emergency is due to Uncontrollable Circumstances, LIPA will reimburse the Energy Manager for its Cost-Substantiated costs incurred due to such a transfer of the operating assets.

### **Energy Manager's Reporting Requirements**

*Monthly Reports.* The Energy Manager is obligated to provide LIPA and the Consulting Engineer with monthly reports no later than 20 days after the end of each month, including such data relating to the Fuel Services and System Power Supply Services as may reasonably be requested to be furnished by LIPA.

*Annual Reports.* The Energy Manager will furnish LIPA and, the Consulting Engineer, within 60 days after the end of each Contract Year, an Annual Settlement Statement together with annual summary of the statistical data provided in the monthly reports, certified by the Energy Manager, as well as such other data relating to the services provided under the Agreement as may be reasonably requested to be furnished by LIPA.

*Fuel Consumption Reports.* Fifteen (15) Business Days following the end of each month, Energy Manager is obligated to submit to LIPA a report summarizing the Fuel burned during that month and such other information as the parties may mutually agree.

### **Indemnification**

The Agreement contains redemnification provisions that are substantially the same as the indemnification provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Miscellaneous Provisions—Indemnification."

### **Miscellaneous Provisions**

*Insurance.* The Agreement provides that Energy Manager shall maintain with financially responsible insurance companies insurance in such amounts and against such risks and losses as are customary for companies engaged in the business of providing services or undertaking activities similar to the Fuel Services and System Power Supply Services to be provided thereunder.

*Assignment and Transfer.* Agreement contains provisions relating to assignment and transfer that are substantially the same as the assignment and transfer provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Miscellaneous Provisions—Assignment and Transfer."

*Non-Binding Mediation; Arbitration.* The Agreement contains provisions relating to mediation and arbitration that are substantially the same as the mediation and arbitration provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain Provisions of the Management Services Agreement—Compensation and Budget—Non-Binding Mediation; Arbitration."

*Affiliate.* Pursuant to the Agreement, the Energy Manager has agreed to remain an Affiliate of the Guarantor.

*Credit Enhancement in Certain Circumstances.* The Agreement contains provisions relating to credit enhancement that are substantially the same as the credit enhancement provisions of the Management Services Agreement that are described herein under the caption "Summary of Certain



Provisions of the Management Services Agreement—Miscellaneous Provisions—Credit Enhancement in Certain Circumstances.”

*Hedging Policies.* The Energy Manager agreed not engage in any hedging activities relating to the Fuel Services or System Power Supply Services without express approval from the Boards of Directors of the Energy Manager and its Parent and without notifying and consulting with LIPA at least 60 days prior to implementing such activities. The Agreement provides that in the event that approval for the use of hedging activities is implemented, the incentive/disincentive program will be reexamined by the parties to determine the appropriateness of the inclusion or exclusion of the related costs, gain or losses and appropriate mutually agreeable revisions thereto will be made.