

# **Long Island Power Authority and Subsidiaries**

**Consolidated Financial Statements  
December 31, 2001 and 2000**

**Report of Independent Accountants**

To the Board of Trustees  
of the Long Island Power Authority and Subsidiaries:

In our opinion, the accompanying consolidated statements of financial position and of capitalization and the related consolidated statements of revenues, expenses and changes in retained earnings/ (accumulated deficit) and of cash flows present fairly, in all material respects, the financial position of the Long Island Power Authority and its subsidiaries (collectively, the "Company") at December 31, 2001 and 2000, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

April 30, 2002

**Consolidated Statements of Financial Position**  
**(Thousands of Dollars)**

	<b>December 31,</b>	
	<b>2001</b>	<b>2000</b>
<b>Assets</b>		
<b>Utility Plant, net</b>	\$ 2,298,136	\$ 2,197,656
<b>Property and Equipment, net</b>	1,253	942
<b>Current Assets</b>		
Cash and cash equivalents	368,866	97,850
Investments	319,503	277,074
Accounts receivable (less allowance for doubtful accounts of \$19,485 and \$21,480, respectively)	197,228	208,644
Fuel inventory	54,418	50,251
Material and supplies inventory	9,794	-
Interest receivable	1,049	1,754
Prepayments and other current assets	3,236	2,085
<b>Total Current Assets</b>	<b>954,094</b>	<b>637,658</b>
<b>Promissory Notes Receivable</b>		
KeySpan Energy	602,427	602,427
Niagara Mohawk Power Corporation	2,862	-
<b>Total Promissory Notes Receivable</b>	<b>605,289</b>	<b>602,427</b>
<b>Nonutility Property and Other Investments</b>	<b>38,903</b>	<b>32,789</b>
<b>Deferred Charges</b>	<b>76,657</b>	<b>67,198</b>
<b>Regulatory Assets</b>		
Shoreham settlement	425,056	335,061
Fuel and purchased power cost recoverable	147,996	125,600
<b>Total Regulatory Assets</b>	<b>573,052</b>	<b>460,661</b>
<b>Acquisition Adjustment (net of accumulated amortization of \$564,849 and \$452,169 respectively)</b>	<b>3,530,662</b>	<b>3,643,342</b>
<b>Total Assets</b>	<b>\$ 8,078,046</b>	<b>\$ 7,642,673</b>
<b>Capitalization</b>		
Long-term debt	\$ 7,502,130	\$ 7,218,889
Accumulated deficit	(29,279)	(61,670)
<b>Total Capitalization</b>	<b>7,472,851</b>	<b>7,157,219</b>
<b>Current Liabilities</b>		
Current maturities of long-term debt	140,085	119,830
Accounts payable and accrued expenses	238,841	175,959
Accrued taxes	29,953	29,163
Accrued interest	49,511	51,925
Customer deposits	24,870	24,550
<b>Total Current Liabilities</b>	<b>483,260</b>	<b>401,427</b>
<b>Deferred Credits</b>	<b>98,467</b>	<b>60,955</b>
<b>Claims and Damages</b>	<b>23,468</b>	<b>23,072</b>
<b>Commitments and Contingencies</b>		
<b>Total Capitalization and Liabilities</b>	<b>\$8,078,046</b>	<b>\$7,642,673</b>

The accompanying notes are an integral part of these financial statements.

**Consolidated Statements of Revenues, Expenses and Changes in  
Retained Earnings/(Accumulated Deficit)  
(Thousands of Dollars)**

	<b>Twelve Months Ended December 31,</b>	
	<b>2001</b>	<b>2000</b>
<b>Electric Revenue</b>	\$2,367,900	\$2,199,741
<b>Expenses</b>		
Operations - fuel and purchased power	880,665	885,732
Operations and maintenance	719,853	636,568
General and administrative	36,746	33,162
Depreciation and amortization	212,283	208,295
Capital recovery amortization	-	34,209
Payments in lieu of taxes	219,955	230,319
Total Operating Expenses	<u>2,069,502</u>	<u>2,028,285</u>
<b>Excess of operating revenues over expenses</b>	<u>298,398</u>	<u>171,456</u>
<b>Other income, net</b>		
Investment income	23,638	31,713
Carrying charges on regulatory asset	36,192	16,068
Other	12,219	2,355
Total other income, net	<u>72,049</u>	<u>50,136</u>
<b>Excess of revenues over expenses before interest charges and (credits) and extraordinary gain</b>	<u>370,447</u>	<u>221,592</u>
<b>Interest charges and (credits)</b>		
Interest on long-term debt, net	316,592	322,095
Other interest	25,914	27,371
Allowance for borrowed funds used during construction	(4,450)	(5,646)
Total interest charges	<u>338,056</u>	<u>343,820</u>
<b>Excess of revenues over expenses (expenses over revenues) before extraordinary gain</b>	32,391	(122,228)
<b>Extraordinary gain on early extinguishment of debt</b>	<u>-</u>	<u>1,688</u>
<b>Excess of revenues over expenses (expenses over revenues)</b>	32,391	(120,540)
<b>(Accumulated deficit) / Retained earnings</b>		
Beginning	<u>(61,670)</u>	<u>58,870</u>
Ending	<u>\$ (29,279)</u>	<u>\$ (61,670)</u>

The accompanying notes are an integral part of these financial statements.

**Consolidated Statements of Cash Flows**  
**(Thousands of Dollars)**

	<b>Twelve Months Ended December 31,</b>	
	<b>2001</b>	<b>2000</b>
<b>Operating Activities</b>		
Excess of revenues over expenses (expenses over revenues)	\$ 32,391	\$ (120,540)
<b>Adjustments to reconcile excess of (expenses over revenues) revenues over expenses to net cash provided by operating activities</b>		
Gain on early extinguishment of debt	-	(1,688)
Depreciation and amortization	212,283	208,295
Capital recovery amortization	-	34,209
Unrealized loss on fuel derivatives	7,606	-
Nuclear fuel burned	5,340	5,146
Shoreham Settlement	(101,072)	(91,830)
Provision for claims and damages	10,727	21,570
Accretion of capital appreciation bonds	27,438	20,015
Amortization of cost of issuing and redeeming securities	8,532	10,052
Other	2,776	(5,426)
<b>Changes in operating assets and liabilities</b>		
Accounts receivable, net	11,416	(8,109)
Fuel and Material and supplies inventory	(13,961)	(1,425)
Fuel and purchased power costs recovered related to 2000 excess costs	102,779	-
Fuel and purchased power costs deferred	(125,175)	(147,613)
Accounts payable and accrued expenses	62,882	7,864
Accrued taxes	790	(12,972)
Accrued interest	(2,414)	(2,758)
Other, net	14,972	10,178
Net cash provided by (used in) operating activities	<u>257,310</u>	<u>(75,032)</u>
<b>Investing Activities</b>		
Net (purchases) sales of investment securities	(42,429)	88,201
Promissory note receivable	(2,862)	-
Other	(5,002)	(12,640)
Net cash (used in) provided by investing activities	<u>(50,293)</u>	<u>75,561</u>
<b>Cash Flows from Non-Capital related Financing Activities</b>		
Proceeds from the issuance of bonds	100,000	325,165
Bond issuance costs	(323)	(9,599)
Net cash provided by non-capital related financing activities	<u>99,677</u>	<u>315,566</u>
<b>Cash Flows from Capital and related Financing Activities</b>		
Capital and nuclear fuel expenditures	(205,733)	(198,920)
Proceeds from the issuance of bonds	1,837,242	-
Bond issuance costs	(20,057)	-
Redemption of long-term debt	(1,647,130)	(184,460)
Net cash used in capital and related financing activities	<u>(35,678)</u>	<u>(383,380)</u>
Net increase (decrease) in cash and cash equivalents	271,016	(67,285)
Cash and cash equivalents at beginning of period	97,850	165,135
Cash and cash equivalents at end of period	<u>\$ 368,866</u>	<u>\$ 97,850</u>
Interest paid	\$ 338,694	\$ 346,708

The accompanying notes are an integral part of these financial statements.

**Consolidated Statements of Capitalization**  
**December 31, 2001**  
**(Thousands of Dollars)**

	Maturity	Interest Rate	Series	December 31,	
				2001	2000
<b>Electric System General Revenue Bonds</b>					
Serial Bonds	Annually to 2016	4.250% to 6.000% a	1998A	\$ 1,136,230	\$ 1,186,140
Term Bonds	December 1, 2018 to 2029	5.000% to 5.750% a	1998A	1,850,575	1,850,575
Capital Appreciation Bonds	December 1, 2003 to 2028	4.400% to 5.300% a	1998A	173,955	165,607
Serial Bonds	Annually to 2016	4.000% to 5.250% a	1998B	1,106,720	1,176,640
Term Bonds	April 1, 2018	4.750% a	1998B	57,145	57,145
Capital Appreciation Bonds	June 1, 2005 to 2029	5.000% to 5.950% a	2000A	356,326	337,235
Serial Bonds	September 1, 2013 to 2021	4.600% to 5 3/8% a	2001A	21,960	-
Term Bonds	September 1, 2025 to 2029	5.000% to 5 3/8% a	2001A	278,040	-
Term Bonds	May 1, 2033	1.650% b	2001B	75,000	-
Term Bonds	May 1, 2033	1.400% b	2001C	25,000	-
Term Bonds	May 1, 2033	1.450% b	2001D	50,000	-
Term Bonds	May 1, 2033	1.550% b	2001E	50,000	-
Term Bonds	May 1, 2033	1.300% b	2001F	50,000	-
Term Bonds	May 1, 2033	1.500% b	2001G	50,000	-
Term Bonds	May 1, 2033	1.395% b	2001H	50,000	-
Term Bonds	May 1, 2033	1.400% b	2001I	50,000	-
Term Bonds	May 1, 2033	1.300% b	2001J	50,000	-
Term Bonds	May 1, 2033	1.350% b	2001K	50,000	-
Term Bonds	May 1, 2033	5.375% a	2001L	116,000	-
Term Bonds	May 1, 2033	1.650% b	2001M	50,000	-
Term Bonds	May 1, 2033	1.700% b	2001N	50,000	-
Term Bonds	May 1, 2033	1.250% b	2001O	50,000	-
Term Bonds	May 1, 2033	1.500% b	2001P	50,000	-
<b>Electric System Subordinated Revenue Bonds</b>					
	May 1, 2033	4.850% b	Series 1	250,000	250,000
	May 1, 2033	4.600% b	Series 2	250,000	250,000
	May 1, 2033	4.125% b	Series 3	200,000	250,000
	May 1, 2033	4.150% b	Series 4	-	250,000
	May 1, 2033	4.900% b	Series 5	-	250,000
	May 1, 2033	4.900% b	Series 6	-	250,000
	April 1, 2025	4.210% b	Series 7	250,000	250,000
	April 1, 2009 to 2012	4.000% to 5.250% a	Series 8	216,860	218,300
Total General and Subordinated Revenue Bonds				<u>6,963,811</u>	<u>6,741,642</u>
<b>Commercial Paper Notes</b>					
	January 7 to April 4, 2002	1.350% to 2.500% b	CP-1	100,000	-
<b>Debentures</b>					
	March 15, 2023	8.200% a		<u>270,000</u>	<u>270,000</u>
<b>NYSERDA Financing Notes</b>					
Pollution Control Revenue Bonds	March 1, 2016	5.150% a	1985 A,B	108,020	108,020
Electric Facilities Revenue Bonds	September 1, 2019	7.150% a	1989 A,B	35,030	35,030
	June 1, 2020	7.150% a	1990 A	73,900	73,900
	December 1, 2020	7.150% a	1991 A	26,560	26,560
	February 1, 2022	7.150% a	1992 A,B	13,455	13,455
	August 1, 2022	6.900% a	1992 C,D	28,060	28,060
	November 1, 2023	5.300% a	1993 B	29,600	29,600
	October 1, 2024	5.300% a	1994 A	2,600	2,600
	August 1, 2025	5.300% a	1995 A	15,200	15,200
Total NYSERDA Financing Notes				<u>332,425</u>	<u>332,425</u>
Unamortized premium and deferred amortization				<u>(24,021)</u>	<u>(5,348)</u>
<b>Total Long-term debt</b>				<u>7,642,215</u>	<u>7,338,719</u>
Less Current Maturities				<u>140,085</u>	<u>119,830</u>
Long-Term Debt				<u>7,502,130</u>	<u>7,218,889</u>
<b>Accumulated Deficit</b>				<u>(29,279)</u>	<u>(61,670)</u>
<b>Total Capitalization</b>				<u>\$ 7,472,851</u>	<u>\$ 7,157,219</u>

a - Fixed rate

b - Variable rate (rate presented is at December 31, 2001)

The accompanying notes are an integral part of these financial statements.

## Notes to Consolidated Financial Statements

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### Note 1. Basis of Presentation

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

As used herein, the term "LILCO" refers to the Long Island Lighting Company, the publicly owned gas and electric utility company as it existed prior to the LIPA/LILCO Merger, as described in Note 2, and the term "LIPA" refers to that company as it exists after the LIPA/LILCO Merger, as a wholly-owned electric utility subsidiary company of the Long Island Power Authority (the "Authority"), doing business as LIPA. LIPA has 1 share of \$1 par value common stock authorized, issued and outstanding, which is held by the Authority and is eliminated in consolidation.

In October 1994, a not-for-profit subsidiary corporation, LIPA Resources, Inc. was formed under Section 402 of the Not-For-Profit Corporation Law. The subsidiary was formed for the purpose of marketing the Authority owned assets and providing consulting services by using the expertise developed by the Authority in decommissioning a fully licensed commercial nuclear plant. LIPA Resources, Inc. was inactive during the years ended December 31, 2001 and 2000 and had no assets or liabilities as of December 31, 2001 and 2000.

The Authority and its subsidiaries, LIPA and LIPA Resources, Inc. are referred to collectively, as the "Company."

### Note 2. Merger/Change in Control/Nature of Operations

#### Merger/Change in Control

On May 28, 1998, LIPA Acquisition Corp., a wholly-owned subsidiary of the Authority, was merged with and into LILCO (the "Merger") pursuant to an Agreement and Plan of Merger dated as of June 26, 1997, by and among LILCO, MarketSpan Corporation (formerly known as BL Holding Corp., and currently known as KeySpan Energy, "KeySpan"), and the Authority, (the "Merger Agreement").

Pursuant to the Merger Agreement, immediately prior to the Merger, all of the assets and liabilities of LILCO related to the conduct of its gas distribution business and its non-nuclear electric generation business, and all common assets used by LILCO in the operation and management of its electric transmission and distribution business and its gas distribution business and/or its non-nuclear electric generation business (the "Transferred Assets") were sold to KeySpan.

As a result of the Merger, the Authority became the holder of 1 share of LILCO's common stock, representing 100% of the outstanding voting securities of LILCO. In addition, KeySpan issued promissory notes to LIPA of approximately \$1.048 billion. At December 31, 2001, approximately \$602.4 million of those notes remain outstanding. The interest rate and timing of principal and interest payments on the promissory notes from KeySpan are identical to the terms of certain LILCO indebtedness assumed by LIPA in the Merger. KeySpan is required to make principal and interest payments to LIPA thirty days prior to the corresponding payment due dates, and LIPA transfers those amounts to debtholders in accordance with the original debt repayment schedule.

## Notes to Consolidated Financial Statements

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The cash consideration required for the Merger was obtained by the Authority from the proceeds of the issuance and sale of its Electric System General Revenue Bonds, Series 1998A and Electric System Subordinated Revenue Bonds, Series 1 through Series 6. The proceeds from the sale of the bonds were transferred by the Authority to LIPA in exchange for a promissory note of approximately \$4.949 billion. As a result of the Merger, there was a change in control of LILCO, which effectively resulted in the creation of a new reporting entity, LIPA.

The assets and liabilities of LILCO acquired by LIPA consist of: (i) LILCO's electric transmission and distribution system; (ii) its net investment in Nine Mile Point Nuclear Power Station, Unit 2 ("NMP2"); (iii) certain regulatory assets and liabilities associated with its electric business, (iv) allocated accounts receivable and other assets and liabilities; and (v) substantially all of its long-term debt.

Because of the manner in which LIPA's rates and charges are established by the Authority's Board of Trustees, the original net book value of the transmission and distribution and nuclear generation assets acquired in the Merger were considered to be the fair value of the assets. The excess of the acquisition costs over the fair value of the net assets acquired has been recorded as an intangible asset titled "acquisition adjustment" and is being amortized over a 35-year period. The acquisition adjustment arose principally through the elimination of LILCO's regulatory assets and liabilities, totaling approximately \$6.3 billion, and net deferred federal income tax liability of approximately \$2.4 billion. The balance of the acquisition adjustment is approximately \$3.5 billion and \$3.6 billion at December 31, 2001 and 2000, respectively.

Effective May 29, 1998, LIPA contracted with KeySpan to provide operations and management services for LIPA's transmission and distribution system through a management services agreement ("MSA"). Therefore, LIPA pays KeySpan directly for services and KeySpan, in turn, pays the salaries of its employees. LIPA has no paid employees. LIPA is charged a management fee by the Authority to oversee LIPA's operations. LIPA contracts for capacity from the fossil fired generating plants of KeySpan, formerly owned by LILCO, through a power supply agreement ("PSA"). Energy is purchased and sold and fuel is purchased by KeySpan on LIPA's behalf through an energy management agreement ("EMA") (collectively; the "Operating Agreements").

The electric transmission and distribution system is located in the New York Counties of Nassau and Suffolk (with certain limited exceptions) and a small portion of Queens County known as the Rockaways ("Service Area"). For the year ended December 31, 2001, LIPA received approximately 48% of its revenues from residential sales, 46% from sales to commercial and industrial customers, and the balance from sales to public authorities.

### **Nature of operations**

LIPA, as owner of the transmission and distribution system and as party to the Operating Agreements, conducts the electric business in the Service Area. The Authority is responsible for administering, monitoring and managing the performance by all parties to the Operating Agreements.

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



## Notes to Consolidated Financial Statements

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As compensation to the Authority for the services described above, the Authority charges LIPA a monthly management fee equal to the costs incurred by the Authority in order to perform its obligations under the agreements described above.

### Note 3. Summary of Significant Accounting Policies

#### General

The Company complies with all applicable pronouncements of the Governmental Accounting Standards Board (“GASB”). In accordance with GASB Statement No. 20, “Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,” the Company complies with all authoritative pronouncements applicable to non-governmental entities (i.e., Financial Accounting Standards Board (“FASB”) statements) that do not conflict with GASB pronouncements.

#### Principles of Consolidation

The consolidated financial statements include the accounts of the Authority and its subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

#### Accounting for the Effects of Rate Regulation

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

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

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

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

If the Company had been unable to continue to apply the provisions of SFAS No. 71, at December 31, 2001, the Company estimates that approximately \$573 million of regulatory assets would be considered for write-off, and the acquisition adjustment, totaling approximately \$3.5 billion would be considered for impairment.

## Notes to Consolidated Financial Statements

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### Utility Plant

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

### Property and Equipment

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

### Cash and Cash Equivalents and Investments

Funds held by the Authority are administered in accordance with the Authority's investment guidelines pursuant to Section 2925 of the New York State Public Authorities Law. These guidelines comply with the New York State Comptroller's investment guidelines for public authorities. Certain investments and cash and cash equivalents have been designated by the Authority's Board of Trustees to be used for specific purposes, including rate stabilization, debt service, capital expenditures, the issuance of credits in accordance with the Shoreham Settlement Agreement, and Clean Energy initiatives. Investments are reported at amortized cost, which approximates fair market value.

### Fuel Inventory

Effective July 2000, LIPA took title to all existing fuel oil in storage facilities owned by KeySpan located at generating stations on Long Island formerly owned by LILCO. Fuel inventory represents the value of low sulfur and internal combustion fuels that LIPA had on hand at each year-end in order to meet the demand requirements of these generating stations. Fuel inventory is valued using the weighted average cost method.

### Material and Supplies Inventory

During the year ended December 31, 2001, Constellation Nuclear LLC purchased 82% of the Nine Mile Point 2 ("NMP2") plant (discussed in further detail in Note 6). Coincident with the sale, LIPA was, in accordance with the terms of existing co-tenant agreements with the selling parties, required to purchase its 18% ownership interests in the materials and supplies inventory supporting the operations of NMP2.

### Promissory Note Receivable—Niagara Mohawk Power Corporation

In order to facilitate the sale of NMP2, LIPA sold to Niagara Mohawk Power Corporation certain transmission assets located at the site of NMP2 in exchange for a promissory note totaling approximately \$2.8 million, payable on the fifth anniversary of the sale with interest accruing at 9.5% compounded annually.

### Deferred Charges

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

## Notes to Consolidated Financial Statements

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### Shoreham Settlement

In January 2000, the Authority reached an agreement with Suffolk County, Town of Brookhaven, Shoreham-Wading River Central School District, Wading River Fire District and Shoreham-Wading River Library District (which was succeeded by the North Shore Library District) (collectively, the “Suffolk Taxing Jurisdictions”) and Nassau County regarding the over assessment of the Shoreham Nuclear Power Station. Under the terms of the agreement, the Authority is required to issue \$457.5 million of rebates and credits to customers over a five-year period, which began May 29, 1998. In order to fund such rebates and credits, the Authority used a portion of the proceeds from the issuance in May 1998 of its Series 1998A Electric System General Revenue Bonds and issued approximately \$325 million of Electric System General Revenue Bonds, Series 2000A in May 2000. Beginning in June 2003, LIPA's Suffolk County customers' bills will include a surcharge (the “Suffolk Surcharge”) to be collected over the succeeding approximate 25 year period to repay the Authority for debt service on the bonds issued by the Authority to fund the Settlement, as well as, to reimburse the Authority for investment earnings the Authority would have otherwise received on the funds advanced for the payment of credits to LIPA's customers.

As future rates will be established at a level sufficient to recover all such costs identified above, LIPA recorded a regulatory asset in accordance with SFAS No. 71. The balance of the Shoreham settlement regulatory asset at December 31, 2001 and 2000 was approximately \$425 million and \$335 million, respectively. The balance represents costs recorded from 1998 through 2001 including rebates and credits issued to customers, costs of administering the program and debt service costs on the Bonds identified above.

In addition to the items described above, other costs related to the Settlement were incurred, but as future rates will not be established at levels to recover such costs, they fail to meet the capitalization criteria of SFAS No. 71. These costs include \$25 million contributed to Nassau County to fund the Clean Energy initiative, as well as the \$50 per meter rebate issued to Non-Suffolk County customers, which totaled approximately \$25 million.

### Fuel and purchased power costs recoverable

LIPA's tariff includes a fuel recovery mechanism – the Fuel and Purchased Power Cost Adjustment (“FPPCA”) – whereby rates may be adjusted to reflect significant changes in the cost of fuel, purchased power and related costs. The FPPCA applies to all service classifications and was designed to ensure that LIPA would recover from or return to customers any fuel and purchased power costs that fall outside an established base fuel and purchased power costs tolerance band. The tolerance band was designed to increase in 1% increments annually until such time as fuel and purchased power costs increase in excess of five percent cumulatively over the original base fuel and purchased power cost, as they did for the year ended December 31, 2000. The FPPCA is designed to recover, from that year forward, all costs in excess of the original base cost.

In February 2001, the Authority announced that in 2000 the Authority's costs for fuel and purchased power exceeded base fuel costs by approximately \$307 million. Pursuant to the provisions of the FPPCA, such additional cost would be recovered in full from customers beginning in 2001. However, on March 1, 2001, the Trustees approved a waiver of the FPPCA that would limit cost recovery to approximately \$125.6 million of the additional amount through a fuel surcharge equaling approximately 5.8 percent of base revenue for the 12-month period beginning on March 7, 2001. As a result, the Authority charged to expense approximately \$181 million of the excess fuel and purchased power costs incurred during the year ended December 31, 2000.

## Notes to Consolidated Financial Statements

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In February 2002, the Authority announced that in 2001 costs for fuel and purchased power exceeded base fuel costs by approximately \$203 million. Pursuant to the provisions of the FPPCA, such additional cost would be recovered in full from customers beginning in 2002. However, on February 28, 2002 the Trustees approved a waiver of the FPPCA that would limit cost recovery to approximately \$125.1 million of the additional amount through a fuel surcharge of approximately 5.8 percent of base revenue for the 12 month period beginning on March 7, 2002. As a result, the Authority has charged to expense, as of December 31, 2001, approximately \$77.9 million of the excess fuel and purchased power costs.

The Authority's Trustees' action left the FPPCA in effect, but there can be no assurance that the Authority will not waive the requirements of the FPPCA in the future and recover less than the full amount of any excess fuel and purchased power costs.

### Acquisition Adjustment

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

### Fair Values of Financial Instruments

The Company's financial instruments approximate their fair market value at December 31, 2001 and 2000. The fair values of the Company's long-term debt are based on quoted market prices.

### Claims and Damages

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

### Revenues

Revenues are comprised of cycle billings rendered to customers, based on meter reads, and the accrual of electric revenues for services rendered to customers not billed at month-end.

### Depreciation

The provisions for depreciation for utility plant result from the application of straight-line rates by groups of depreciable properties in service. The rates are determined by age-life studies performed on depreciable properties.

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

### Capital Recovery Amortization

In the first quarter of 2000, LIPA generated sufficient cash flow to allow it to retire, before maturity, approximately \$58 million of long-term debt. The early retirement of debt reflects the advanced recovery of costs and as a result, LIPA recorded accelerated amortization of the acquisition adjustment totaling approximately \$34 million in 2000. LIPA had no early retirement of debt during the year ended December 31, 2001.

## Notes to Consolidated Financial Statements

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### **Payments-in-lieu-of-taxes**

The Company is required to make payments-in-lieu-of-taxes (“PILOTS”) for all operating taxes previously paid by LILCO, including gross income, gross earnings, property, Metropolitan Transportation Authority and certain taxes related to fuels used in utility operations. PILOTS also include payments to municipalities and school districts in which the defunct Shoreham power plant is located. Shoreham related PILOTS paid in the first year following the Company’s acquisition of Shoreham, which occurred on February 29, 1992, were equal to the taxes and assessments which would have been paid had Shoreham not been transferred to the Company. In each succeeding year through 2001, Shoreham related PILOTS have been reduced by ten percent of the first year’s required payment.

In 2002, the Company made its final payment in accordance with the Settlement Agreement and has satisfied all PILOT obligation payments with respect to the Shoreham property.

### **Allowance for Borrowed Funds Used During Construction**

The allowance for funds used during construction (“AFC”) is the net cost of borrowed funds used for construction purposes. AFC is not an item of current cash income. AFC is computed monthly on a portion of construction work in progress.

### **Income Taxes**

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

### **Derivative Instruments**

In June 1998, the FASB issued Statement No. 133, “Accounting for Derivative Instruments and Hedging Activities” (“SFAS No. 133”), which was subsequently amended in June 2000 by SFAS No. 138, “Accounting for Certain Derivative Instruments and Certain Hedging Activities and Amendment of FASB Statement No. 133.” These statements establish accounting and reporting requirements for derivative instruments and for hedging activities. These standards require that an entity recognize the fair value of all derivative instruments as either assets or liabilities in the balance sheet with the offsetting gains or losses recognized in earnings. These standards permit the deferral of hedge gains and losses to Other Comprehensive Income, under specific hedge accounting provisions, until the hedged transaction is realized.

The Company implemented these statements on January 1, 2001. However, the Authority is a governmental agency and, therefore, its financial statements are prepared in accordance with the provisions of the Governmental Accounting Standards Board, which do not provide for Other Comprehensive Income, but are accounted for as noted below.

Fuel and purchased power transactions--The Company uses derivative financial instruments to protect itself from market price fluctuations in related underlying transactions for the physical purchase of fuel oil or natural gas. These instruments are recorded at their market value as of December 31, 2001 and any unrealized gains and losses are recognized in current period results, as a component of fuel and purchased power. At December 31, 2001, the Authority recognized an unrealized loss on its fuel derivatives of approximately \$7.6 million. Despite inclusion in current period earnings, these unrealized charges are not includable in the FPPCA calculation until realized.

To limit its exposure to credit risk, the Authority will only enter into derivative transactions with counterparties that have a credit rating of “investment grade” or better.

## Notes to Consolidated Financial Statements

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Interest rate transactions--The Authority has entered into an interest rate swap agreement in connection with its \$116 million Electric System General Revenue Bonds--Series 2001 L. Under this swap, the Authority pays a variable rate equivalent to the Bond Market Association ("BMA") Index (1.61% at December 31, 2001) and receives fixed rate payments at 5.1875%. The swap agreement contains an interest rate cap of 18% through May 25, 2002. The agreement allows for the third party to terminate the agreement each May 1 and November 1, commencing on May 1, 2011. The term of the swap is equal to the maturity of the Series L Bonds.

The Authority also entered into an interest rate swap agreements in connection with its \$250 million Electric System Subordinated Revenue Bonds--Series 7 Bonds. The Authority has two separate agreements having notional amounts of \$150 million and \$100 million. These agreements effectively change the Authority's interest rate exposure on the Series 7 Bonds to a fixed rate of 4.2%. The interest rate swap agreements are co-terminus with the Series 7 Bonds, with optional earlier termination at the Authority's discretion.

In accordance with the provisions of SFAS No. 133, the Authority marked its interest rate swaps to their respective market values at December 31, 2001, resulting in an unrealized gain of approximately \$1.1 million. As the Authority falls under the provision of SFAS No. 71, such unrealized gains were deferred and recorded as a deferred credits. The Authority will continue to defer unrealized gains or losses until realization, at which point the Authority will incorporate such amounts in its cost of service.

### Use of Estimates

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

### Reclassifications

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

### Recent Accounting Pronouncements

*Basic Financial Statements-and Management's Discussion and Analysis-for State and Local Governments*  
In June 1999, the Governmental Accounting Standards Board issued GASB Statement No. 34, "Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments," which was subsequently amended by GASB Statement No. 37, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments: Omnibus an Amendment of GASB Statement No. 21 and No. 34 (collectively "GASB No. 34") which requires the basic financial statements to include management's discussion and analysis ("MD&A") and supplementary information other than MD&A. In addition, in June 2001, GASB No. 38, "Certain Note Disclosures" was issued. The Company will adopt GASB Statements No. 34 and No. 38 on January 1, 2002. Adoption of GASB Statements No. 34 and No. 38 are not expected to have a material effect on the Company's financial statements.

## Notes to Consolidated Financial Statements

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### **Plant Decommissioning**

In June 2001, the FASB issued Statement No. 143 “Accounting for Asset Retirement Obligations” (“SFAS No. 143”). The Company will adopt SFAS No. 143 on January 1, 2003. The accounting standard requires that the fair value of a liability for an asset retirement obligation be recognized in the period in which it is incurred if a reasonable estimate of that value can be made. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and subsequently allocated to expense over the asset’s useful life.

The Authority believes that this statement will have an impact on its consolidated financial statements, however, such impact has yet to be determined.

### *Accounting for the Impairment or Disposal of Long-Lived Assets*

In August 2001, the FASB issued Statement No. 144, “Accounting for the Impairment or Disposal of Long-Lived Assets.” This statement supersedes SFAS No. 121, “Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of.” This statement requires that long-lived assets be measured at the lower of book value or fair value less cost to sell. The provisions of this Statement are effective for financial statements issued for fiscal year 2002. The Authority does not believe that this accounting standard will have a material adverse effect on its financial position, cash flows or results of operations.

### **Note 4. Rate Matters**

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

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

LIPA’s tariff includes the FPPCA to allow LIPA to adjust customers’ bills to reflect significant changes in the cost of fuel and purchased power and related costs.

**Notes to Consolidated Financial Statements**

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LIPA’s rates are largely based on LILCO’s pre-Merger rate design to avoid customer confusion and facilitate an efficient transition from LILCO billing to LIPA billing. In addition, LIPA’s tariff includes the FPPCA, a PILOTS recovery rider, a rider providing for the recovery of costs associated with the Shoreham tax settlement (credits and rebates) and a rider providing for the RICO Credits (credits to the bills of customers as a result of the settlement by LILCO of a RICO action in connection with the construction and completion of nuclear generating facilities). The RICO Credits expired in May 2000.

The Act requires LIPA to make PILOTS for certain New York State and local revenue taxes that would otherwise have been imposed on LILCO. The PILOTS recovery rider allows for LIPA’s rate adjustments to accommodate the PILOTS.

For a discussion on the Shoreham tax settlement and Suffolk County matters see Note 11.

**Note 5. Utility Plant and Property and Equipment**

	<i>(in thousands)</i>	
	<b>December 31,</b>	
<b>Utility Plant consists of:</b>	<b>2001</b>	<b>2000</b>
Generation - nuclear	\$ 663,492	\$ 657,335
Transmission and distribution	1,705,112	1,573,076
Common	15,005	4,096
Construction work in progress	140,939	117,894
Nuclear fuel in process and in reactor	27,579	25,696
	<u>2,552,127</u>	<u>2,378,097</u>
Less - Accumulated depreciation and amortization	253,991	180,441
Total Net Utility Plant	<u>\$ 2,298,136</u>	<u>\$ 2,197,656</u>
	<b>2001</b>	<b>2000</b>
<b>Property and Equipment consists of:</b>		
Office equipment	\$ 1,204	\$ 870
Leasehold improvements	455	352
Office furniture	623	377
	<u>2,282</u>	<u>1,599</u>
Less - Accumulated depreciation and amortization	1,029	657
Total Net Property and Equipment	<u>\$ 1,253</u>	<u>\$ 942</u>



**Notes to Consolidated Financial Statements**

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**Note 6. Nine Mile Point Nuclear Power Station, Unit 2 (“NMP2”)**

LIPA has an undivided 18% interest in Nine Mile Point 2 Nuclear Power Station (“NMP2”), located in Scriba, New York which, until November 6, 2001, was operated by Niagara Mohawk Power Corporation (“NMPC”). On November 7, 2001, Constellation Nuclear LLC (“Constellation”) purchased 100% of the Nine Mile Point 1 Nuclear Power Station, and 82% of NMP2, with LIPA retaining its 18% interest in NMP2. Prior to the sale, the cotenants of NMP2 and their respective percentage ownership were as follows: LIPA (18%), NMPC (41%), New York State Electric & Gas Corporation (18%), Rochester Gas Electric Corporation (14%) and Central Hudson Gas & Electric Corporation (9%).

LIPA’s share of the rated capability of NMP2 is approximately 205 megawatts (“MW”). LIPA’s net utility plant investment, excluding nuclear fuel, was approximately \$613 million and \$630 million at December 31, 2001 and 2000, respectively. Generation from NMP2 and operating expenses incurred by NMP2 are shared by LIPA at its 18% ownership interest. LIPA is required to provide its share of financing for any capital additions to NMP2. Nuclear fuel costs associated with NMP2 are being amortized on the basis of the quantity of heat produced for the generation of electricity.

LIPA has entered into an amended and restated operating agreement for NMP2 with Constellation, which provides for a management committee comprised of one representative from each co-tenant. Constellation controls the operating and maintenance decisions of NMP2 in its role as operator. LIPA and Constellation have joint approval rights for the annual business plan, the annual budget and material changes to the budget. In addition to its involvement through the management committee, LIPA employs an on-site nuclear oversight consultant to provide additional support to protect LIPA’s interests.

**Nuclear Plant Decommissioning**

LIPA is making provisions for decommissioning costs for NMP2 based on a site-specific study performed in 1995. LIPA’s share of the total decommissioning costs for both the contaminated and non-contaminated portions 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, 2001 had an approximate value of \$33.1 million. LIPA established a separate decommissioning fund for its share of the non-contaminated portion of NMP2, which had a value at December 31, 2001 totaling approximately \$4.6 million. Through continued deposits and investment returns being maintained within these trusts, the Company believes that the value of these trusts will, in 2026, be sufficient to meet the Company’s decommissioning obligations.

**NMP2 Radioactive Waste**

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

## Notes to Consolidated Financial Statements

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### **Nuclear Plant Insurance**

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

The Price-Anderson Amendments Act mandates that nuclear power generators secure financial protection in the event of a nuclear accident. This protection must consist of two levels. The primary level provides liability insurance coverage of \$200 million (the maximum amount available) in the event of a nuclear accident. If claims exceed that amount, a second level of protection is provided through a retrospective assessment of all licensed operating reactors. Currently, this “secondary financial protection” subjects each of the 106 presently licensed nuclear reactors in the United States to a retrospective assessment of up to \$88.1 million for each nuclear incident, payable at a rate not to exceed \$10 million per year. LIPA’s interest in NMP2 could expose it to a maximum potential loss of \$15.9 million, per incident, through assessments of up to \$1.8 million per year in the event of a serious nuclear accident at NMP2 or another licensed U.S. commercial nuclear reactor. These assessments are subject to periodic inflation indexing and to a 5% surcharge if funds prove insufficient to pay claims.

Constellation has also procured \$500 million of primary nuclear property insurance and approximately \$2.25 billion of additional protection (including decontamination costs) in excess of the primary layer through the Nuclear Electric Insurance Limited (“NEIL”). Each member of NEIL, including LIPA, is also subject to retrospective premium adjustments in the event losses exceed accumulated reserves. For its share of NMP2, LIPA could be assessed up to approximately \$2.2 million per loss. This level of insurance is in excess of the NRC required minimum of \$1.06 billion of coverage.

LIPA has obtained insurance coverage from NEIL for the expense incurred in purchasing replacement power during prolonged accidental outages. Under this program, coverage would commence twelve weeks after any accidental outage, with reimbursement from NEIL at the rate of approximately \$553,000 per week for the purchase of replacement power with a maximum limit of \$13.9 million over a three-year period.

### **Other matters**

The Nuclear Regulatory Commission (“NRC”) issued a policy statement on the Restructuring and Economic Deregulation of the Electric Utility Industry (“Policy Statement”) in 1997. The Policy Statement addresses the NRC’s concerns about the adequacy of decommissioning funds and about the potential impact on operational safety and reserves. It gives the NRC the right, in highly unusual situations where adequate protection of public health and safety would be compromised, to consider imposing joint and several liability on minority co-owners when one or more co-owners have defaulted on their contractual obligations. On January 5, 1999, the NRC commenced review of a petition for rulemaking filed by a group of utilities which are non-operating joint owners of nuclear plants. These utilities requested that the enforcement provisions of the NRC regulations be amended to clarify NRC policy regarding the potential liability of joint owners if other joint owners become financially incapable of bearing their share of the burden for safe operation or decommissioning of a nuclear power plant. On July 25, 2000, the NRC denied the petition and reaffirmed its position recognizing joint and several regulatory responsibility on co-owners. The Authority is unable to predict how this ruling may ultimately affect the results of operations or financial position.

**Notes to Consolidated Financial Statements**

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**Note 7. Investments and Cash and Cash Equivalents**

Funds of the Authority are administered in accordance with the Authority’s investment guidelines pursuant to Section 2925 of the New York State Public Authorities Law. The Authority’s investments may also be required to conform with additional restrictions contained in financing documents. The Authority’s guidelines and any additional restrictions as required by financing documents comply with the New York State Comptroller’s investment guidelines for public authorities.

All investments of the Authority are held by designated custodians in the name of the Authority. Investments are reported at amortized cost, which approximates fair market value at December 31, 2001 and 2000. Investments with original maturities of less than 90 days are classified as cash and cash equivalents. Certain cash and cash equivalents and investments have been designated by the Authority’s Board of Trustees to be used for specific purposes such as rate stabilization, capital additions, debt repayment, the funding of credits in accordance with the Shoreham Settlement Agreement, and Clean Energy initiatives.

Cash deposits at banks were collateralized for amounts above the Federal Deposit Insurance Corporation (“FDIC”) limits with securities held by the custodian banks in the Authority’s name. The Authority is required to maintain compensating balances of approximately \$1 million.

Investments and cash and cash equivalents of the Authority at December 31, 2001 and 2000, are detailed below:

	<i>(in thousands)</i>	
	<b>December 31,</b>	
	<b>2001</b>	<b>2000</b>
Investments:		
Commercial Paper	\$ 178,720	\$ 102,105
Repurchase Agreement	102,473	174,969
U.S. Government/Agencies	38,310	-
Total investments:	<u>319,503</u>	<u>277,074</u>
Cash and cash equivalents:		
Money market mutual funds	196,850	45,832
Commercial paper	115,568	50,179
U.S. Government/Agencies	50,125	-
Master Notes	5,952	-
Demand deposits	371	1,839
Total cash and cash equivalents	<u>368,866</u>	<u>97,850</u>
<b>Total investments and cash and cash equivalents</b>	<u>\$ 688,369</u>	<u>\$ 374,924</u>

## Notes to Consolidated Financial Statements

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### Note 8. Debt

#### **The Authority**

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

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

#### **Electric System General Revenue Bonds**

##### Series 2001A

During the year ended December 31, 2001, the Authority issued Series 2001A Electric System General Revenue Bonds totaling \$300 million. These Bonds were issued for various capital purposes and to pay costs of issuance. This Series is comprised of Serial Bonds with maturities beginning September 1, 2013 and continuing through 2021 and Term Bonds with maturities beginning September 1, 2025 and continuing through 2029. These Bonds pay interest at a fixed rate every March 1 and September 1.

##### *Optional Redemption*

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

##### *Sinking Fund*

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

##### Series 2001 B through K

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

**Notes to Consolidated Financial Statements**

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

*Optional Redemption*

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

*Sinking Fund*

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

Series 2001 L through P

Also during the year ended December 31, 2001, the Authority issued Electric System General Revenue Bonds, Series L through P totaling \$316 million maturing on May 1, 2033. The proceeds of this issuance were used to refund \$300 million of the Authority’s Electric System Subordinated General Revenue Bonds consisting of Series 4 and a portion of Series 3, and to pay certain costs of issuance related to Series B through P.

Series M through P bear interest at an auction rate that the Auction Agent advises results from an auction conducted for each applicable auction period. The auction date and auction period for each Series as of December 31, 2001 is as follows:

<b>Series</b>	<b>Auction Date</b>	<b>Auction Period</b>	<b>Interest payment Date</b>
2001 M	Each Monday	Seven day	Each Tuesday
2001 N	Each Friday	Seven day	Each Monday
2001 O	Each fifth Monday	35 day	Each fifth Tuesday
2001 P	Each Thursday	Seven day	Each Friday

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

*Optional Redemption*

Series L Bonds are subject to redemption prior to maturity, at the option of the Authority on any date on and after May 1, 2011 in whole or in part from time to time, and in any order of maturity selected by the Authority, at a redemption price of par plus accrued interest. Each Series of the M through P Auction Rate

## Notes to Consolidated Financial Statements

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

### *Sinking Fund*

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

### Commercial Paper Notes

The Authority's Supplemental Bond Resolution authorizes the issuance of Commercial Paper Notes, Series CP-1 ("Notes") up to a maximum amount of \$300 million. The aggregate principal amount of the Notes outstanding at any time may not exceed \$300 million. As of December 31, 2001, the Authority had Notes outstanding totaling \$100 million. In connection with the issuance of the Notes, the Authority has entered into a Letter of Credit and Reimbursement Agreement, expiring on May 23, 2003. The Notes do not have maturity dates of longer than 270 days from their date of issuance and as Notes mature, the Authority continually replaces them with additional Notes. No Note can be issued with a maturity date after the expiration date of the Letter of Credit. The Letter of Credit agreement meets the conditions of a financing agreement that permits the Authority to refinance this short-term obligation on a long-term basis (the life of the Letter of Credit), and, therefore, the Commercial Paper Notes have been excluded from current liabilities.

### Series 2000A

During the year ended December 31, 2000, the Authority issued Series 2000A Electric System General Revenue Bonds totaling approximately \$325 million. These Bonds were issued to fund certain rebates and credits in accordance with the Shoreham Settlement Agreement, as more fully discussed in Note 11. These Bonds are comprised of tax-exempt Capital Appreciation Bonds with maturities beginning in June 2005 and continuing each year through 2029 and are not subject to optional redemption, mandatory sinking fund redemptions or any other redemption prior to maturity.

### Series 1998A

This Series is comprised of Current Interest and Capital Appreciation Bonds. The Current Interest Bonds include: (i) tax exempt Serial Bonds with maturities that began in December 1999 and continue each year through December 2016; and (ii) tax exempt Term Bonds with maturities beginning in December 2018 and a final maturity in December 2029. The Capital Appreciation Bonds are tax exempt bonds with maturities beginning in December 2003 continuing each year through December 2028. The Current Interest Bonds pay interest at a fixed rate every June 1 and December 1. During the year ended December 31, 2001 and 2000, the Company retired at maturity, with cash from operations, its 5.25% and 4.25% Serial Bonds totaling approximately \$49.9 million and its 4.1% Serial Bonds totaling approximately \$47.9 million, respectively.

### *Optional Redemption*

The 5.0% Serial Bonds due on December 1, 2014 (\$39.4 million) and the Serial and Term Bonds maturing on or after December 1, 2015 (except the Term Bonds maturing on December 1, 2029), which total \$207 million and \$1.4 billion, respectively, are subject to redemption prior to maturity, at the option of the Authority, at a price of 101% of the principal amounts on any date beginning on June 1, 2008 through May

## Notes to Consolidated Financial Statements

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31, 2009, or at 100.5% beginning on June 1, 2009 through May 31, 2010 or at 100% beginning June 1, 2010 through maturity, in whole, or in part from time to time, and in any order of maturity selected by the Authority. Interest accrued on such principal amount redeemed is added to the redemption price.

The Term Bonds maturing on December 1, 2029 (\$587.2 million) are subject to redemption prior to maturity, at the option of LIPA, on any date on and after June 1, 2003, in whole, or in part from time to time, at a redemption price of 101% of the principal amounts, together with the interest accrued on such principal amount to the redemption date.

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

### *Sinking Fund*

Certain Term Bonds are subject to redemption, in part, beginning on December 1, 2017 through December 1, 2029 at 100% of the principal amounts, plus accrued interest at the redemption date, from mandatory sinking fund installments which are required to be made in amounts sufficient to redeem such Bonds.

### Series 1998B

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

During the year ended December 31, 2001 and 2000, the Company retired at maturity, with cash from operations, Serial Bonds totaling approximately \$69.9 million and \$80 million, respectively.

### *Optional Redemption*

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

### *Sinking Fund*

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

Notes to Consolidated Financial Statements

Electric System Subordinated Revenue Bonds

Series 1 through 6

During the year ended December 31, 2001, the Authority remarketed or refinanced Series 1 through 6 as detailed below:

	<b>Outstanding at December 31, 2000</b>	<b>Remarketed</b>	<b>Refinancing Transactions</b>	<i>(in thousands)</i> <b>Outstanding at December 31, 2001</b>
Series 1	\$ 250,000	\$ (250,000)		\$ -
Series 2	250,000	(250,000)		-
Series 3	250,000	(200,000)	\$ (50,000)	-
Series 4	250,000		(250,000)	-
Series 5	250,000		\$ (250,000)	-
Series 6	250,000		(250,000)	-
<i>Issued: Electric System Subordinated Revenue Bonds</i>				
Series 1A		125,000		125,000
Series 1B		125,000		125,000
Series 2A		125,000		125,000
Series 2B		100,000		100,000
Series 2C		25,000		25,000
Series 3A		100,000		100,000
Series 3B		100,000		100,000
<i>Issued: Electric System Subordinated Revenue Bonds</i>				
Series 2001 L - P			316,000	316,000
Series 2001 B - K			500,000	500,000
	<u>\$ 1,500,000</u>	<u>\$ -</u>	<u>\$ 16,000</u> <u>\$ -</u>	<u>\$ 1,516,000</u>

\*The Authority used \$16 million to pay costs of issuance.

As a result of these transactions, the remaining outstanding Series consists of Series 1A through 3B. These Bonds are variable rate bonds payable from and secured by the Trust Estate subject to and subordinated to the Authority's Electric System General Revenue Bonds and are supported by letters of credit that expire on May 23, 2003. These Bonds are classified into various modes that determine the frequency that the interest rate is re-determined, the interest rate applied and the optional redemption features. Subseries 1A, 2A and 3A are currently Weekly Mode bonds, therefore, the applicable interest rate is re-determined on a weekly basis. Subseries 1B, 2B, 2C and 3B are currently Daily Mode, and as such, the interest rates are re-determined daily.

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



**Notes to Consolidated Financial Statements**

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A debt refinancing charge of approximately \$15.7 million resulted from these refundings/refinancings, representing unamortized issuance costs related to Series 1 through 6. In accordance with the provisions of GASB No. 23, the refinancing charge has been deferred and shown in the Statement of Financial Position as Deferred amortization within long term debt and is being amortized, on a straight line basis, over the life of the new debt or the old debt, whichever is shorter. The unamortized balance at December 31, 2001 totaled approximately \$15.5 million.

Series 7

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

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

*Optional and Mandatory Redemption*

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

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

Series 8 (Subseries A-H)

This Series is comprised of Current Interest Bonds issued as follows:

<b>This Series is Comprised of Subseries</b>	<b>Mandatory Purchase Date (April 1)</b>	<b>Maturity (April 1)</b>	<b>Principal Outstanding \$(000)</b>	<b>Interest Rate to Mandatory Purchase Date</b>
8A		2009	\$ 23,360	5.25%
8A		2009	2,500	4.13%
8B	2002	2009	27,300	4.00%
8C	2003	2010	27,300	4.00%
8D	2004	2010	27,300	4.50%
8E	2005	2011	27,300	4.50%
8F	2006	2011	27,300	5.00%
8G	2007	2012	27,300	5.00%
8H	2008	2012	27,200	5.00%

## Notes to Consolidated Financial Statements

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

During the year ended December 31, 2001, the Authority remarketed its Subseries 8A Bonds. Subseries 8A Bonds are in the Fixed Rate Mode and pay interest on April 1 and October 1 of each year through its maturity date.

The Authority also remarketed its Subseries 8B Bonds on its mandatory purchase date of April 1, 2002 and accordingly, such Bonds are not classified as current maturities of long term debt.

No Subseries of Series 8 is subject to optional redemption nor mandatory sinking fund redemption prior to its mandatory purchase date.

### **LIPA**

The LILCO debt assumed by LIPA as part of the Merger, consisted of \$1.186 billion of General and Refunding Bonds, ("G&R Bonds"), that were defeased by LIPA immediately upon the closing of the Merger, debentures totaling \$2.27 billion, and tax exempt debt totaling approximately \$915.7 million. As part of the Merger, KeySpan and LIPA executed Promissory Notes whereby KeySpan was obligated to LIPA for approximately \$1.048 billion of the assumed debt (the "Promissory Notes"). KeySpan is required to pay LIPA principal and interest on the Promissory Notes 30 days in advance of the date amounts are due to bond holders. The balance of the Promissory Notes between KeySpan and LIPA totaled \$602.4 million at December 31, 2001.

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

### *Bond Defeasance/Refundings*

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

### *General and Refunding Bonds*

On May 29, 1998, LIPA refunded all the G&R Bonds totaling \$1.186 billion by depositing \$1.190 billion in an irrevocable escrow deposit account to be invested in the direct obligations of the United States of America. The maturing principal of and interest on these obligations were sufficient to pay the principal and interest on the G&R Bonds, which were defeased on June 29, 1998. At December 31, 2001, approximately \$1.130 billion of the G&R Bonds, outstanding are considered defeased.

**Notes to Consolidated Financial Statements**

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

*Debentures*

In March 2000, LIPA deposited approximately \$58 million, that it generated from operations, in an irrevocable escrow deposit account to be invested in direct obligations of the United States of America. The Company has received certification from an independent verification agent that the maturing principal of and interest on these obligations will be sufficient to pay the principal and interest on the following debentures that LIPA assumed as part of the Merger, which includes the fair market value adjustment on the date of purchase (reflected at the Company’s carrying value).

<i>(in thousands)</i>		
Maturity	Interest Rate	Carrying Value
7/15/2001	6.250%	\$ 8,460
3/15/2003	7.050%	5,890
3/01/2004	7.000%	2,999
6/01/2005	7.125%	14,307
11/01/2022	9.000%	26,532

As a result of this defeasance, LIPA realized a gain on the early extinguishment of debt totaling approximately \$1.7 million.

*NYSERDA*s

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

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

*Deferred Amortization*

A debt refinancing charge of \$61.9 million resulted from the refundings that the Authority has undertaken between May 28, 1998 and December 31, 2000, primarily because of the difference between the amounts paid for refundings, including amounts deposited with the Escrow Agent, and the carrying amount of the G&R Bonds, Debentures and NYSERDA Notes. In accordance with the provisions of GASB No. 23,

**Notes to Consolidated Financial Statements**

approximately \$61.9 million was deferred and shown in the Statement of Financial Position as Deferred amortization within long term debt and is being amortized, on a straight line method, over the shorter of the life of the new debt or the old debt. The unamortized balance at December 31, 2001 and 2000 totaled \$28.1 million and \$37.2 million, respectively.

*Debt Maturity Schedule*

The total long-term debt maturing in each of the next five years ending December 31 is as follows: 2002, \$140.1 million; 2003, \$247.2 million; 2004, \$163.1 million; 2005, \$171.5 million, and 2006, \$208.9 million.

*Fair Values of Long-Term Debt*

The fair values of the Company’s long-term debt at December 31, 2001 and 2000 were as follows:

<i>Fair Value</i>	<i>(in thousands)</i>	
	<b>December 31, 2001</b>	<b>2000</b>
Electric System General Revenue Bonds, Series 1998 A	\$ 3,165,086	\$ 3,210,817
Electric System General Revenue Bonds, Series 1998 B	1,192,204	1,250,375
Electric System General Revenue Bonds, Series 2000 A	375,538	362,009
Electric System General Revenue Bonds, Series 2001 A	281,347	-
Electric System General Revenue Bonds, Series 2001 B through K	500,000	-
Electric System General Revenue Bonds, Series 2001 L through P	311,360	-
Electric System Subordinated Revenue Bonds, Series 1-3 & 1-6, respectively	700,000	1,500,000
Electric System Subordinated Revenue Bonds, Series 7	250,000	250,000
Electric System Subordinated Revenue Bonds, Series 8 (subseries A-H)	225,502	222,816
Electric System Commercial Paper Notes, CP-1	100,000	-
Debentures	279,261	278,100
NYSERDA Notes	338,412	324,874
<b>Total</b>	<b>\$ 7,718,710</b>	<b>\$ 7,398,991</b>

**Debt Covenants**

Certain debt agreements require the maintenance by the Company of certain financial ratios and contain other restrictive covenants. As of December 31, 2001, the Company has met all such requirements.

**Note 9. Retirement Plans**

The Authority participates in the New York State Employees’ Retirement System (the “System”), which is a cost-sharing, multi-employer, and public employee retirement system. The plan benefits are provided under the provisions of the New York State Retirement and Social Security Law that are guaranteed by the State Constitution and may be amended only by the State Legislation. For full time employees, membership in and annual contributions to the System are required by the New York State Retirement and Social Security Law. The System offers plans and benefits related to years of service and final average salary, and, effective July 17, 1998, all benefits generally vest after five years of accredited service.

## Notes to Consolidated Financial Statements

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

Under this plan, the Authority’s required contributions and payments made to the System were approximately \$114,000, \$82,000, and \$40,000 for the years ended December 31, 2001, 2000, and 1999, respectively. Contributions are made in accordance with funding requirements determined by the actuary of the System using the aggregate cost method.

The State of New York and the various local governmental units and agencies which participate in the Retirement System are jointly represented, and it is not possible to determine the actuarial computed value of benefits for the Authority on a separate basis. The New York State Employees' Retirement System issues a publicly available financial report. The report may be obtained from the New York State and Local Retirement Systems, A.E. Smith State Office Building, Albany, New York 12244.

### Note 10. Commitments

#### Existing Purchased Power and Transmission Agreements

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

With respect to contracts entered into with the IPPs, LIPA is obligated to purchase all the energy they make available to LIPA at prices that often exceed current market prices. However, LIPA has no obligation to the IPPs if they fail to deliver energy. For purposes of the table below, LIPA has assumed full performance by the IPPs, as no event has occurred to suggest anything less than full performance by these parties. The contracts with the IPPs expire on various dates through 2022.

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

Notes to Consolidated Financial Statements

Although LIPA has elected to convert its ETAs into TCCs, LIPA will continue to pay all transmission charges per the ETAs, which expire in 2020. In return, LIPA has the right to receive revenues from congestion charges. All such charges and revenue associated with the TCCs are considered components of or reductions to fuel costs, and as such are included in the FPPCA calculation.

The following table represents LIPA’s commitments under existing purchased power and transmission contracts:

*(in thousands)*

	NYPA Holtsville			Firm Transmission	IPPs*	Total Business*
	Debt Service	Other Fixed Charges	Energy*			
<b>For the years ended</b>						
2002	\$ 21,959	\$ 15,128	\$ 11,086	\$ 21,188	\$ 147,600	\$ 216,961
2003	22,051	15,497	12,622	21,237	150,900	222,307
2004	22,146	15,823	13,077	21,237	133,700	205,983
2005	22,246	16,157	12,621	21,237	120,900	193,161
2006	22,351	16,588	11,716	21,237	122,600	194,492
Subsequent thereto	149,146	130,727	98,956	552,162	759,300	1,690,291
<b>Total</b>	259,899	209,920	160,078	658,298	1,435,000	2,723,195
Less: Imputed interest	77,050	66,584	50,427	382,196	412,900	989,157
	<u>\$ 182,849</u>	<u>\$ 143,336</u>	<u>\$ 109,651</u>	<u>\$ 276,102</u>	<u>\$ 1,022,100</u>	<u>\$ 1,734,038</u>

\* Assumes full performance by NYPA and the IPPs.

**Additional Power Supplies**

In order to meet the anticipated needs and demands of the service area for the summer of 2002, the Authority, through its subsidiary LIPA, entered into agreements with four private companies to construct and operate ten generating units at six sites throughout the service area. LIPA has entered into power purchase agreements (“PPA”) with each of the companies for 100% of the capacity, and energy if needed, for the term of each PPA. The PPAs vary in duration from three to 25 years.

In accordance with accounting principles generally accepted in the United States of America, the PPAs are considered leases, and as such, will be accounted for in accordance with the provisions of SFAS No. 13, “Accounting for Leases.” Four of the leases, covering seven of the ten generating units, will be accounted for as capitalized lease obligations, whereas the remaining two leases, covering the other three generating units, will be accounted for as operating leases.

LIPA has also entered into a capital lease to construct and operate a submarine cable from Connecticut to Long Island. Under the terms of this agreement, LIPA will be entitled to up to 330 megawatts of firm transmission capacity.

**Notes to Consolidated Financial Statements**

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

The following is a schedule by year of future minimum lease payments under capital and operating leases, together with the present value of the net minimum lease payments. The minimum lease payments represent costs that LIPA will be obligated to pay as long as the facilities are in service and available to LIPA.

This schedule assumes a commercial operation date of July 1, 2002. Should the units not be completed as scheduled, LIPA may be entitled to liquidated damages, and the minimum lease payments, as identified below, would require adjustment.

<b>For the years ended December 31,</b>	<i>Amounts in thousands</i>	
	<b>Capital Leases</b>	<b>Operating Leases</b>
2002	\$ 42,558	\$ 12,481
2003	80,004	25,329
2004	78,410	25,271
2005	77,032	17,098
2006	75,739	-
Thereafter	1,051,461	-
Total minimum lease payments	\$ 1,405,204	\$ 80,179
Less: Amount representing interest	604,012	-
Present Value of Minimum Lease Payments	\$ 801,192	\$ 80,179

Provisions of certain of the agreements entered into as described above include incentives for meeting commercial operation dates. LIPA is contingently liable for such incentive payments totaling approximately \$19 million, which will be expensed as incurred.

**Notes to Consolidated Financial Statements**

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**Office lease**

In December 1996, the Authority entered into a non-cancelable office lease agreement for the period January 1, 1997 through January 31, 2003. In January 2001, the lease was amended to include additional premises. As a result of the amendments, the lease expiration date was changed to January 31, 2011. The future minimum payments under the lease are as follows:

<b>Years Ended December 31,</b>	<i>(in thousands)</i>
2002	\$ 1,156
2003	1,199
2004	1,243
2005	1,290
2006	1,338
Thereafter	6,001
	<u>\$ 12,227</u>

Rental expense for the office lease amounted to approximately \$988,000 and \$578,000 for the period ended December 31, 2001 and 2000, respectively.

**Note 11. Legal Proceedings**

**Shoreham Tax Matters**

Through November 1992, Suffolk County, Town of Brookhaven, Shoreham-Wading River Central School District, Wading River Fire District and Shoreham-Wading River Library District (which was succeeded by the North Shore Library District)(collectively, the “Suffolk Taxing Jurisdictions”), levied and received real estate taxes from LILCO on the Shoreham plant. When the Authority acquired the Shoreham plant in February 1992, it was obligated pursuant to the LIPA Act to make PILOTs on the Shoreham plant beginning in December 1992. As part of the agreement between LILCO and the Authority providing for the transfer of Shoreham to the Authority, LILCO agreed to fund these payments. Prior to the Merger, LILCO charged rates sufficient to make these payments to the Authority. Both LILCO and the Authority contested the assessments on the Shoreham plant, claiming the plant was overassessed.

On March 26, 1997, a judgment was entered in the Supreme Court, State of New York, Suffolk County, on behalf of LILCO against the Suffolk Taxing Jurisdictions ordering them to refund to LILCO property tax overpayments (resulting from over-assessments of Shoreham) in an amount exceeding \$868 million, including interest as of the date of the judgment. In addition, the judgment provides for the payment of post-judgment interest (the “Shoreham Property Tax Litigation”). The Court also determined that the Shoreham plant had a value of nearly zero during the period the Authority has owned Shoreham. This judgment was unanimously affirmed by the Appellate Division of the State of New York on July 13, 1998. Certain of the Suffolk Taxing Jurisdictions sought leave from the Appellate Division to appeal this judgment to the New York State Court of Appeals. Their applications were unanimously denied by the Appellate Division. New applications for leave to appeal were made to the Court of Appeals. On January 19, 1999, the Court of Appeals denied the motions. There is no further review in the New York State court system.



## Notes to Consolidated Financial Statements

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On January 11, 2000, the Authority, LIPA, and the Suffolk Taxing Jurisdictions entered into a Shoreham Settlement Agreement. Pursuant to the Shoreham Settlement Agreement, an amended judgment was filed, reducing the amount of the judgment and the Authority's PILOT claims to the greater of (i) \$620 million, plus interest, less the principal of the Shoreham Tax Settlement Bonds paid with the surcharge or (ii) the amount required to fully satisfy the Authority's remaining debt service and related obligations in connection with the Shoreham Tax Settlement Bonds. The amended judgment is enforceable by the Authority or LIPA in the event, among others, that any portion of the Shoreham Settlement Agreement is declared invalid or unenforceable.

In April 2000, an Article 78 proceeding was filed by the Town of Islip, its Supervisor and the Supervisors of three other townships, against the Authority, LIPA, the Suffolk Taxing Jurisdictions and the County of Nassau. The lawsuit seeks a judgment declaring illegal those provisions of the Shoreham Settlement Agreement providing for the repayment of certain tax certiorari judgments by imposition of a surcharge on electric rates. On August 18, 2000, the Authority submitted its papers in opposition to the petition. A hearing was held on October 5, 2000 in the Supreme Court, State of New York, Suffolk County. Supplemental memoranda of law were submitted on October 19, 2000. In a decision dated December 5, 2000, the Court held that to the extent the Shoreham Settlement Agreement imposes a surcharge on electric rates on Suffolk County ratepayers, the Settlement Agreement violates the Suffolk County Tax Act. The Suffolk County Tax Act provides that Suffolk County shall pay the full amount of a tax judgment against Suffolk County and the other affected municipalities and shall recover from such other affected municipalities their share of the judgment. Defendants have filed notices of appeal, briefs have been filed and the appeal was argued on March 7, 2002. In the event the Authority is unable to collect the surcharge imposed on the electric rates of Suffolk County ratepayers, the Shoreham Property Tax Settlement Agreement provides, among other things, that the Authority may proceed to collect the amended judgment.

### Merger Matters

LIPA was named as a defendant in an action brought by the County of Suffolk in the Supreme Court of the State of New York, challenging the \$67 million in compensation received by certain former LILCO officers in connection with the closing of the Brooklyn Union merger with LILCO and the Authority's acquisition of the common stock of LILCO. This action was voluntarily discontinued by plaintiffs without prejudice. The plaintiffs refiled their claims related to executive compensation in federal court, where they were consolidated with an existing action entitled The County of Suffolk, et al. v. Long Island Power Authority, et al., as set forth below.

On September 28, 1998, Suffolk County and the Towns of Huntington and Babylon (collectively, the "Plaintiffs") brought a class action on behalf of themselves and all electric utility ratepayers in Suffolk County (the "Ratepayers") against the Authority, LIPA, KeySpan and others in the United States District Court for the Eastern District of New York entitled County of Suffolk, et al. v. Long Island Power Authority, et al. (the "Huntington Lawsuit"). The Huntington Lawsuit alleged that (i) LIPA and the Authority failed to refund alleged capital gains directly to Ratepayers as a result of the Merger, unlawfully depriving Ratepayers of their property under federal and state constitutional provisions and (ii) LIPA failed to refund to Ratepayers certain deferred tax reserves carried on LILCO's books at the time of the Merger, unjustly enriching KeySpan. An amended complaint was filed and served on or about January 5, 1999. Pursuant to the Shoreham Settlement Agreement, in May 2000, Suffolk discontinued its claims against all defendants with prejudice. KeySpan and the Authority filed motions to dismiss the complaint for failure to state a claim. On December 3, 1999, the court declined to consider KeySpan's motion to dismiss and defendants moved for summary judgment on or about December 13, 1999. By order dated August 14,

## Notes to Consolidated Financial Statements

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2000, the United States District Court granted the motions to dismiss the complaint. Plaintiffs filed a motion to reargue, which was denied. Plaintiffs have prosecuted an appeal with the Second Circuit Court of Appeals. Oral argument was heard on June 1, 2001. By order dates June 5, 2001, the Second Circuit affirmed the dismissal of the lawsuit. This proceeding is thus concluded.

### **Environmental**

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

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

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

### Environmental Matters Retained by LIPA

*Long Island Sound Transmission Cables.* The Connecticut Department of Environmental Protection (“DEP”) and the New York State Department of Environmental Conservation (“DEC”) separately have issued Administrative Consent Orders (“ACOs”) in connection with releases of insulating fluid from an electric transmission cable system located under the Long Island Sound. The ACOs require the submission of a series of reports and studies describing cable system condition, operation and repair practices, alternatives for cable improvements or replacement, and environmental impacts associated with prior leaks of fluid into the Long Island Sound. Compliance activities associated with the ACOs are ongoing.

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

*Superfund Sites.* Under Section 107(a) of the federal Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”, also commonly referred to as the “Superfund Legislation”), parties who generated or arranged for disposal of hazardous substances are liable for costs incurred by the

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Environmental Protection Agency (“EPA”) in responding to a release or threat of release of the hazardous substances.

*Metal Bank.* In December 1997, the EPA issued its Record of Decision (“ROD”), in connection with the remediation of a licensed disposal site located in Philadelphia, Pennsylvania, and operated by Metal Bank of America. In the ROD, the EPA estimated that the present worth cost of the selected remedy for the site is \$17.3 million. In June 1998, the EPA issued a unilateral administrative order to 13 Potential Responsible Parties (“PRPs”), including LIPA, for the remedial design and for remedial action at the site. LIPA cannot predict with reasonable certainty the actual cost of the selected remedy, who will implement the remedy, or the cost, if any, to LIPA. Under a PRP participation agreement, LIPA is responsible for 7.95% of the costs associated with implementing the remedy. LIPA has recorded a liability equal to its estimated cost representing its estimated share of the additional cost to remediate this site. The case is scheduled for trial in August 2002.

*PCB Treatment Inc.* LILCO has also been named a PRP for disposal sites in Kansas City, Kansas and Kansas City, Missouri. The two sites were used by a company named PCB Treatment, Inc. from 1982 until 1987 for the storage, processing, and treatment of electric equipment, oils and other materials containing Polychlorinated Biphenyls (“PCBs”). According to the EPA, the buildings and certain soil areas outside the buildings are contaminated with PCBs. Certain of the PRPs, including LILCO and several other utilities, formed a group, signed a consent order, and have developed a work plan for investigating environmental conditions at the site. The EPA provided LILCO with documents indicating that LILCO was responsible for less than 1% of the materials that were shipped to this site and is a de minimis PRP. LIPA is currently unable to determine its share of the cost to remediate these sites.

*Mattiace Petrochemical Site.* This site in Glen Cove operated as a bulked and drummed solvent retailer from the 1960s until 1987, and as a drum reconditioning facility from 1974 through June 1983. In 1988, EPA began remediating the heavily contaminated soil found at the site. LIPA was identified as a PRP by the EPA for LILCO’s distribution of empty drums that may have contained solvent residues for reconditioning at the site and for the purchase of solvents during the 1980s. EPA is seeking to settle this matter with approximately 80 targeted PRPs for \$1.3 million in discounted past remediation costs and \$15 million in anticipated present value future remediation costs. LIPA’s share of these costs is estimated at 3.6% based upon present allocations. A Joint Defense Group consisting of approximately 20 identified PRPs has been formed, of which LIPA is a member, and is actively negotiating a settlement with EPA.

### Environmental Matters Which May Be Recoverable From LIPA By KeySpan Through The PSA

*Asharoken.* In March 1996, the Village of Asharoken (the "Village") filed a lawsuit against LILCO in the New York Supreme Court, Suffolk County (*Incorporated Village of Asharoken, New York, et al. v. Long Island Lighting Company*). After negligence claims were dismissed the Village is currently seeking injunctive relief based upon a theory of nuisance in connection with the LILCO design and construction of the Northport Power Plant which the Village alleges upset the littoral drift, thereby causing beach erosion. The case is currently on trial. In March 2002, 132 additional plaintiffs sued seeking monetary damages and injunctive relief. This case is pending before the same judge. The liability, if any, resulting from these proceedings cannot yet be determined. However, LIPA does not believe that these proceedings will have a material adverse effect on its financial position, cash flows or results of operations.

### Environmental Matters Which Are Currently Untraceable For Which LIPA Could Have Responsibility

*Other Superfund Sites.* DEC has notified LILCO, pursuant to the New York State superfund program, that LIPA may be responsible for the disposal of hazardous substances at the Huntington/East Northport Site, a

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municipal landfill property. The estimated response cost for remediating this site is \$19.1 million. LIPA is currently unable to determine its share, if any, of the costs to investigate and remediate this site.

The EPA notified LILCO that LIPA may be responsible for the disposal of hazardous substances at the Port Washington Landfill, another municipal landfill property. The EPA and the Attorney General of the State of New York are pursuing remediation. The cleanup cost for this site is estimated at \$45 million. LIPA is currently unable to determine its share of costs to investigate and remediate this site. LIPA has entered into a tolling agreement with the Attorney General to allow for further investigation regarding this matter.

### **Other Matters**

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

### **Note 12. Subsequent Events**

#### **Generation Purchase Right Agreement (“GPRA”)**

The Authority and KeySpan executed an agreement in June 1997, whereby the Authority secured the right to purchase the interests in the KeySpan subsidiary that owns the on-island generation assets formerly owned by LILCO. Under the terms of the original agreement, the Authority had to exercise such right during the 12-month period that began on May 28, 2001. In March 2002, the Authority and KeySpan entered into an agreement amending the exercise period of the GPRA to November 2004 through May 2005. In consideration for providing this extension, KeySpan has been provided with a corresponding extension of 31 months for the Management Services Agreement.