LONG ISLAND POWER AUTHORITY

(A Component Unit of The State of New York)

Basic Financial Statements

December 31, 2004 and 2003

(With Independent Auditors' Report Thereon)

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

Basic Financial Statements

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Independent Auditors' Report

The Board of Trustees
Long Island Power Authority:

We have audited the balance sheets, statements of revenues, expenses, and changes in net assets, and statements of cash flows of the Long Island Power Authority (Authority), a component unit of the State of New York, as of and for the years then ended December 31, 2004 and 2003, which collectively comprise the Authority's basic financial statements. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Authority as of December 31, 2004 and 2003, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 21, 2005 on our consideration of the Authority's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope and of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis on pages 2 through 12 is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

March 21, 2005

Overview of the Financial Statements

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

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

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

The following is a summary of the Authority's financial information for 2004, 2003, and 2002 (thousands of dollars):

Balance Sheet Summary

	December 31 2004	2003	2002
Assets:			
Current assets:			
Cash, cash equivalents and investments	$ 412,968	$ 417,987	$ 610,326
Other current assets	369,636	328,929	319,294
Noncurrent assets:			
Utility plant, net	3,540,103	3,390,387	3,041,699
Promissory notes receivable	155,425	155,425	605,247
Nonutility property and other investments	120,213	72,192	75,324
Deferred charges	180,149	120,102	110,053
Regulatory assets	876,357	957,540	693,082
Acquisition adjustment, net	3,192,620	3,305,300	3,417,981
Total assets	$ 8,847,471	$ 8,747,862	$ 8,873,006
Liabilities and net assets:			
Current liabilities	$ 765,504	$ 802,228	$ 764,418
Noncurrent liabilities:			
Long-term debt	6,865,277	6,835,943	7,267,657
Capital lease obligation	772,800	721,630	538,619
Other noncurrent liabilities	412,270	376,441	313,565
Total liabilities	8,815,851	8,736,242	8,884,259
Net assets (deficit):			
Capital assets net of related debt	(634,292)	(566,082)	(583,359)
Unrestricted	665,912	577,702	572,106
Total net assets (deficit)	31,620	11,620	(11,253)
Total liabilities and net assets	$ 8,847,471	$ 8,747,862	$ 8,873,006

(Continued)

Summary of Revenues, Expenses, and Changes in Net Assets

	Year ended December 31		
	2004	2003	2002
Electric revenue	$ 2,853,837	$ 2,583,603	$ 2,459,210
Operating expenses:			
Operations – fuel and purchased power	1,386,907	1,076,969	924,778
Operations and maintenance	691,937	733,655	767,217
General and administrative	40,962	44,875	49,780
Depreciation and amortization	229,316	230,085	220,654
Payments in lieu of taxes	215,312	213,382	218,156
Total operating expenses	2,564,434	2,298,966	2,180,585
Operating income	289,403	284,637	278,625
Other income, net	47,248	53,988	52,204
Interest charges	(316,651)	(318,625)	(310,717)
Change in net assets before cumulative effect of change in accounting principle	20,000	20,000	20,112
Cumulative effect of change in accounting principle	—	2,873	—
Change in net assets	20,000	22,873	20,112
Net assets (deficit) – beginning of year	11,620	(11,253)	(31,365)
Net assets (deficit) – end of year	$ 31,620	$ 11,620	$ (11,253)

Excess of Revenues over Expenses

The revenues in excess of expenses for the twelve months ended December 31, 2004, 2003, and 2002 were $20 million.

Revenue

Revenue for the year ended December 31, 2004, increased approximately $270 million when compared to the similar period in 2003. The increase is primarily attributable to system load growth totaling $24 million, higher recoveries of excess fuel costs totaling $239 million, and the impact of the August 2003 blackout which caused a revenue loss in 2003 estimated at $7 million. Weather is estimated to have positively affected revenue by $1 million relative to the weather experienced in 2003. Such increases were partially offset by lower nonsystem revenue of approximately $1 million.

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

Fuel and Purchased Power Costs

LIPA's tariff includes a fuel recovery provision — the Fuel and Purchased Power Cost Adjustment (FPPCA). During 2003, the FPPCA was modified to allow LIPA to recover from customers amounts incurred for fuel and purchased power beyond those included in base rates (Excess Fuel Costs) in the period incurred, as opposed to a deferral method. This modification was fully implemented on January 1, 2004, and accordingly, in 2004. LIPA recovered an amount of Excess Fuel Costs necessary to achieve revenue in excess of expenses of $20 million annually.

Effective with the Board's adoption of the 2004 budget in mid-February, the FPPCA surcharge was increased by an annual rate of 4.5% and, as a result of the continuing increases in fuel and purchased power costs, the Authority increased the surcharge by an additional annual rate of 5.0% effective June 8, 2004, and by another 1.0% effective October 1, 2004. These increases were necessary to comply with the modified FPPCA mechanism to ensure the $20 million of excess revenue over expenses by year-end.

During the year ended December 31, 2004, approximately $425 million of current year Excess Fuel Costs were billed to customers through the FPPCA, and no amounts were deferred for future recovery. During the year ended December 31, 2003, approximately $74 million of current year Excess Fuel Costs had been billed to customers through the FPPCA, and approximately $365 million was deferred for collection over the 10-year period that began January 1, 2004.

For the year ended December 31, 2004, fuel and purchased power expense increased approximately $310 million. This increase is due in part to higher recoveries of excess fuel costs totaling $239 million, higher sales volumes of approximately $6 million, and higher currently recognized fuel costs totaling approximately $65 million. Of the remaining excess fuel costs, LIPA applied $36 million of previously deferred credits (amounts owed to customers) to mitigate the impact of future surcharges.

After eliminating the accounting effects of the FPPCA, fuel and purchased power costs in 2004 increased by approximately $94 million when compared to the year ended December 31, 2003. Approximately $6 million is attributable to increased sales for the 2004 period compared to 2003, and the balance is attributable to increased fuel and purchased power prices.

For the year ended December 31, 2003, fuel and purchased power expense increased approximately $152 million. This increase is primarily the result of higher recoveries of excess fuel costs totaling approximately $96 million, higher sales volumes of approximately $35 million, lower credits derived from derivative transactions totaling approximately $18 million, and lower credits resulting from off-system sales profits totaling approximately $3 million.

After eliminating the effects of the FPPCA, fuel and purchased power costs in 2003 increased by approximately \$327 million when compared to the year ended December 31, 2002. Approximately \$35 million is attributable to increased sales for the 2003 period compared to 2002, and the balance is attributable to increased fuel and purchased power prices.

Operations and Maintenance Expense (O&M)

O&M decreased approximately \$42 million for the year ended December 31, 2004, compared to the similar period in 2003 primarily due to lower MSA costs totaling approximately \$19 million, lower clean energy expenses totaling approximately \$9 million, one-time recognition in 2003, of LIPA's \$5 million contribution to the Shoreham bill credits as required by the Shoreham Property Tax Settlement Agreement (LIPA had no such funding in 2004), lower storm cost accruals totaling approximately \$12 million and lower costs associated with renting temporary emergency stand-by generators totaling approximately \$1 million. Partially offsetting these decreases was increased customer accounts expenses of approximately \$2 million, and \$2 million related to the settlement of the Cross Sound Cable dispute.

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

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

General and Administrative Expenses (G&A)

General and administrative expenses decreased for the year ended December 31, 2004, approximately \$4 million due primarily to decreased consulting costs related to forensic auditing services of approximately \$3 million. The remaining decrease is due to lower insurance costs totaling approximately \$1 million.

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

Depreciation and Amortization

For the year ended December 31, 2004, depreciation and amortization decreased approximately \$1 million. During 2003, an adjustment totaling approximately \$6 million was recognized in conjunction with the adoption of the accounting for asset retirement obligations. Partially offsetting that decrease of \$6 million is higher utility plant balances in 2004 when compared to 2003 resulting in approximately \$5 million higher depreciation expense.

For the year ended December 31, 2003, depreciation and amortization increased approximately $9 million when compared to the similar period of 2002. Approximately $6 million of that increase is related to an adjustment to nuclear decommissioning accruals resulting from the adoption of the accounting for asset retirement obligations. The remaining increase is due to higher utility plant balances in 2003 when compared to 2002.

Payments in Lieu of Taxes

For the year ended December 31, 2004, payments in lieu of taxes (PILOTs) increased approximately $2 million due to increased property taxes totaling approximately $6 million. This increase was partially offset by decreased revenue taxes (due to lower tax rates) totaling approximately $4 million.

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

Other Income, Net

For the year ended December 31, 2004, other income decreased approximately $7 million. This decrease was the result of lower investment income of approximately $2 million due to lower investment balances, and lower emissions credit income totaling approximately $9 million. These decreases were partially offset by interest received on New York Independent System Operator (NYISO) prior months' re-bills totaling approximately $3 million and higher carrying charges of approximately $1 million on the Shoreham property tax settlement regulatory asset.

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

Interest Charges and Credits

For the year ended December 31, 2004, interest charges and credits decreased approximately $2 million resulting from lower carrying charge expenses on deferred credits and lower deferred loss amortizations totaling approximately $7 million. This decrease was partially offset by higher interest on long term debt totaling approximately $3 million, due to higher average debt outstanding, and further offset by lower credits from allowance for borrowed funds used during construction (AFC) of approximately $2 million, due to lower construction work in progress balances in 2004 compared to 2003.

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

Cash, Cash Equivalents, and Investments

The Authority's cash, cash equivalents, and investments totaled approximately $413 million, $418 million and $610 million at December 31, 2004, 2003, and 2002, respectively. The decrease from 2003 to 2004 is primarily the result of higher fuel and purchased power costs. The decrease from 2002 to 2003 is primarily the result of higher payments related to fuel and purchased power costs (most of which was deferred for future recovery) and funding capital expenditures with cash from operations. The Authority has maintained a $250 million balance in its Rate Stabilization Fund.

Capital Assets

During 2004 two new generating facilities were constructed on Long Island by separate entities, with a combined capacity of approximately 96MW. Each of these facilities began supplying capacity and energy to LIPA in accordance with the terms of Power Purchase Agreements (PPA's) negotiated in 2003. Under the terms of the first agreement, LIPA receives 100% of the output from the newly constructed generating unit for a term of 13 years. The agreement contains two optional renewal periods of five years each. This lease qualifies for capitalization under Statement of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases*, and has been included in both Utility Plant and Capital Lease Obligations. The second agreement provides LIPA with 10MW of the capacity and energy from a separate facility for a period of 30 years. This lease did not qualify for capitalization.

During 2003 the Authority began taking capacity and energy under two 15-year Power Purchase Agreements (PPA's), each for 100% of the output from two newly constructed generating units with a total capacity of approximately 88MW, which were completed prior to the summer of 2003. Each of these PPA's qualified as capital leases under Statement of Financial Accounting Standards (SFAS) No. 13, *Accounting for Leases*, and is included in both Utility Plant and Capital Lease Obligations.

Costs incurred under the PPAs, whether capitalized or not, are includible in fuel and purchased power costs in the period incurred, in accordance with the FPPCA.

For additional information on power purchase agreements, see footnote 11 of notes to basic financial statements.

The Authority also continued its program of strategic investment in transmission and distribution upgrades to improve reliability and to enhance capacity needed to meet growing customer demands. For the years ended December 31, 2004, and 2003, capital improvements totaled $208 million and $202 million, respectively. These improvements included the replacement or upgrade of transformer banks and circuit breakers, new substations, enhanced transmission lines and upgraded command and control equipment.

Promissory Notes Receivable

The KeySpan Energy Corporation ("KeySpan") note decreased significantly in 2003 as the Authority called for redemption its $270 million Long Island Lighting Company Debentures, 8.2% Series due 2023, and its NYSERDA financing notes, totaling approximately $177 million, with varying maturity dates between 2019 and 2022. Funding for these redemptions, including interest to the date of redemption and call premiums, was provided by KeySpan in accordance with the terms of a promissory note to LIPA.

Regulatory Assets

Regulatory assets decreased approximately $81 million from December 31, 2003 to December 31, 2004. The decrease is the result of (i) the recovery of a portion of the 2003 deferred Excess Fuel Costs totaling approximately $36 million (the remainder to be collected over a 9-year period in accordance with LIPA's tariff), (ii) the decrease in the deferred unrealized gains or losses on LIPA's fuel hedges totaling approximately $41 million and (iii) the scheduled recovery of approximately $35 million related to the Shoreham Property Tax Settlement Agreement through a surcharge on billings for electric service to customers residing in Suffolk County (the Shoreham surcharge), which began in June 2003 (as discussed in greater detail in note 3 of notes to basic financial statements); offset by the additional carrying charges on the Shoreham Property Tax Settlement Agreement related credits totaling approximately $31 million.

Regulatory assets increased approximately $265 million from December 31, 2002 to December 31, 2003. The increase is the result of (i) the issuance of Shoreham Property Tax Settlement Agreement related credits totaling approximately $20 million, additional carrying charges related to the balance of the Shoreham Property Tax Settlement Agreement totaling approximately $30 million, offset by the scheduled recovery of approximately $19 million through the Shoreham surcharge, which began in June 2003 and (ii) 2003 deferred Excess Fuel Costs totaling approximately $365 million, to be recovered over the 10-year period which began January 1, 2004, in accordance with LIPA's tariffs; offset by (iii) the recovery of 2002 deferred Excess Fuel Costs totaling approximately $130 million.

Capitalization

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

Capitalization
(Thousands of dollars)

	Balance at December 31		
	2004	2003	2002
General Revenue Bonds	$ 5,966,549	$ 5,900,544	$ 5,646,894
Subordinated Revenue Bonds	962,345	989,645	1,165,518
Commercial Paper Notes	100,000	100,000	100,000
NYSERDA Notes	155,420	155,420	332,425
Debentures	—	—	270,000
	$ 7,184,314	$ 7,145,609	$ 7,514,837

During 2004, the Authority issued $200 million Electric System General Revenue Bonds, Series 2004A. The issuance consists of $33.9 million of Serial bonds and $166.1 million of Term bonds. The Serial bonds have maturities that begin in 2013 and continue each year through 2025. Interest rates on the Serial bonds range from 3.8% to 4.875%. The Term bonds have maturities of $64.9 million in 2029, $12.4 million in 2032, and $88.8 million in 2034. Interest rates on the Term bonds are 5.0% and 5.1%. The purpose of these bonds was to reimburse LIPA's treasury for capital projects funded previously with cash from operations, and to provide funding for future capital spending.

In addition, long-term debt decreased as a result of the scheduled maturities of approximately $186 million, partially offset by the accretion of the capital appreciation bonds totaling $25 million.

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

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

The Authority's Supplemental Bond Resolution authorizes the issuance of Commercial Paper Notes, Series CP-1 (the CP-1 Notes) up to a maximum amount of $300 million. In May 2003, the Authority replaced the existing CP Credit Facility securing the CP-1 Notes and re-designated its Commercial Paper Notes into Series CP-1, CP-2, and CP-3. The three substitute CP Credit Facilities have an aggregate principal of $200 million and are supported by a Letter of Credit and Reimbursement Agreement dated May 1, 2003, which expires June 15, 2006. Unless and until additional letters of credit are delivered, the aggregate principal amount of the Commercial Paper Notes will be limited to $200 million. As of December 31, 2004 and 2003, the Authority had Notes outstanding totaling $100 million, leaving $100 million undrawn liquidity available.

Investment Ratings

The Authority's securities are rated by Standard and Poor's Corporation (S&P), Moody's Investors Service (Moody's), and Fitch Investors Services, LP (Fitch). The ratings as of March 1, 2005, which reflect an upgrade by Moody's in 2005, are below:

Investment Ratings

	Moody's	Standard & Poors	Fitch
Senior Lien Debt	A3	A-	A-

- Certain Senior and all Subordinated Lien debt and the Commercial Paper Notes are supported by either a Letter of Credit (LOC) or are insured. Such debt carries the ratings of the LOC syndicate or insurance company, not that of the Authority.

Risk Management

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

Whenever the Authority enters into a transaction to mitigate risk, it becomes exposed to an event of nonperformance by the counterparty. To limit its exposure to such risk, the Authority will only enter into derivative transactions with counterparties that have a credit rating of "investment grade" or better. For commodity derivatives the Authority requires collateral for mark to market values above an established credit limit for each counterparty.

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

Fuel and purchased power transactions: – The Authority uses derivative financial instruments to protect its customers from market price fluctuations for the purchase of fuel oil, natural gas, and electricity. These instruments are recorded at their market value. Any unrealized gains and losses are deferred until realized, in accordance with the modifications to the FPPCA. Upon realization, such gains and losses will be reflected in income and considered in the determination of the FPPCA. At December 31, 2004 and 2003, the Authority had unrealized gains (losses) on commodity derivatives of approximately $24 million and ($17) million, respectively.

Interest rate transactions: – During 2004, the Authority entered into a basis swap with three counterparties for a notional amount of approximately $1 billion under terms that require LIPA to pay the counterparties the Bond Market Association (BMA) Index in exchange for a fixed percent of LIBOR. This agreement became effective July 1, 2004, and continues through August 15, 2033. Under the terms of the agreement, LIPA received, on June 28, 2004, an up front premium of $35 million which is being amortized as an interest rate modifier over the life of the agreement.

The Authority also entered into two fixed-to-floating rate swap agreements, each with a notional amount of approximately $101 million. Under the terms of these identical agreements, LIPA pays a floating rate equal to the BMA index, and receives a fixed rate of interest. The agreements became effective July 1, 2004, and are co-terminus with the underlying securities, the last of which matures September 1, 2016. These agreements are cancelable by the counterparties on July 1, 2007.

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

(Continued)

In February 2003, UBS AG exercised its option to hedge the call feature of the Authority's $587 million Electric System General Revenue Bonds, Series 1998A, 5.50% maturing in 2029. In exchange for the option, the Authority received an upfront option premium of $82 million plus administrative costs totaling approximately $24.4 million. As a result of the exercise of the option, the Authority issued $587 million Electric System General Revenue Bonds, Series D through O, variable rate bonds, in order to call its 1998A 5.50% Electric System General Revenue Bonds. In exchange for the upfront premium, the Authority received a floating-to-fixed interest rate swap on its variable rate bonds. The $106 million premium the Authority received is being amortized as an interest rate modifier over the life of the variable rate debt.

In accordance with SFAS No. 133, *Accounting for Derivatives and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, the Authority marked-to-market its swap transactions at December 31, 2004 and 2003, and recorded unrealized gains and losses. These gains and losses have been deferred, and will be charged to expense when realized.

Other Power Supply

During 2004, the Authority entered into several agreements for capacity and energy necessary to continue to satisfy the increasing energy demand of Long Island, while increasing the diversity of its fuel mix alternatives. These contracts are for: i) 100% of the output from two newly constructed facilities with total combined capacity of approximately 160MW, to be commercially operational by the summer of 2005, and ii) the construction and installation of a submarine cable to connect Long Island to the power supplies of the PJM Interconnection, to be commercially operational by the summer of 2007. In addition, the Authority has entered into negotiations for the construction and operation of a 350MW (LIPA's allocation is approximately 300MW) combined cycle gas fired facility on Long Island, to be commercially operational by the summer of 2009, and for a 140MW off-shore wind farm with a targeted commercial operation date of 2008.

Contacting the Long Island Power Authority

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

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

Balance Sheet

December 31, 2004 and 2003

(Dollars in thousands)

Assets	**2004**	**2003**
Current assets:		
Cash and cash equivalents	$ 335,068	$ 219,095
Investments	77,900	198,892
Accounts receivable (net of allowance for doubtful accounts of $19,635 and $19,485, respectively)	274,184	235,732
Other accounts receivable	11,344	24,978
Fuel inventory	66,948	54,651
Material and supplies inventory	7,128	7,130
Interest receivable	300	602
Prepayments and other current assets	9,732	5,836
Total current assets	782,604	746,916
Noncurrent assets:		
Utility plant and property and equipment, net	3,540,103	3,390,387
Promissory notes receivable:		
KeySpan Energy	155,425	155,425
Total promissory notes receivable	155,425	155,425
Nonutility property and other investments	120,213	72,192
Deferred loss related to nonfuel derivatives	86,177	39,671
Deferred charges	93,972	80,431
Regulatory assets:		
Shoreham property tax settlement	572,101	575,660
Fuel and purchased power costs recoverable	304,256	381,880
Total regulatory assets	876,357	957,540
Acquisition adjustment (net of accumulated amortization of $902,891 and $790,211, respectively)	3,192,620	3,305,300
Total assets	$ 8,847,471	$ 8,747,862

See accompanying notes to basic financial statements.

Liabilities and Net Assets		2004		2003
Current liabilities:				
Short-term debt	$	100,000	$	100,000
Current maturities of long-term debt		193,630		186,380
Current portion of capital lease obligation		89,552		80,073
Accounts payable and accrued expenses		275,054		329,971
Accrued payments in lieu of taxes		38,082		38,552
Accrued interest		44,465		42,000
Customer deposits		24,721		25,252
Total current liabilities		765,504		802,228
Noncurrent liabilities:				
Long-term debt		6,865,277		6,835,943
Capital lease obligation		772,800		721,630
Asset retirement obligation		68,320		64,452
Deferred credits		85,323		130,196
Deferred credits – financial derivatives		228,126		151,737
Deferred gain – financial derivatives		10,410		8,575
Claims and damages		20,091		21,481
Commitments and contingencies (note 11)				
Total noncurrent liabilities		8,050,347		7,934,014
Net assets (deficit):				
Invested in capital assets net of related debt		(634,292)		(566,082)
Unrestricted		665,912		577,702
Total net assets		31,620		11,620
Total liabilities and net assets	$	8,847,471	$	8,747,862

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

Statement of Revenues, Expenses, and Changes in Net Assets

Years ended December 31, 2004 and 2003

(Dollars in thousands)

	2004	2003
Operating revenues – electric sales	$ 2,853,837	$ 2,583,603
Operating expenses:		
Operations – fuel and purchased power	1,386,907	1,076,969
Operations and maintenance	691,937	733,655
General and administrative	40,962	44,875
Depreciation and amortization	229,316	230,085
Payments in lieu of taxes	215,312	213,382
Total operating expenses	2,564,434	2,298,966
Operating income	289,403	284,637
Nonoperating revenues and expenses:		
Other income, net:		
Investing income	7,362	9,501
Carrying charges on regulatory asset	31,577	30,481
Other	8,309	14,006
Total other income, net	47,248	53,988
Interest charges and (credits):		
Interest on long-term debt, net	298,764	295,958
Other interest	20,110	27,576
Allowance for borrowed funds used during construction	(2,223)	(4,909)
Total interest charges	316,651	318,625
Total nonoperating revenues and expenses	(269,403)	(264,637)
Change in net assets before cumulative effect of change in accounting principle	20,000	20,000
Cumulative effect of change in accounting principle	—	2,873
Change in net assets	20,000	22,873
Total net assets (deficit), beginning of year	11,620	(11,253)
Total net assets, end of year	$ 31,620	$ 11,620

See accompanying notes to basic financial statements.

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

Statement of Cash Flows

Years ended December 31, 2004 and 2003

(Dollars in thousands)

	2004	2003
Cash flows from operating activities:		
Received from customers for the system sales, net of refunds	$ 2,896,658	$ 2,619,232
Other operating revenues received	28,750	36,024
Paid to suppliers and employees:		
Operations and maintenance	(781,617)	(825,695)
Fuel and purchased power	(1,398,626)	(1,280,133)
Payments in lieu of taxes	(304,004)	(294,017)
Net cash provided by operating activities	441,161	255,411
Investing activities:		
Net sales (purchases) of investment securities	120,992	(80,552)
Earnings received on investments	5,773	8,406
Other	3,371	8,521
Net cash provided by (used in) investing activities	130,136	(63,625)
Cash flows from capital and related financing activities:		
Capital and nuclear fuel expenditures	(208,431)	(201,506)
Insurance proceeds	—	747
Swaption proceeds	35,000	29,892
Proceeds of promissory note redemption	—	447,005
Proceeds from the issuance of bonds, net of issuance costs	192,806	1,580,368
Interest paid, net	(288,319)	(278,901)
Redemption of long-term debt	(186,380)	(2,042,282)
Net cash used in capital and related financing activities	(455,324)	(464,677)
Net increase (decrease) in cash and cash equivalents	115,973	(272,891)
Cash and cash equivalents at beginning of period	219,095	491,986
Cash and cash equivalents at end of period	$ 335,068	$ 219,095
Reconciliation to net cash provided by operating activities:		
Operating income	$ 289,403	$ 284,637
Adjustments to reconcile excess of operating income to net cash provided by operating activities:		
Depreciation and amortization	229,316	230,085
Nuclear fuel burned	4,951	5,830
Shoreham surcharges (credits), net	35,136	(1,081)
Provision for claims and damages	5,019	17,000
Accretion of asset retirement obligation	3,868	3,648
Other, net	(41,995)	(4,597)
Changes in operating assets and liabilities:		
Accounts receivable, net	(24,818)	(23,526)
Fuel and material and supplies inventory	(12,295)	(7,665)
Fuel and purchased power costs recovered related to prior periods	36,085	149,040
Excess fuel and purchased power costs deferred	—	(364,640)
Accounts payable and accrued expenses	(83,509)	(33,320)
Net cash provided by operating activities	$ 441,161	$ 255,411

See accompanying notes to basic financial statements.

(1) Basis of Presentation

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

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

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

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

(2) Nature of Operations

LIPA, as owner of the transmission and distribution system located in the New York State Counties of Nassau and Suffolk (with certain limited exceptions) and a small portion of Queens County known as the Rockaways (Service Area), is responsible for supplying electricity to customers within the service area. To assist LIPA in meeting these responsibilities, LIPA contracted with KeySpan Energy Corporation (KeySpan) or its affiliates to provide: operations and management services related to the transmission and distribution system through a management services agreement (MSA); capacity and energy from the fossil fired generating plants of KeySpan, formerly owned by LILCO, through a power supply agreement (PSA); and, energy and fuel management services through an energy management agreement (EMA) (collectively; the Operating Agreements). Through these contracts, LIPA pays KeySpan directly for these services and KeySpan, in turn, pays the salaries of its employees and fees of its contractors and suppliers. In 2004, LIPA paid to KeySpan approximately $1.7 billion under the operating agreements, which includes all fees under such agreements, reimbursement for various taxes and PILOTS, certain fuel and purchases power costs, major capital projects, conservation services, research and development and various other expenditures authorized by the Company.

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

(3) Summary of Significant Accounting Policies

(a) General

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

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

(b) Accounting for the Effects of Rate Regulation

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

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

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

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

If the Company had been unable to continue to apply the provisions of SFAS No. 71, as of December 31, 2004, the Company estimates that approximately $304.3 million of regulatory assets would be considered for write-off, and the acquisition adjustment, totaling approximately $3.2 billion would be considered for impairment.

(c) Utility Plant and Property and Equipment

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

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

(d) Cash and Cash Equivalents and Investments

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

(e) Fuel Inventory

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

(f) Material and Supplies Inventory

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

(g) Promissory Note Receivable

As part of the 1998 Merger, KeySpan issued promissory notes to LIPA of approximately $1.048 billion. As of December 31, 2004 and 2003, approximately $155.4 million remained outstanding, respectively. The interest rates and timing of principal and interest payments on the promissory notes from KeySpan are identical to the terms of certain LILCO indebtedness assumed by LIPA in the merger. KeySpan is required to make principal payments to LIPA thirty days prior to the corresponding payment due dates, and LIPA transfers those amounts to the debt holders in accordance with the original debt repayment schedule.

(h) Deferred Loss Related to Non-Fuel Derivatives

The Authority uses financial derivative instruments to manage the impact of interest rates on its customers, earnings and cash flows. Under the provisions of SFAS No. 133, *Accounting for Derivatives and Hedging Activities*, as amended by SFAS No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*, and SFAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, the Authority is required to recognize the fair value of all derivative instruments as either an asset or liability on the balance sheet with an offsetting gain or loss recognized in earnings or deferred charges. These standards permit the deferral of hedge gains and losses to Other Comprehensive Income, under specific hedge accounting provisions, until the hedged transaction is realized. However, the Authority is a governmental agency and, therefore, its financial statements are prepared in accordance with the provisions of the Governmental Accounting Standards Board, which do not provide for Other Comprehensive Income.

As the Authority is subject to the provisions of SFAS No. 71, all such gains and losses are deferred until realized. Accordingly, the Authority's balance sheet reflects the inclusion of deferred losses and the deferred gains.

(i) Deferred Charges

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

(j) Regulatory Assets

Shoreham Property Tax Settlement ("Settlement")

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

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

As future rates will be established at a level sufficient to recover all such costs identified above, LIPA recorded a regulatory asset in accordance with SFAS No. 71. The balance of the Shoreham property tax settlement regulatory asset as of December 31, 2004 and 2003 was approximately $572.1 million and $575.6 million, respectively. The balance represents costs recorded from 1998 through 2004 including rebates and credits issued to customers, costs of administering the program and debt service costs on the Bonds identified above less surcharges collected since May 2003 totaling approximately $54 million.

Fuel and Purchased Power Costs Recoverable

LIPA's tariff includes a fuel recovery mechanism – the Fuel and Purchased Power Cost Adjustment (FPPCA) – whereby customer bills may be adjusted to reflect changes in the cost of fuel, purchased power and related costs. The FPPCA allows LIPA to recover from customers amounts incurred for fuel and purchased power beyond those included in base rates (Excess Fuel Costs).

Modification to the FPPCA Mechanism

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

- With respect to 2003 excess fuel costs: (i) $75 million was scheduled to be collected in 2003 between March and December; and, (ii) an additional amount sufficient to generate an excess of revenue over expenses of $20 million in 2003 was deferred and is being collected in level annual amounts over a ten year period commencing in January 1, 2004. Approximately $74 million of the $75 million scheduled to be collected in 2003 was billed to customers in 2003. The remaining $1 million was incorporated in the 2004 FPPCA surcharge. With respect to item (ii) above, approximately $365 million was deferred for collection over the ten year period.
- With respect to 2004 and subsequent years' Excess Fuel Costs, collections of these amounts are on a current year basis (with the recovery factor adjusted throughout the year as necessary) in amounts sufficient to generate excess revenue over expenses of $20 million.

Pursuant to the provisions of the revised FPPCA, LIPA's Board of Trustee approved an annual 4.5% increase in the FPPCA surcharge in February 2004. As a result of continuing increases in fuel and purchased power costs, the Authority increased the surcharge by an additional annual rate of 5.0% effective June 8, 2004 and by an additional annual rate of 1.0% effective October 1, 2004. The revised surcharge as designed, provided sufficient recovery of Excess Fuel Costs throughout 2004 for LIPA to achieve revenue in excess of expenses of $20 million by year-end.

To protect its customers from significant market price fluctuations for the purchase of fuel oil, natural gas, and electricity, LIPA uses derivative financial instruments which, are recorded at their market value. Effective with the 2003 modifications to the FPPCA, unrealized gains and losses derived from these derivatives are deferred as a regulatory asset until realized, at which time they are included in current period results as a component of fuel and purchased power.

Accordingly, as of December 31, 2004, the Authority deferred its unrealized gain on fuel derivatives of approximately $24 million.

(k) Acquisition Adjustment

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

(l) Fair Values of Financial Instruments

The Company's financial instruments approximate their fair market value as of December 31, 2004 and 2003. The fair values of the Company's long-term debt and derivative instruments are based on quoted market prices.

(m) Capitalized Lease Obligations

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

As of December 31, 2004, and 2003, the unamortized net present value of the minimum lease payments related to the various contracts totaled approximately $862 million, and $801 million, respectively.

As permitted under SFAS No. 71, LIPA recognizes in Fuel and Purchased Power expense an amount equal to the contract payment of the capitalized leases discussed above, as allowed through the ratemaking process. The value of the asset and the obligation are reduced each month so that the balance sheet properly reflects the remaining value of the asset and obligation at each month end.

For a further discussion on the capitalization of capacity and/or energy contracts, please see note 11 of notes to basic financial statements.

(n) Deferred Credits

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

During 2004, amounts determined as due to customers totaling approximately $36 million were applied against the Excess Fuel Costs.

(o) Claims and Damages

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

(p) Revenues

Operating revenues are comprised of cycle billings for electric service rendered to customers, based on meter reads, and the accrual of revenues for electric service rendered to customers not billed at month-end. All other revenue not meeting this definition is reported as nonoperating revenue when service is rendered. For the years ended December 31, 2004, and 2003, LIPA received approximately 51% of its revenues from residential sales, 46% from sales to commercial and industrial customers, and the balance from sales to public authorities and municipalities.

(q) Depreciation

The provisions for depreciation for utility plant result from the application of straight-line rates by groups of depreciable properties in service. The rates are determined by age-life studies performed on depreciable properties. The average composite depreciation rate is 2.91%.

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

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

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

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

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

(s) Allowance for Borrowed Funds Used During Construction

The allowance for borrowed funds used during construction (AFUDC) is the net cost of borrowed funds used for construction purposes. AFUDC is not an item of current cash income. AFUDC is computed monthly on a portion of construction work in progress, and is shown as a net reduction in interest expense.

(t) Income Taxes

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

(u) Asset Retirement Obligation

On January 1, 2003, the Authority adopted SFAS No. 143, *Accounting for Asset Retirement Obligations*. An Asset Retirement Obligation (ARO) exists when there is a legal obligation associated with the retirement of a tangible long-lived asset that results from the acquisition, construction, or development and/or normal operation of the asset. LIPA, as an 18% owner of Nine Mile Point 2 Nuclear Power Station, has a legal obligation associated with its retirement. This obligation is offset by the capitalization of the obligation which is included in “Utility plant and property and equipment, net”. As of December 31, 2004 and 2003, respectively, the asset retirement obligation was approximately $68.3 million and $64.5 million.

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

(v) Long-Lived Assets

Long-lived assets, such as property, plant, and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is assessed by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flow, an impairment charge to be recognized is measured by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of and assets held for sale are reported at the lower of the carrying amount or fair value less costs to sell, whether reported in continuing operations or in discontinued operations, and are no longer depreciated.

(w) 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.

(x) Reclassifications

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

(4) Risk Management

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

Fuel and purchased power transactions: The Authority uses derivative financial instruments as detailed in the table below. At December 31, 2004, oil related contracts had a fair market value of approximately $30.7 million, and for natural gas related contracts the fair market value was approximately $24.9 million.

Fuel Derivative Transactions

Type of contract		Duration	Volume per month
Oil contracts (volumes in barrels):			
Options			
Put	Short	Jan 05 – Dec 07	75,000-200,000
Call	Long	Jan 05 – Dec 07	75,000-200,000
Swap	Long	Jan 05 – Dec 07	420,000-1,007,500
Gas transactions (volumes in decatherms):			
Put	Short	May 05 – Dec 07	140,000-620,000
Call	Long	May 05 – Dec 08	140,000-620,000
Swap	Long	Jan 05 – Dec 07	70,000-3,410,000
Basis transactions:			
Swap	Long	Jan 05 – Mar 06	420,000-1,007,500

Interest Rate Transactions: The Authority has entered into several interest rate swap agreements with several counterparties to modify the effective interest rates on outstanding debt as detailed below (thousands of dollars):

Notional amount	Effective date	Type of swap		December 31, 2004 Mark to market	December 31, 2004 Deferred gain (loss)
$ 150,000	11/12/1998	Floating to Fixed		$ 11,516	$ (11,516)
100,000	11/12/1998	Floating to Fixed		8,630	(8,630)
587,225	6/1/2003	Floating to Fixed	(a)	136,133	(36,088)
116,000	4/1/2003	Floating to Fixed	(b)	9,194	(1,425)
502,090	7/1/2004	Basis Swap	(c)	31,685	(14,618)
251,045	7/1/2004	Basis Swap	(d)	15,561	(7,027)
251,045	7/1/2004	Basis Swap	(d)	15,407	(6,873)
Total				$ 228,126	$ (86,177)
116,000	11/1/2001	Fixed to Floating		$ 8,493	$ 8,493
100,995	7/1/2004	Fixed to Floating		1,038	1,038
100,995	7/1/2004	Fixed to Floating		879	879
Total				$ 10,410	$ 10,410

(a) The Authority received an upfront premium totaling approximately $106 million.
(b) The Authority received an upfront premium totaling approximately $8 million.
(c) The Authority received an upfront premium totaling approximately $17.5 million.
(d) The Authority received an upfront premium totaling approximately $8.75 million.

(5) Rate Matters

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

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

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

(6) Utility Plant and Property and Equipment

The following schedule summarizes the utility plant and property and equipment of the Authority as of December 31, 2004 (thousands of dollars):

	Beginning balance	Additions	Deletions	Ending balance
Capital assets, not being depreciated:				
Land	$ 9,833	$ 108	$ —	$ 9,941
Retirement work in progress	6,860	16,003	16,013	6,850
Construction in progress	29,806	184,786	141,044	73,548
Total capital assets not being depreciated	46,499	200,897	157,057	90,339
Capital assets, being depreciated:				
Generation – nuclear	693,183	7,732	—	700,915
Transmission and distribution	2,207,033	132,546	13,734	2,325,845
Common	4,440	766	482	4,724
Nuclear fuel in process and in reactor	37,142	9,371	—	46,513
Office equipment, furniture, and leasehold improvements	2,920	387	—	3,307
Generation assets under capital lease	844,914	99,484	—	944,398
Total capital assets being depreciated	3,789,632	250,286	14,216	4,025,702
Less accumulated depreciation for:				
Generation – nuclear	106,657	26,172	—	132,829
Transmission and distribution	260,665	89,466	29,728	320,403
Common	653	655	501	807
Nuclear fuel in process and in reactor	32,705	4,951	—	37,656
Office equipment, furniture, and leasehold improvements	1,853	344	—	2,197
Generation assets under capital lease	43,211	38,835	—	82,046
Total accumulated depreciation	445,744	160,423	30,229	575,938
Net value of capital assets, being depreciated	3,343,888	89,863	(16,013)	3,449,764
Net value of all capital assets	$ 3,390,387	$ 290,760	$ 141,044	$ 3,540,103

In 2004, depreciation expense related to capital assets was approximately $116.6 million.

The following schedule summarizes the utility plant and property and equipment of the Authority as of December 31, 2003 (thousands of dollars):

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

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

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

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

LIPA's share of the rated capability of NMP2 is approximately 207 megawatts (MW). LIPA's net utility plant investment, excluding nuclear fuel, was approximately $568 million and $587 million as of December 31, 2004 and 2003, respectively. Generation from NMP2 and operating expenses incurred by NMP2 are shared by LIPA at its 18% ownership interest. LIPA is required to provide its share of financing for any capital additions to NMP2. Nuclear fuel costs associated with NMP2 are being amortized on the basis of the quantity of heat produced for the generation of electricity.

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

Nuclear Plant Decommissioning

LIPA is making provisions for decommissioning costs for NMP2 based on a site-specific study performed in 1995, as updated by LIPA's engineering consultants. LIPA's share of the total decommissioning costs for both the contaminated and noncontaminated portions is estimated to be approximately $68.3 million as of December 31, 2004, and is included in the balance sheet as the asset retirement obligation. LIPA maintains a trust fund for its share of the decommissioning costs of NMP2, which as of December 31, 2004 and 2003, had an approximate value of $54.1 million and $48.9 million, respectively. Through continued deposits and investment returns being maintained within these trusts, the Company believes that the value of these trusts in 2046 will be sufficient to meet the Company's decommissioning obligations.

NMP2 Radioactive Waste

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

Nuclear Plant Insurance

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

In November 2002, the Terrorism Risk Insurance Act (TRIA) of 2002 was enacted by the federal government. Under the TRIA, property and casualty insurance companies are required to offer insurance for losses resulting from Certified acts of terrorism. The United States Secretary of State and Attorney General determine certified acts of terrorism. The nuclear property and accidental outage insurance programs, as discussed later in this section provide coverage for Certified acts of terrorism.

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

The Price-Anderson Amendments Act mandates that nuclear power generators secure financial protection in the event of a nuclear accident. This protection must consist of two levels. The primary level provides liability insurance coverage of $300 million (the maximum amount available) in the event of a nuclear accident. If claims exceed that amount, a second level of protection is provided through a retrospective assessment of all licensed operating reactors. Currently, this "secondary financial protection" subjects each of the 104 presently licensed nuclear reactors in the United States to a retrospective assessment of up to $100.6 million for each nuclear incident, payable at a rate not to exceed $10 million per year. LIPA's interest in NMP2 could expose it to a maximum potential loss of $18.1 million, per incident, through assessments of up to $1.8 million per year in the event of a serious nuclear accident at NMP2 or another licensed U.S. commercial nuclear reactor.

Constellation participates in the American Nuclear Insurers Master Worker Program that provides coverage for worker tort claims filed for radiation injuries. Effective January 1, 1998, this program was modified to provide coverage to all workers whose nuclear-related employment began on or after the commencement date of reactor operations. Waiving the right to make additional claims under the old policy was a condition for coverage under the new policy. The old and new policies are described below:

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

Constellation has also procured $500 million of primary nuclear property insurance and approximately $2.25 billion of additional protection (including decontamination costs) in excess of the primary layer through the Nuclear Electric Insurance Limited (NEIL). Each member of NEIL, including LIPA, is also subject to retrospective premium adjustments in the event losses exceed accumulated reserves. For its share of NMP2, LIPA could be assessed up to approximately $3.1 million per loss.

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

NMP2 License Renewal

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

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

(8) Cash and Cash Equivalents and Investments

All investments of the Authority are held by designated custodians in the name of the Authority. Investments with maturities when purchased of less than 90 days are classified as cash and cash equivalents. The Authority's investments are reported at amortized cost which approximates fair market value.

The bank balances were $8.0 million and $11.9 million as of December 31, 2004 and 2003, respectively. Cash deposits at banks were collateralized for amounts above the Federal Deposit Insurance Corporation (FDIC) limits with securities held by the custodian banks in the Authority's name. The Authority is required to maintain compensating balances of $1.2 million. All Authority investment securities are classified as securities acquired by a financial institution for the Authority and held by the financial institutions trust department in the Authority's name.

Cash and cash equivalents and investments of the Authority as of December 31, 2004 and 2003 are detailed below (thousands of dollars):

	December 31	
	2004	2003
Cash and cash equivalents and investments:		
Commercial paper	$ 294,232	$ 161,883
U.S. Government/Agencies	69,994	207,684
Money market mutual funds	16,824	13,244
Master notes	4,316	564
Corporate bonds	20,022	9,998
Time and demand deposits	7,580	24,614
Total cash and cash equivalents and investments	$ 412,968	$ 417,987

(9) Long-Term and Short-Term Debt

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

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.

The Company's bond and note indebtedness and other long-term liabilities as of December 31, 2004 are comprised of the following obligations (thousands of dollars):

	Beginning balance	Accretion/ additions	Retirements/ refundings	Ending balance	Due within one year
Authority debt:					
Electric system general revenue bonds:					
Series 1998A	$ 2,219,636	$ 8,137	$ 69,980	$ 2,157,793	$ 166,330
Series 1998B	744,205	—	32,625	711,580	—
Series 2000A	292,123	16,948	—	309,071	—
Series 2001A	300,000	—	—	300,000	—
Series 2001B-K	500,000	—	—	500,000	—
Series 2001L-P	316,000	—	—	316,000	—
Series 2003A	106,400	—	19,500	86,900	—
Series 2003B	511,575	—	36,975	474,600	—
Series 2003C	323,380	—	—	323,380	—
Series 2003D-O	587,225	—	—	587,225	—
Series 2004A	—	200,000	—	200,000	—
Subtotal – bonds	5,900,544	225,085	159,080	5,966,549	166,330
Electric system subordinate revenue bonds:					
Series 1-3	525,000	—	—	525,000	—
Series 7	250,000	—	—	250,000	—
Series 8	214,645	—	27,300	187,345	27,300
Subtotal – bonds net	989,645	—	27,300	962,345	27,300
LIPA Debt:					
NYSERDA notes	155,420	—	—	155,420	—
Subtotal – debt	155,420	—	—	155,420	—
Net unamortized discounts/premiums and deferred amortization	(23,286)	(2,488)	(367)	(25,407)	—
Total bonds and notes net of unamortized discounts/ premiums	$ 7,022,323	$ 222,597	$ 186,013	$ 7,058,907	$ 193,630
Other long-term liabilities:					
Deferred credits	$ 130,196	$ 5,105	$ 49,978	$ 85,323	$ —
Claims and damages	21,481	5,019	6,409	20,091	—
Capital lease obligation	801,703	99,484	38,835	862,352	89,552
Total other long-term liabilities	$ 953,380	$ 109,608	$ 95,222	$ 967,766	$ 89,552

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

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

	Beginning balance	Accretion/ additions	Retirements/ refundings	Ending balance	Due within one year
Authority debt:					
Electric system general revenue bonds:					
Series 1998A	$ 3,117,288	$ 8,581	$ 906,233	$ 2,219,636	$ 69,980
Series 1998B	1,076,020	—	331,815	744,205	32,625
Series 2000A	376,494	17,755	102,126	292,123	—
Series 2001A	300,000	—	—	300,000	—
Series 2001B-K	500,000	—	—	500,000	—
Series 2001L-P	316,000	—	—	316,000	—
Series 2003A	—	106,400	—	106,400	19,500
Series 2003B	—	516,075	4,500	511,575	36,975
Series 2003C	—	323,380	—	323,380	—
Series 2003D-O	—	587,225	—	587,225	—
Subtotal – bonds	5,685,802	1,559,416	1,344,674	5,900,544	159,080
Electric system subordinate revenue bonds:					
Series 1-3	700,000	—	175,000	525,000	—
Series 7	250,000	—	—	250,000	—
Series 8 (subseries A-H)	216,720	25,225	27,300	214,645	27,300
Subtotal – bonds net	1,166,720	25,225	202,300	989,645	27,300
LIPA Debt:					
Debentures	270,000	—	270,000	—	—
NYSERDA notes	332,425	—	177,005	155,420	—
Subtotal – debt	602,425	—	447,005	155,420	—
Net unamortized discounts/premiums and deferred amortization	(14,155)	(5,740)	3,391	(23,286)	—
FMV 1998A Term Bond	(25,955)	—	(25,955)	—	—
Total bonds and notes net of unamortized discounts/ premiums	$ 7,414,837	$ 1,578,901	$ 1,971,415	$ 7,022,323	$ 186,380
Other long-term liabilities:					
Deferred credits	$ 117,395	$ 23,358	$ 10,557	$ 130,196	$ —
Claims and damages	24,207	17,000	19,726	21,481	—
Capital lease obligation	599,871	232,499	30,667	801,703	80,073
Total other long-term liabilities	$ 741,473	$ 272,857	$ 60,950	$ 953,380	$ 80,073

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

The Company's schedule of capitalization for the years ended December 31, 2004 and 2003 is as follows (thousands of dollars):

	Maturity	Interest rate		Series	December 31 2004	December 31 2003
Electric system general						
Revenue bonds:						
Serial bonds	Annually to 2016	4.250% to 6.000%	a	1998 A	$ 738,310	$ 795,320
Term bonds	December 1, 2018 to 2029	5.000% to 5.750%	a	1998 A	1,263,350	1,263,350
Capital appreciation bonds	December 1, 2003 to 2028	4.400% to 5.300%	a	1998 A	156,133	160,966
Serial bonds	Annually to 2016	4.000% to 5.250%	a	1998 B	654,435	687,060
Term bonds	April 1, 2018	4.750%	a	1998 B	57,145	57,145
Capital appreciation bonds	June 1, 2005 to 2029	5.000% to 5.950%	a	2000 A	309,071	292,123
Serial bonds	September 1, 2013 to 2021	4.600% to 5.375%	a	2001 A	21,960	21,960
Term bonds	September 1, 2025 to 2029	5.000% to 5.375%	a	2001 A	278,040	278,040
Term bonds	May 1, 2033	1.700%	b	2001 B	75,000	75,000
Term bonds	May 1, 2033	1.650%	b	2001 C	25,000	25,000
Term bonds	May 1, 2033	1.700%	b	2001 D	50,000	50,000
Term bonds	May 1, 2033	1.450%	b	2001 E	50,000	50,000
Term bonds	May 1, 2033	1.600%	b	2001 F	50,000	50,000
Term bonds	May 1, 2033	1.550%	b	2001 G	50,000	50,000
Term bonds	May 1, 2033	1.800%	b	2001 H	50,000	50,000
Term bonds	May 1, 2033	1.740%	b	2001 I	50,000	50,000
Term bonds	May 1, 2033	1.560%	b	2001 J	50,000	50,000
Term bonds	May 1, 2033	1.760%	b	2001 K	50,000	50,000
Term bonds	May 1, 2033	5.375%	a	2001 L	116,000	116,000
Term bonds	May 1, 2033	1.450%	b	2001 M	50,000	50,000
Term bonds	May 1, 2033	1.400%	b	2001 N	50,000	50,000
Term bonds	May 1, 2033	1.700%	b	2001 O	50,000	50,000
Term bonds	May 1, 2033	1.500%	b	2001 P	50,000	50,000
Serial bonds	June 1, 2004 to 2009	3.00% to 5.00%	a	2003 A	86,900	106,400
Serial bonds	December 1, 2003 to 2014	3.00% to 5.25%	a	2003 B	474,600	511,575
Serial bonds	September 1, 2013 to 2028	4.25% to 5.50%	a	2003 C	137,860	137,860
Term bonds	September 1, 2027 to 2033	5.00% to 5.25%	a	2003 C	185,520	185,520
	December 1, 2029	1.09% to 2.00%	c	2003 D-H	293,625	293,625
	December 1, 2029	1.09% to 2.00%	b	2003 I-O	293,600	293,600
Serial bonds	September 1, 2013 to 2025	3.80% to 4.875%	a	2004 A	33,900	—
Term bonds	September 1, 2029 to 2034	5.00% to 5.10%	a	2004 A	166,100	—
Electric system subordinated						
Revenue bonds	May 1, 2033	1.98% to 2.20%	c	Series 1A-3A	275,000	275,000
	May 1, 2033	1.95% to 2.17%	d	Series 1B-3B	250,000	250,000
	April 1, 2025	4.210%	a	Series 7	250,000	250,000
	April 1, 2009 to 2012	4.000% to 5.250%	a	Series 8	187,345	214,645
Total general and subordinated revenue bonds					6,928,894	6,890,189
Commercial paper notes		1.70% to 1.83%	b	CP-1	100,000	100,000

	Maturity	Interest rate		Series		December 31 2004		2003
NYSERDA financing notes:								
Pollution control revenue bonds	March 1, 2016	5.150%	a	1985 A,B	$	108,020	$	108,020
Electric facilities revenue bonds	November 1, 2023	5.300%	a	1993 B		29,600		29,600
	October 1, 2024	5.300%	a	1994 A		2,600		2,600
	August 1, 2025	5.300%	a	1995 A		15,200		15,200
Total NYSERDA financing notes						155,420		155,420
Unamortized premium and deferred amortization						(25,407)		(23,286)
Total long-term debt						7,158,907		7,122,323
Less current maturities						193,630		186,380
Long-term debt						6,965,277		6,935,943
Net assets						31,620		11,620
Total capitalization					$	6,996,897	$	6,947,563

a – Fixed rate

b – Variable rate (rate presented is as of December 31, 2004); Auction rate mode reset at rates as determined by auction agent.

c – Variable rate (rate presented is as of December 31, 2004); Weekly interest rate mode reset at rates as determined by remarketing agent.

d – Variable rate (rate presented is as of December 31, 2004); Daily reset rate mode as determined by remarketing agent.

The debt service requirements for the Company's bonds as of December 31, 2004 are as follows (thousands of dollars):

	December 31, 2004			
Due	**Principal**	**Interest**	**Net swap**	**Total**
2005	$ 193,630	$ 269,691	$ 19,662	$ 482,983
2006	229,625	260,461	19,662	509,748
2007	241,720	249,384	19,662	510,766
2008	253,155	239,316	19,691	512,162
2009	240,730	228,175	19,662	488,567
2010-2014	1,014,985	986,096	105,576	2,106,657
2015-2019	1,107,900	776,149	125,119	2,009,168
2020-2024	1,238,975	569,603	114,036	1,922,614
2025-2029	1,551,060	320,338	80,645	1,952,043
2030-2034	1,537,770	94,056	—	1,631,826
	7,609,550	3,993,269	523,715	12,126,534
Unamortized discounts/premiums	(25,407)	—	—	(25,407)
Unaccreted interest on CABs	(525,236)	—	—	(525,236)
Total	$ 7,058,907	$ 3,993,269	$ 523,715	$ 11,575,891

Future debt service is calculated using rates in effect at December 31, 2004 for variable rate bonds. The net swap payment amounts were calculated by subtracting the future variable rate interest payments subject to swap agreements from the synthetic fixed rate amount intended to be achieved by the swap agreements.

Electric System General Revenue Bonds

Series 2004A

The Authority issued Series 2004A Electric System General Revenue Bonds totaling $200 million for various capital projects and to reimburse the Authority for capital expenditures funded with cash from operations. Series 2004A is comprised of Serial Bonds and Term Bonds with maturities beginning September 1, 2013 and continuing through 2034 and pays interest at a fixed rate every March 1 and September 1.

Series 2003A

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

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

Series 2003B

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

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

Series 2003C

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

Series 2003D through O

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

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

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

Optional Redemption

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

Sinking Fund

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

Electric System Subordinated Revenue Bonds

Series 1 through 3

In connection with the expiration of certain letters of credits, during 2003, the Authority refunded, with Series 2003C, $75 million of its Series 1B and 2A, and $25 million of its Series 2C. As a result of this refinancing transaction the Authority will realize a gross debt service increase of approximately $10 million over the original life of the bonds. The refunding produced an economic loss (the present value of the increase in debt service requirements) of approximately $32 million.

The Bonds that remain outstanding are variable rate bonds payable from and secured by the Trust Estate subject to and subordinated to the Authority's Electric System General Revenue Bonds and are supported by letters of credit that expire on June 15, 2006.

Series 8 (SubSeries A-H)

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

This series is comprised of subseries	Mandatory purchase date (April 1)	Maturity (April 1)		Principal outstanding	Interest rate to mandatory purchase date
8A		2009	$	23,360	5.25%
8A		2009		2,500	4.13%
8B		2009		17,160	4.30%
8B		2009		10,000	5.25%
8C		2010		25,225	5.00%
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%
			$	187,345	

Prior to the mandatory purchase date, the Authority determines to either purchase the Subseries or have such Subseries remarketed. Remarketed securities would become due at the maturity date or an earlier date as determined by the remarketing. 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. Principal, interest, and purchase price on the mandatory purchase date are secured by a financial guaranty insurance policy.

During the years ended December 31, 2004, the Authority redeemed its SubSeries 8D Bonds totaling $27.3 million. SubSeries 8A through 8C bonds were remarketed and are in the Fixed Rate Mode, and pay interest on April 1 and October 1 of each year. The Authority intends to redeem its SubSeries 8E Bonds on the mandatory purchase date of April 1, 2005.

Commercial Paper Notes

The Authority's Supplemental Bond Resolution authorizes the issuance of Commercial Paper Notes, Series CP-l through CP-3 (Notes) up to a maximum amount of $200 million. The aggregate principal amount of the Notes outstanding at any time may not exceed $200 million. In connection with the issuance of the Notes, the Authority has entered into a Letter of Credit and Reimbursement Agreement, expiring on June 15, 2006. The Notes do not have maturity dates of longer than 270 days from their date of issuance and as Notes mature, the Authority continually replaces them with additional Notes.

During 2004, the Authority issued an additional $100 million of Commercial Paper Notes to reimburse the Authority's treasury for capital projects. As of December 31, 2004, the Authority redeemed all of this issuance. As of December 31, 2004 and 2003, the Authority had Notes outstanding totaling $100 million.

The Company's short-term indebtedness as of December 31, 2004 and 2003 is comprised of the following obligations (thousands of dollars):

	Beginning balance	Issuances	Retirements	Ending balance
Short term debt – CP-1	$ 100,000	$ —	$ —	$ 100,000
Short term debt – CP-2	—	50,000	(50,000)	—
Short term debt – CP-3	—	50,000	(50,000)	—
	$ 100,000	$ 100,000	$ (100,000)	$ 100,000

LIPA Debt - Debentures

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

LIPA Debt - NYSERDA Notes

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

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

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

Fair Values of Long-Term Debt

The fair values of the Company's long-term debt as of December 31, 2004 and 2003 were as follows (thousands of dollars):

Fair Value

	December 31, 2004	December 31, 2003
Electric System General Revenue Bonds, Series 1998 A	$ 2,312,071	$ 2,380,812
Electric System General Revenue Bonds, Series 1998 B	762,682	812,504
Electric System General Revenue Bonds, Series 2000 A	360,780	344,145
Electric System General Revenue Bonds, Series 2001 A	305,863	304,592
Electric System General Revenue Bonds, Series 2001 B through K	500,000	500,000
Electric System General Revenue Bonds, Series 2001 L through P	313,736	316,502
Electric System General Revenue Bonds, Series 2003 A	90,488	112,738
Electric System General Revenue Bonds, Series 2003 B	500,441	546,392
Electric System General Revenue Bonds, Series 2003 C	331,846	330,063
Electric System General Revenue Bonds, Series 2003 D through O	587,225	587,225
Electric System General Revenue Bonds, Series 2004 A	178,644	—
Electric System Subordinated Revenue Bonds, Series 1-3 & 1-6	525,000	525,000
Electric System Subordinated Revenue Bonds, Series 7	250,000	250,000
Electric System Subordinated Revenue Bonds, Series 8 (subseries A-H)	199,164	238,673
Electric System Commercial Paper Notes, CP-1	100,000	100,000
NYSERDA Notes	156,440	152,124
Total	$ 7,474,380	$ 7,500,770

(10) Retirement Plans

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

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

Under this plan, the Authority's required contributions and payments made to the System were approximately $867,000, $426,000, and $131,000, for the years ended December 31, 2004, 2003, and 2002, respectively. Contributions are made in accordance with funding requirements determined by the actuary of the System using the aggregate cost method.

The State of New York and the various local governmental units and agencies which participate in the Retirement System are jointly represented, and it is not possible to determine the actuarial computed value of benefits for the Authority on a separate basis. The New York State Employees' Retirement System issues a publicly available financial report. The report may be obtained from the New York State and Local Retirement Systems, 110 State Street, Albany, New York 12244.

(11) Commitments and Contingencies

(a) Power Supply Agreement

The PSA provides for the sales to LIPA by KeySpan of all of the capacity and, to the extent necessary, energy from the oil and gas-fire generating plants on Long Island formerly owned by LILCO. Such sales of capacity and energy are made at cost-based wholesale rates regulated by the Federal Energy Regulatory Commission (FERC). The rates may be modified in accordance with the terms of the PSA for: i) agreed upon labor and expense indices applied to the base year; ii) a return of and return on net capital additions, which require approval by the Authority; and iii) reasonably incurred expenses that are outside of the control of KeySpan. The PSA rates were reset in 2004, and, in accordance with the agreement, will be reset again in 2009. The annual capacity charge as reset in 2004, was $305.4 million, and the variable charge remained unchanged at $0.90/Mwh. Between 2004 and 2009, the rates will be adjusted annually in accordance with the formula established in the PSA.

The PSA provides incentives and penalties for up to $4 million annually, to maintain the output capability of the facilities, as measured by annual industry-standard tests of operating capability, and to maintain/or make capital improvements which benefit plant availability. The performance incentives averaged approximately $3.9 million in 2004 and 2003.

(b) Purchased Power and Transmission Agreements

LIPA has contracts with numerous Independent Power Producers (IPPs) and the New York Power Authority (NYPA) for electric generating capacity. Under the terms of the 2004 amended agreement with NYPA, which will expire in April 2020, LIPA may purchase up to 100% of the electric energy produced at the NYPA facility located within LIPA's service territory at Holtsville, New York. LIPA is required to reimburse NYPA for the minimum debt service payments and to make fixed nonenergy payments associated with operating and maintaining the plant.

With respect to contracts entered into with the IPPs, LIPA is obligated to purchase all the energy they make available to LIPA at prices that often exceed current market prices. However, LIPA has no obligation to the IPPs if they fail to deliver energy.

LIPA also has a contract with NYPA for firm transmission (wheeling) capacity in connection with a transmission cable that was constructed, in part, for the benefit of LIPA. With the inception of the New York Independent System Operator (NYISO) on November 18, 1999, this contract was provided with "grandfathered rights" status. Grandfathered rights allow the contract parties to continue business as they did prior to the implementation of the NYISO. That is, the concept of firm physical transmission service continues. 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 NYISO. Under the rules of the NYISO, energy can be moved from point A to point B without a transmission reservation however, the entity moving such energy is required to pay a tolling fee to the owner of the TCC. This tolling fee is called transmission congestion and is set by the NYISO.

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

In addition, in 2000, the Company entered into a lease for a submarine cable running between Connecticut and Long Island whereby LIPA would be entitled to up to 330 megawatts of transmission capacity. The cable was not able to obtain an operating license, as it had been determined that several sections of the cable were not buried to depths required by its permits. During 2003, the Department of Energy (DOE) issued an emergency order allowing the cable to operate. Because the cable owner has not been able to obtain an operating license, the Authority was under no obligation to remit payments to the owner based on the 2000 lease agreement. As a result, LIPA entered into an interim agreement with the cable owner which established LIPA's ability to pay for 330 megawatts of capacity at a discounted rate from the original lease agreement during the term of the emergency order. In May 2004, the DOE lifted the emergency order.

To resolve the outstanding issues associated with the cable, among other things, LIPA entered into a June 24, 2004, Settlement Agreement with certain Connecticut regulators, the cable owner and others. The Settlement Agreement provided for the immediate re-energization and operation of the cable subject to certain conditions, such as the cable meeting the depth requirements under its Connecticut permits. LIPA and the cable owner have negotiated the terms of a Bridge Agreement, which allows LIPA to utilize the cable during the period June 27, 2004 (when the cable was energized pursuant to the Settlement Agreement) to July 1, 2007, which is the new target date for initial commercial operation of the cable. Under the Bridge Agreement, LIPA may purchase 330 MW of firm transmission capacity at a discount from the rate contained in the original lease agreement. LIPA also entered into an amendment to the original agreement with the cable owner extending the original term of the agreement from 20 to 25 years, at the same rate set in the original agreement.

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

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

Purchased power and transmission contracts

	PPA	Firm transmission	IPPs*	Total business*
For the years ended:				
2005	$ 34,237	$ 45,541	$ 118,800	$ 198,578
2006	34,745	45,951	119,600	200,296
2007	35,270	36,801	118,300	190,371
2008	35,813	27,651	120,400	183,864
2009	36,375	27,651	112,100	176,126
2010 through 2014	175,362	138,255	238,400	552,017
2015 through 2019	187,499	138,255	50,300	376,054
2020 through 2024	20,636	82,953	—	103,589
2025 through 2029	—	69,128	—	69,128
2030 through 2034	—	69,128	—	69,128
Total	$ 559,937	$ 681,314	$ 877,900	$ 2,119,151

* Assumes full performance by NYPA and the IPPs.

(c) Additional Power Supplies

Purchase Power Agreements

The Company has contracts with seven private companies to construct and operate 14 generating units at eight sites throughout Long Island. Six of the contracts covering 13 of the units are for 100% of the capacity, totaling approximately 575 MWs (and energy if needed), for the term of each contract, which vary in duration from three to 25 years. The remaining contract provides the Company with capacity and/or energy of up to 10MW, and is for a term of 30 years.

In accordance with the provisions of SFAS No. 13, *Accounting for Leases*, six of the contracts, covering 11 of the generating units, have been accounted for as capitalized lease obligations, whereas the remaining leases, covering the other three generating units, will be accounted for as operating leases.

The following table represents LIPA's minimum lease payments under its capacity and/or energy contracts (thousands of dollars):

Purchase Power Agreements

	Capital	Operating
Minimum lease/rental payments:		
2005	$ 89,552	$ 21,425
2006	88,363	1,796
2007	87,776	1,802
2008	86,198	1,807
2009	85,197	1,813
2010 through 2014	422,538	9,182
2015 through 2019	324,664	9,376
2020 through 2024	81,100	9,595
2025 through 2029	29,827	9,842
2030 through 2035	—	8,554
Total	1,295,215	75,192
Less imputed interest	432,863	—
Net present value	$ 862,352	$ 75,192

(d) Office Lease

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

Year ended December 31:		
2005	$	1,290
2006		1,338
2007		1,388
2008		1,440
2009		1,494
2010 through 2011		1,680
Total	$	8,630

Rental expense for the office lease amounted to approximately $1.4 million and $1.3 million for the years ended December 31, 2004 and 2003, respectively.

(e) Insurance Programs

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

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

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

(12) Legal Proceedings

(a) Environmental

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

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

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

(b) Environmental Matters Retained by LIPA

Long Island Sound Transmission Cables. The Connecticut Department of Environmental Protection (DEP) and the New York State Department of Environmental Conservation (DEC) separately have issued Administrative Consent Orders (ACOs) in connection with releases of insulating fluid from an electric transmission cable system located under the Long Island Sound that LIPA owns jointly with the Connecticut Light and Power Company (CL&P). The ACOs require the submission of a series of reports and studies describing cable system condition, operation and repair practices, alternatives for cable improvements or replacement, and environmental impacts associated with prior leaks of fluid into the Long Island Sound. In 2004, in a multi-party Settlement Agreement LIPA and CL&P agreed to remove and replace the existing cables. The Settlement Agreement, and an associated Implementation Plan and Schedule, provide for various penalties if certain project replacement milestones are not met. If this project does not progress as intended, operation of LIPA's Cross Sound Cable may be curtailed. LIPA believes that the milestone will be met at this time, however, there can be no assurance that this will continue. Liability, if any, resulting from this proceeding cannot yet be determined. However, LIPA does not believe that this proceeding will have a material adverse effect on its financial position, cash flows or results of operations.

In November 2002, a work boat, owned and operated by a third party, dragged its anchor, causing extensive damage to four of the seven cables of the 138-kilovolt facility and the release of a minimal amount of dielectric cable fluid into the Long Island Sound. The work boat had been at the cable site working as part of a large natural gas pipeline project. Temporary repairs were promptly carried out (the cable ends were capped) and permanent repairs completed in June 2003. Litigation arising from the incident commenced in December 2002 and in that litigation LIPA and CL&P aggressively pursued the owner of the work boat as well as the other parties involved in the natural gas pipeline project and who were involved in this incident. As a result of a voluntary mediation in February 2005, LIPA, CL&P and their underwriters reached a settlement agreement with the owner of the work boat and the other parties. It is anticipated that the settlement process should be completed by April 2005.

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

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

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

Metal Bank. In December 1997, the EPA issued its Record of Decision (ROD), in connection with the remediation of a licensed disposal site located in Philadelphia, Pennsylvania, and operated by Metal Bank of America. In the ROD, the EPA estimated that the present worth cost of the selected remedy for the site is $17.3 million. In June 1998, the EPA issued a unilateral administrative order to 13 Potential Responsible Parties (PRPs), including LIPA, for the remedial design and for remedial action at the site. LIPA cannot predict with reasonable certainty the actual cost of the selected remedy, who will implement the remedy, or the cost, if any, to LIPA. Under a PRP participation agreement, LIPA is responsible for 7.95% of the costs associated with implementing the remedy. LIPA has recorded a liability equal to its estimated cost representing its estimated share of the additional cost to remediate this site. The liability phase of the case was tried in the fall of 2002, which resulted in a finding of liability against Metal Bank in January 2003. At a March, 2003 conference before the federal judge, the court ordered that the second stage trial (determination of the final remedy) be held on November 1, 2003. In May, 2003, the Metal Bank parties filed for Federal Bankruptcy protection under Chapter 11, resulting in a reorganization plan that obligated the emerging entity to fund $13.25 million of the final remedy with no further obligation. In 2003, all the parties (EPA, the PRPs, and two Schorsch brothers [owners who were adjudicated liable early in 2003 along with the Metal Bank parties]) entered into nonbinding mediation of two issues: i) the scope of the remedy, and ii) whether and how much the Schorsch brothers are prepared to contribute. As a result of that mediation, a final global settlement has been negotiated, which will not require any monetary payment from the PRPs, but will require individual payments from the Schorsch brothers. The terms of a Consent Decree with the PRPs memorializing this settlement is being finalized and is expected to be so ordered by the court in the summer of 2005. Settlement with the Schorsch brothers, whereby they agree to collectively pay $9.6 million total to the EPA and PRPs is still being negotiated and finalized. The damages phase of the case is suspended, pending the outcome of the final settlements. LIPA believes that the global settlement which includes the $13.25 million from the bankruptcy fund and the $9.6 million from the Schorsch brothers will provide sufficient funding for a full remediation of this site and as such, this proceeding will not have material adverse effect on its financial position, cash flows or results of operations.

PCB Treatment Inc. LILCO has also been named a PRP for disposal sites in Kansas City, Kansas and Kansas City, Missouri. The two sites were used by a company named PCE Treatment, Inc. from 1982 until 1987 for the storage, processing, and treatment of electric equipment, oils, and other materials containing Polychlorinated Biphenyls (PCBs). According to the EPA, the buildings and certain soil areas outside the buildings are contaminated with PCBs. Certain of the PRPs, including LILCO and several other utilities, formed a group, signed a consent order, and investigated environmental conditions at these properties. The work required under this consent order has been completed, and the PRPs, including LIPA, recently signed a second consent order that obligates them to clean up and restore the two contaminated properties. LIPA has been determined to be responsible for less than 1% of the materials that were shipped to this site. Although LIPA is currently unable to determine its precise liability for costs to remediate these sites, LIPA does not believe that this liability will have a material adverse effect on its financial position, cash flows or results of operations.

Environmental Matters Which May be Recoverable from LIPA by KeySpan Through the PSA

Asharoken. In March 1996, the Village of Asharoken (the Village) filed a lawsuit against LILCO in the New York Supreme Court, Suffolk County (Incorporated Village of Asharoken, New York, et al. v. Long Island Lighting Company). Although the Village's negligence claims were dismissed, the causes of action sounding in nuisance remain at issue. Specifically, the Village seeks injunctive relief based upon allegations that the design and construction of the Northport Power Plant upset the littoral drift of sand in the area, thereby causing beach erosion. In a related matter, certain individual residents of the Village commenced an action in New York Supreme Court Suffolk County seeking similar relief (Sbarro v. Long Island Lighting Company). The cases were tried jointly before a judge without a jury. The trial was completed in December 2002 and the parties filed post-trial briefs in March 2003. Since that time, the judge passed away and the case has been reassigned. The parties have agreed that the new judge can decide the case on the existing and supplemental record in lieu of a new trial. Liability, if any, resulting from this proceeding cannot yet be determined. However, LIPA does not believe that this proceeding will have a material adverse effect on its financial position, cash flows or results of operations.

Asbestos Proceedings

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

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

Other Superfund Sites. The Attorney General is in negotiations with LIPA and other parties to achieve settlements at two of three municipal landfills where LILCO allegedly disposed of hazardous substances. The landfills are located in Towns of North Hempstead (the Port Washington Landfill) and Southampton, (the North Sea Landfill). The other municipal landfill where LILCO allegedly disposed of hazardous substances is in the Town of Huntington (the East Northport Landfill). All three landfills have been remediated and the Attorney General is seeking to recover the monies spent by the State in remediating the sites. The East Northport Landfill site was settled with the parties, resulting in an Order on Consent issued by the Attorney General on October 29, 2004. LIPA's share of the settlement was $173,800. The other two sites are still open and the subject of tolling agreements to extend the statute of limitations so that the State does not have to initiate litigation in order to achieve settlements with the various parties. LIPA's share of alleged liability at each site has not been established. LIPA was also served with an Request for Information by the Attorney General seeking information related to LILCO's activities at the Babylon Landfill Site in the Town of Babylon between 1946 and 1992. LIPA has responded to that request even though the statute of limitations has run against the Attorney General for seeking recovery against LIPA. The other potentially responsible parties who have signed tolling agreements could, however, bring an action against LIPA if they are sued by the Attorney General.

Other Matters

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

Future Environmental Compliance Obligations

LIPA, through its contractual obligations to KeySpan under the PSA and the MSA, is subject to the cost of compliance with various current and potential future environmental regulations as promulgated by the federal government and by state and local governments with respect to environmental matters, such as emission of air pollutants, cooling water for generation, the handling and disposal of toxic substances and hazardous, and solid wastes, and the handling and use of chemical products. Electric utility companies generally use or generate a range of potentially hazardous products and by-products that are the focus of such regulation. LIPA is also subject to state laws regarding environmental approval and certification of proposed major transmission facilities.

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

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

In March 2005, the Federal Clean Air Interstate Rule was promulgated, requiring further reduction of SO2 and NOx emissions. Depending on the outcome of one or more legal challenges, compliance requirements would begin in 2010, and are estimated at $4 million rising to as much as $13 million annually in later years. Another rule issued in March 2005, the Hazardous Air Pollutants Rule, set new limits for mercury emissions. While these do not apply to the PSA units, future regulations being considered for nickel would affect PSA units. However, specific control requirements have not been determined by the EPA, and the costs, if any cannot be estimated at this time.

In 2003 the State of New York promulgated separate regulations that would further limit SO2 and NOx beginning in 2004. The PSA units are expected to comply with the NOx requirements without additional material expenditures, and utilize lower sulfur fuel to meet the SO2 regulations at an approximate cost of $20 million in 2005.

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

The Clean Water Act (CWA) requires that electric generating stations hold State Pollutant Discharge Elimination System (SPDES) permits, which reflect water quality considerations for the protection of the environment. Additional capital expenditures may be required by the New York State Department of Environmental Conservation (DEC) upon the periodic renewal of these water discharge permits due to recently promulgated changes in Section 316(b) of the CWA. KeySpan is undertaking the study of the impact of current permit conditions on aquatic resources in consultation with the DEC. The nature and extent of any expenditures cannot be determined until these regulations are finalized, and the studies are completed.

(13) 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 agreement, as amended in March 2002, the Authority had to exercise such right during the 6-month period that began on November 28, 2003 and ended May 28, 2005. In March 2005, the Authority and KeySpan entered into another agreement to extend the window for LIPA's option to purchase KeySpan's Long Island generation assets to December 15, 2005.

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

The Board of Trustees
Long Island Power Authority:

We have audited the basic financial statements of the Long Island Power Authority (Authority) as of and for the year ended December 31, 2004, and have issued our report thereon dated March 21, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States.

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

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

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

KPMG LLP

March 21, 2005