

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

Basic Financial Statements

December 31, 2005 and 2004

(With Independent Auditors' Report Thereon)

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

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KPMG LLP
Suite 200
1305 Walt Whitman Road
Melville, NY 11747-4302

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, 2005 and 2004, 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, 2005 and 2004, and the changes in its financial position and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued a report dated March 23, 2006 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 3 through 12 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. 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 23, 2006

LONG ISLAND POWER AUTHORITY
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Management's Discussion and Analysis

Years ended December 31, 2005 and 2004

Overview of the Financial Statements

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

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

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

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The following is a summary of the Authority's financial information for 2005, 2004, and 2003 (thousands of dollars):

Balance Sheet Summary

	December 31		
	2005	2004	2003
Assets:			
Current assets:			
Cash, cash equivalents and investments	\$ 470,880	412,968	417,987
Other current assets	501,018	369,636	328,929
Noncurrent assets:			
Utility plant, net	4,004,646	3,540,103	3,390,387
Promissory notes receivable	155,425	155,425	155,425
Nonutility property and other investments	464,334	120,213	72,192
Deferred charges	173,828	180,149	120,102
Regulatory assets	859,513	900,032	957,540
Acquisition adjustment, net	3,079,939	3,192,620	3,305,300
Total assets	<u>\$ 9,709,583</u>	<u>8,871,146</u>	<u>8,747,862</u>
Liabilities and net assets:			
Current liabilities	\$ 1,100,126	765,504	802,228
Noncurrent liabilities:			
Long-term debt	6,686,136	6,865,277	6,835,943
Capital lease obligation	1,097,055	772,800	721,630
Other noncurrent liabilities	774,646	435,945	376,441
Total liabilities	<u>9,657,963</u>	<u>8,839,526</u>	<u>8,736,242</u>
Net assets (deficit):			
Capital assets net of related debt	(475,991)	(634,292)	(566,082)
Unrestricted	527,611	665,912	577,702
Total net assets (deficit)	<u>51,620</u>	<u>31,620</u>	<u>11,620</u>
Total liabilities and net assets	<u>\$ 9,709,583</u>	<u>8,871,146</u>	<u>8,747,862</u>

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**Summary of Revenues, Expenses, and Changes in
Net Assets**

	Year ended December 31		
	2005	2004	2003
Electric revenue	\$ 3,281,186	2,853,837	2,583,603
Operating expenses:			
Operations – fuel and purchased power	1,758,533	1,386,907	1,076,969
Operations and maintenance	723,774	691,937	733,655
General and administrative	43,567	40,962	44,875
Depreciation and amortization	237,863	229,316	230,085
Payments in lieu of taxes	222,609	215,312	213,382
Total operating expenses	<u>2,986,346</u>	<u>2,564,434</u>	<u>2,298,966</u>
Operating income	294,840	289,403	284,637
Other income, net	57,518	47,248	53,988
Interest charges	<u>(332,358)</u>	<u>(316,651)</u>	<u>(318,625)</u>
Change in net assets before cumulative effect of change in accounting principle	20,000	20,000	20,000
Cumulative effect of change in accounting principle	<u>—</u>	<u>—</u>	<u>2,873</u>
Change in net assets	20,000	20,000	22,873
Net assets (deficit) – beginning of year	<u>31,620</u>	<u>11,620</u>	<u>(11,253)</u>
Net assets – end of year	<u>\$ 51,620</u>	<u>31,620</u>	<u>11,620</u>

Excess of Revenues over Expenses

The revenues in excess of expenses for the twelve months ended December 31, 2005, 2004, and 2003 were \$20 million.

Revenue

Revenue for the twelve months ended December 31, 2005, increased approximately \$427 million. The increase is attributable to higher recoveries of excess fuel costs totaling approximately \$378 million, the positive effects of weather, load growth and sales mix totaling approximately \$49 million, and higher other miscellaneous revenue of approximately \$5 million primarily due to service fees initiated during 2005. These increases were partially offset by the impact of having one less day of sales in 2005 as 2004 was a leap year, estimated to be approximately \$5 million.

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Revenue for the year ended December 31, 2004, increased approximately \$270 million when compared to the similar period in 2003. The increase is attributable to higher recoveries of excess fuel costs totaling approximately \$239 million, the positive effects of weather, load growth and sales mix totaling approximately \$25 million and the impact of the August 2003 blackout which caused a revenue loss in 2003 estimated at \$7 million. These positive impacts were partially offset by lower nonsystem revenue of approximately \$1 million.

Fuel and Purchased Power Costs

LIPA's tariff includes a fuel recovery provision—the Fuel and Purchased Power Cost Adjustment (“FPPCA”). The FPPCA was modified by the Board in 2003 to allow LIPA to recover in the period incurred fuel and purchased power costs beyond those included in base rates (“Excess Fuel Costs”). As a result of this modification, the FPPCA is designed to recover a sufficient amount of fuel and purchased power costs to allow the Authority to earn \$20 million of excess revenue over expenses each year as a reserve. If fuel prices change such that LIPA would exceed or fail to meet that financial target, the FPPCA will be reduced or increased accordingly. As a result of continuing increases in fuel and purchased power costs, the Authority increased the FPPCA in 2004 by an annual rate of 4.5% of base revenues in February, and by an additional annual rate of 5.0% and 1.0% in June and October, respectively. In 2005, the Authority increased the FPPCA by 1.9% annually, effective June 8, and an additional 5.5% annually, effective October 8, as a result of the increasing fuel and purchased power costs. In December 2005, the Authority proposed to its Board a modified FPPCA to allow the Authority to earn \$75 million of excess revenue over expenses each year with a variance of \$50 million above or below such amount in each year. The proposed modification to the 2006 FPPCA was subject to a public hearing held in March 2006 and must be approved by the Board following such hearing prior to becoming effective. Also in connection with the adoption of the 2006 Operating Budget in December 2005, the Authority decreased the FPPCA by 1% effective January 1, 2006.

Fuel and purchased power costs for the twelve months ended December 31, 2005, increased approximately \$371 million as compared to the same period in 2004. This increase is primarily attributable to increased commodity costs totaling \$330 million and higher sales volumes totaling approximately \$24 million. Also the Authority partially offset fuel and purchased power costs by applying customer credits totaling \$20 million whereas in the similar period of 2004, customer credits totaled \$36 million.

Fuel and purchased power costs for the twelve months ended December 31, 2004 increased approximately \$310 million as compared to the same period in 2003. However, due to the accounting mechanism of the FPPCA, prior year recoveries and deferrals comprise approximately \$216 million of this variation. After eliminating these mechanisms, the increase is attributable to commodity costs totaling approximately \$88 million and higher sales volumes totaling approximately \$6 million.

Operations and Maintenance Expense (O&M)

O&M increased approximately \$32 million for the twelve month period ended December 31, 2005, compared to the similar period in 2004 due to higher PSA costs totaling approximately \$21 million (due primarily to agreed upon increased capacity charges totaling \$14 million and the 2004 Utility Plant true-up totaling approximately \$4 million), higher storm reserve accruals totaling approximately \$7 million, higher MSA costs totaling approximately \$7 million, higher bad debt expense of approximately \$5 million, higher clean energy expenses totaling approximately \$4 million, and various other items totaling approximately \$2 million.

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These increases were partially offset by the absence in 2005 of any costs associated with renting temporary emergency stand-by generators whereas in 2004 LIPA incurred approximately \$14 million.

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 reserve 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.

General and Administrative Expenses (G&A)

General and administrative expenses increased for the year ended December 31, 2005 approximately \$3 million due to the costs associated with the strategic assessment to evaluate LIPA's long-term organizational and business options, other various consulting costs and increased salary and benefit expenses.

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.

Depreciation and Amortization

For the year ended December 31, 2005, depreciation and amortization increased approximately \$9 million due to higher utility plant balances in 2005 when compared to 2004.

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.

Payments in Lieu of Taxes

For the year ended December 31, 2005, payments in lieu of taxes (PILOTs) increased approximately \$7 million due to increased property and school taxes.

For the year ended December 31, 2004, 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.

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Other Income, Net

For the year ended December 31, 2005, other income increased approximately \$10 million due to higher earnings on investment balances which includes amounts held as collateral from various counterparties, totaling approximately \$9 million and higher sales of emissions credits totaling approximately \$6 million. These increases were partially offset by lower interest income related to New York Independent System Operator (NYISO) prior month's re-bills totaling approximately \$5 million.

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.

Interest Charges and Credits

For the year ended December 31, 2005, interest charges and credits increased approximately \$16 million due to increased interest expense on long term debt due primarily to higher interest rates on variable rate debt combined with slightly higher average debt balances outstanding in 2005 when compared to 2004. Additionally during 2005, the Authority incurred interest expense on amounts held as collateral from various counterparties which is offset with increased "other income" earned on amounts held as collateral.

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.

Cash, Cash Equivalents, and Investments

The Authority's cash, cash equivalents, and investments totaled approximately \$471 million, \$413 million, and \$418 million at December 31, 2005, 2004, and 2003, respectively. The increase from 2004 to 2005 is primarily the result of counterparty collateral held by LIPA. The decrease from 2003 to 2004 is primarily the result of higher fuel and purchased power costs. The Authority has maintained a \$250 million balance in its Rate Stabilization Fund. The Authority also has the ability to issue up to \$200 million of commercial paper notes, \$100 million of which is outstanding as of December 31, 2005 and 2004.

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Capital Assets

During 2005 two new natural gas fired generating facilities were constructed on Long Island by separate entities, with a combined capacity of 160 MW. Each of these facilities began supplying capacity and energy to LIPA in accordance with the terms of the Power Purchase Agreements (PPA's) negotiated in 2004. Under the terms of these agreements, LIPA receives 100% of the output from the newly constructed generating unit for a term of 20 years. These PPAs qualify for capitalization under FASB Emerging Issues Task Force Issue No. 01-08 *Determining Whether an Arrangement is a Lease* and SFAS No. 13, *Accounting for Leases*, and have been included in both Utility Plant and Capital Lease Obligations.

During 2004 two generating facilities were constructed on Long Island by two 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 the PPA's negotiated in 2003. Under the terms of one of those agreements, LIPA receives 100% of the output from the facility for a term of 13 years. The agreement contains two optional renewal periods of five years each. This PPA qualifies for capitalization under FASB Emerging Issues Task Force Issue No. 01-08 *Determining Whether an Arrangement is a Lease* and SFAS No. 13, *Accounting for Leases*, and has been included in both Utility Plant and Capital Lease Obligations. The other PPA provides LIPA with 10MW of the capacity and energy for a period of 30 years. This PPA did not qualify for capitalization and is being reported as an executory contract.

Costs incurred under the PPAs are includible in fuel and purchased power costs in the period incurred, in accordance with the FPPCA provisions of the Authority Tariff for Electric Service.

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 (T&D) upgrades to improve reliability and to enhance capacity needed to meet growing customer demands. For the years ended December 31, 2005 and 2004, T&D capital improvements totaled \$215 million and \$204 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.

Regulatory Assets

Regulatory assets decreased approximately \$41 million from December 31, 2004 to December 31, 2005. The decrease is the result of (i) the scheduled recovery of approximately \$37 million, representing a portion of the 2003 deferred Excess Fuel Costs scheduled to be recovered over a ten-year period which began January 1, 2004, in accordance with LIPA's tariff (ii) the scheduled recovery of approximately \$36 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); (iii) partially offset by the additional carrying charges on the Shoreham Property Tax Settlement Agreement related credits totaling approximately \$32 million.

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Regulatory assets decreased approximately \$57 million from December 31, 2003 to December 31, 2004. The decrease is the result of (i) the scheduled recovery of a portion of the 2003 deferred Excess Fuel Costs totaling approximately \$36 million, (ii) the decrease in the deferred unrealized losses on LIPA's fuel hedges totaling approximately \$17 million and (iii) the scheduled recovery of approximately \$35 million related to the Shoreham Property Tax Settlement; partially offset by the additional carrying charges on the Shoreham Property Tax Settlement Agreement related credits totaling approximately \$31 million.

Debt

The Authority's long-term debt, including current maturities is comprised of the following instruments:

Debt
(Thousands of dollars)

	Balance at December 31		
	2005	2004	2003
General Revenue Bonds	\$ 5,826,115	5,966,549	5,900,544
Subordinated Revenue Bonds	935,045	962,345	989,645
Commercial Paper Notes	100,000	100,000	100,000
NYSERDA Notes	155,420	155,420	155,420
	\$ 7,016,580	7,184,314	7,145,609

During 2005, debt decreased as a result of the scheduled maturities of approximately \$194 million, partially offset by the accretion of the capital appreciation bonds totaling \$26 million.

During 2004, the Authority issued \$200 million Electric System General Revenue Bonds, Series 2004A. The issuance consisted 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, 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.

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Investment Ratings

Below are the Authority's securities as rated by Standard and Poor's Corporation (S&P), Moody's Investors Service (Moody's), and Fitch Investors Services, LP (Fitch):

	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 set for each counterparty. At December 31, 2005, the Authority held approximately \$232 million of counterparty collateral, included in current liabilities. At December 31, 2004, no such amounts were required to be posted by the Authority's counterparties.

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, 2005 and 2004, the Authority had unrealized gains on commodity derivatives of approximately \$369 million and \$24 million, respectively, based on quoted market prices.

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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.

During 2004, 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 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 marks its financial derivatives to market and records unrealized gains and losses. At December 31, 2005 and 2004, the Authority had as unrealized market value loss of approximately \$218 million. The Authority received approximately \$125 million of upfront premiums related to those transactions which are being amortized as interest rate modifiers. The gains and losses resulting from these market values have been deferred, and will be recognized when realized.

Other Power Supply

The Authority has entered into numerous 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. During 2005, the Authority began to receive 100% of the output from two newly constructed facilities with total combined capacity of approximately 160MW, which became commercially operational just prior to the summer of 2005. In addition, the construction and installation of a submarine cable to connect Long Island to the power supplies of the PJM Interconnection has progressed on schedule to be commercially operational by the summer of 2007, and the vendor with whom LIPA has engaged to construct and operate 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, are in the permitting and engineering phase of the project. LIPA also entered into an agreement 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 funds 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
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Balance Sheets

December 31, 2005 and 2004

(Dollars in thousands)

Assets	2005	2004
Current assets:		
Cash and cash equivalents	\$ 454,414	335,068
Investments	16,466	77,900
Accounts receivable (net of allowance for doubtful accounts of \$19,485 and \$19,635, respectively)	343,673	274,184
Other accounts receivable	23,902	11,344
Fuel inventory	104,652	66,948
Material and supplies inventory	7,365	7,128
Interest receivable	153	300
Prepayments and other current assets	21,273	9,732
Total current assets	971,898	782,604
Noncurrent assets:		
Utility plant and property and equipment, net	4,004,646	3,540,103
Promissory notes receivable – KeySpan Energy	155,425	155,425
Nonutility property and other investments	464,334	120,213
Deferred loss related to nonfuel derivatives	88,778	86,177
Deferred charges	85,050	93,972
Regulatory assets:		
Shoreham property tax settlement	568,316	572,101
Fuel and purchased power costs recoverable	291,197	327,931
Total regulatory assets	859,513	900,032
Acquisition adjustment (net of accumulated amortization of \$1,015,572 and \$902,891, respectively)	3,079,939	3,192,620
Total assets	\$ 9,709,583	8,871,146

See accompanying notes to basic financial statements.

Liabilities and Net Assets	2005	2004
Current liabilities:		
Short-term debt	\$ 100,000	100,000
Current maturities of long-term debt	202,325	193,630
Current portion of capital lease obligation	121,813	89,552
Accounts payable and accrued expenses	332,008	275,054
Accrued payments in lieu of taxes	43,552	38,082
Accrued interest	44,780	44,465
Counterparty collateral	232,424	—
Customer deposits	23,224	24,721
Total current liabilities	<u>1,100,126</u>	<u>765,504</u>
Noncurrent liabilities:		
Long-term debt	6,686,136	6,865,277
Capital lease obligation	1,097,055	772,800
Asset retirement obligation	81,463	68,320
Deferred credits	68,601	85,323
Deferred credits – financial derivatives	222,996	228,126
Deferred gain – financial derivatives	6,339	10,410
Regulatory liability – fuel derivatives	368,666	23,675
Claims and damages	26,581	20,091
Commitments and contingencies (note 11)		
Total noncurrent liabilities	<u>8,557,837</u>	<u>8,074,022</u>
Net assets (deficit):		
Invested in capital assets net of related debt	(475,991)	(634,292)
Unrestricted	527,611	665,912
Total net assets	<u>51,620</u>	<u>31,620</u>
Total liabilities and net assets	<u>\$ 9,709,583</u>	<u>8,871,146</u>

LONG ISLAND POWER AUTHORITY
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Statements of Revenues, Expenses, and Changes in Net Assets

Years ended December 31, 2005 and 2004

(Dollars in thousands)

	2005	2004
Operating revenues – electric sales	\$ 3,281,186	2,853,837
Operating expenses:		
Operations – fuel and purchased power	1,758,533	1,386,907
Operations and maintenance	723,774	691,937
General and administrative	43,567	40,962
Depreciation and amortization	237,863	229,316
Payments in lieu of taxes	222,609	215,312
Total operating expenses	2,986,346	2,564,434
Operating income	294,840	289,403
Nonoperating revenues and expenses:		
Other income, net:		
Investing income	17,886	7,362
Carrying charges on regulatory asset	32,345	31,577
Other	7,287	8,309
Total other income, net	57,518	47,248
Interest charges and (credits):		
Interest on long-term debt, net	311,391	298,764
Other interest	23,398	20,110
Allowance for borrowed funds used during construction	(2,431)	(2,223)
Total interest charges	332,358	316,651
Total nonoperating revenues and expenses	(274,840)	(269,403)
Change in net assets	20,000	20,000
Total net assets, beginning of year	31,620	11,620
Total net assets, end of year	\$ 51,620	31,620

See accompanying notes to basic financial statements.

LONG ISLAND POWER AUTHORITY
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Statements of Cash Flows

Years ended December 31, 2005 and 2004

(Dollars in thousands)

	2005	2004
Cash flows from operating activities:		
Received from customers for the system sales, net of refunds	\$ 3,273,787	2,896,658
Other operating revenues received	26,979	28,750
Paid to suppliers and employees:		
Operations and maintenance	(745,937)	(781,617)
Fuel and purchased power	(1,704,529)	(1,398,626)
Payments in lieu of taxes	(314,511)	(304,004)
Margin calls on fuel derivative transactions, net	232,424	—
Net cash provided by operating activities	768,213	441,161
Investing activities:		
Net sales (purchases) of investment securities	61,434	120,992
Earnings received on investments	17,703	5,773
Other	2,545	3,371
Net cash provided by investing activities	81,682	130,136
Cash flows from capital and related financing activities:		
Capital and nuclear fuel expenditures	(229,691)	(208,431)
Swaption proceeds		35,000
Proceeds from the issuance of bonds, net of issuance costs	—	192,806
Interest paid, net	(307,228)	(288,319)
Redemption of long-term debt	(193,630)	(186,380)
Net cash used in capital and related financing activities	(730,549)	(455,324)
Net increase in cash and cash equivalents	119,346	115,973
Cash and cash equivalents at beginning of period	335,068	219,095
Cash and cash equivalents at end of period	\$ 454,414	335,068
Reconciliation to net cash provided by operating activities:		
Operating income	\$ 294,840	289,403
Adjustments to reconcile excess of operating income to net cash provided by operating activities:		
Depreciation and amortization	237,863	229,316
Nuclear fuel burned	5,806	4,951
Shoreham surcharges (credits), net	36,130	35,136
Provision for claims and damages	19,824	5,019
Accretion of asset retirement obligation	6,295	3,868
Other, net	(13,893)	(41,995)
Changes in operating assets and liabilities:		
Accounts receivable, net	(81,897)	(24,818)
Fuel and material and supplies inventory	(37,941)	(12,295)
Fuel and purchased power costs recovered related to prior periods	37,034	36,085
Counterparty collateral	232,424	—
Accounts payable and accrued expenses	31,728	(83,509)
Net cash provided by operating activities	\$ 768,213	441,161

See accompanying notes to basic financial statements.

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

Notes to Basic Financial Statements

December 31, 2005 and 2004

(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 Statement 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 2005 and 2004, LIPA paid to KeySpan approximately \$1.7 billion each year under the operating agreements, which includes all fees under such agreements, reimbursement for various taxes and PILOTS, certain fuel and purchase power costs, capital projects, conservation services, research and development and various other expenditures authorized by the Company.

On February 27, 2006 KeySpan announced a definitive agreement under which KeySpan would be acquired in early 2007 by an affiliate of National Grid plc, a company organized under the laws of England and Wales. The transaction is subject to the approval of the shareholders of both companies and to various regulatory approvals. In the event there is a change of control of KeySpan, the Authority and LIPA would have the option of canceling their contracts with KeySpan and the KeySpan subsidiaries.

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.

LONG ISLAND POWER AUTHORITY
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Notes to Basic Financial Statements

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(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, 2005, the Company estimates that approximately \$291 million of fuel and purchased power and the acquisition adjustment, totaling approximately \$3.1 billion would be considered for impairment.

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

Notes to Basic Financial Statements

December 31, 2005 and 2004

(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, and Clean Energy initiatives. Investments' carrying value is reported at amortized cost, which approximates fair market value.

The Authority adopted the provisions of GASB Statement No. 40, *Deposit and Investment Risk Disclosures* for the year ended December 31, 2005.

(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.

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Notes to Basic Financial Statements

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(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, 2005 and 2004, approximately \$155 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) *Nonutility Property and Other Investments*

The Authority's nonutility property and other investments consist of: (i) the fair value of its derivatives totaling approximately \$405 million and (ii) its investment in the Nine Mile Point 2 Decommissioning Trust Fund totaling approximately \$59 million.

(i) *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. 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.

(j) *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. Also included in deferred charges are amounts incurred by the Authority related to various energy projects, the amortization of which will be over the period of benefit (the life of the related Power Purchase Agreement).

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(k) 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, 2005 and 2004 was approximately \$568.3 million and \$572.1 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 \$90 million.

Fuel and Purchased Power Costs Recoverable

LIPA's Tariff for Electric Service ("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

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. As of that date, the FPPCA was set so that LIPA would recover an amount of Excess Fuel Costs necessary to achieve revenue in excess of expenses of \$20 million annually as a reserve. In no event, however, would the FPPCA be set at a level that would recover more than LIPA's Excess Fuel Costs.

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Effective with the Board's adoption of the 2004 budget in mid-February 2004, 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 1.0% effective October 1, 2004. In 2005, the Authority increased the FPPCA by 1.9% annually, effective June 8, and an additional 5.5% annually, effective October 8, 2005. These increases were necessary to comply with the modified FPPCA mechanism, in effect during 2004 and 2005.

In December 2005, a modification to the 2006 FPPCA was proposed that would increase the reserve target noted above from \$20 million annually to \$75 million with a "tolerance band". At the start of each calendar year, the FPPCA would be set at a level designed to achieve the targeted reserve of \$75 million, with a tolerance band of \$50 million above and \$50 million below that level. During the year, the Authority would monitor, and if necessary modify, the FPPCA to achieve no less than \$25 million and no more than \$125 million of reserve. If the reserve is projected to fall below \$25 million for the year, the FPPCA would be increased to a level sufficient to produce a reserve of \$25 million to \$75 million for the year (i.e., the lower half of the tolerance band). If the reserve is projected to exceed \$125 million for the year, the FPPCA would be decreased to a level sufficient to produce \$75 million to \$125 million for the year (i.e., the upper half of the tolerance band). If the projected reserve for the year is between \$25 million and \$125 million, the FPPCA would not change. The proposed modification to the FPPCA was subject to a public hearing held in March 2006 and must be approved by the Board following such hearing prior to becoming effective. Also in connection with the adoption of the 2006 Operating Budget in December 2005, the Authority decreased the FPPCA by 1% annually effective January 1, 2006.

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 or 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, 2005, the Authority deferred its unrealized gain on fuel derivatives of approximately \$369 million.

(l) 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.

(m) Fair Values of Financial Instruments

The Company's financial instruments approximate their fair market value as of December 31, 2005 and 2004. The fair values of the Company's long-term debt and derivative instruments are based on quoted market prices.

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(n) 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, 2005, and 2004, the unamortized net present value of the minimum contract payments related to the various contracts totaled approximately \$1.2 billion and \$862 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, see note 11 of notes to basic financial statements.

(o) 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, KeySpan or the Internal Revenue Service.

During 2005 and 2004, amounts determined as due to customers totaling approximately \$20 million and \$36 million, respectively, were applied against the Excess Fuel Costs.

(p) 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.

(q) 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, 2005, and 2004, LIPA received approximately 52% of its revenues from residential sales, 44% from sales to commercial and industrial customers, and the balance from sales to public authorities and municipalities.

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(r) 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 2.99%.

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	—

(s) 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.

(t) 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.

(u) 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.

LONG ISLAND POWER AUTHORITY
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Notes to Basic Financial Statements

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(v) ***Asset Retirement Obligation***

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 (NMP2) 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, 2005 and 2004, respectively, the asset retirement obligation was approximately \$72.4 million and \$68.3 million.

Additionally, during 2005, FASB Summary of Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*—an interpretation of SFAS No. 143 was issued. This Interpretation clarifies that the term conditional asset retirement obligation as used in SFAS No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and (or) method of settlement. Prior to this interpretation, LIPA did not report an ARO on certain of its utility assets. However, as a result of this interpretation, approximately \$3 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 \$4 million and increased utility plant, and property and equipment. The required obligation under the standard was approximately \$9 million.

(w) ***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.

(x) ***Use of Estimates***

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

LONG ISLAND POWER AUTHORITY
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Notes to Basic Financial Statements

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(y) **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:

Fuel Derivative Transactions

<u>Type of contract</u>	<u>Duration</u>	<u>Volume per month</u>
Oil contracts (volumes in barrels):		
Options		
Put Short	Jan 06 – Dec 08	80,000-600,000
Call Long	Jan 06 – Dec 08	80,000-600,000
Swap Long	Jan 06 – Dec 08	20,000-535,000
Gas transactions (volumes in decatherms):		
Put Short	Jan 06 – Dec 08	435,000-3,255,000
Call Long	Jan 06 – Dec 08	435,000-3,255,000
Swap Long	Jan 06 – Dec 08 *	75,000-3,065,000
Basis transactions (volumes in decatherms):		
Swap Long	Jan 06 – Mar 07 **	140,000-1,240,500

* No ownership from January to April 2008

** No ownership from April to October 2006

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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, 2005	
			Mark to market	Deferred gain (loss)
\$ 150,000	11/12/1998	Floating to Fixed	\$ (11,134)	(11,134)
100,000	11/12/1998	Floating to Fixed	(8,168)	(8,168)
587,225	6/1/2003	Floating to Fixed (a)	(136,285)	(40,257)
100,995	7/1/2004	Fixed to Floating	(657)	(657)
100,995	7/1/2004	Fixed to Floating (b)	(619)	(619)
502,090	7/1/2004	Basis Swap (c)	(30,150)	(13,945)
251,045	7/1/2004	Basis Swap (d)	(15,165)	(7,062)
251,045	7/1/2004	Basis Swap (d)	(15,039)	(6,936)
	Total		\$ (217,217)	(88,778)
116,000	11/1/2001	Fixed to Floating	\$ 4,623	4,623
116,000	4/1/2003	Floating to Fixed (b)	(5,779)	1,716
	Total		\$ (1,156)	6,339

(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).

For a further discussion on rate matters, see note 12 of notes to basic financial statements.

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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).

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Notes to Basic Financial Statements

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(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, 2005 (thousands of dollars):

	<u>Beginning balance</u>	<u>Additions</u>	<u>Deletions</u>	<u>Ending balance</u>
Capital assets, not being depreciated:				
Land	\$ 9,941	2,233	—	12,174
Retirement work in progress	6,850	15,043	725	21,168
Construction in progress	73,548	203,477	186,595	90,430
Total capital assets not being depreciated	<u>90,339</u>	<u>220,753</u>	<u>187,320</u>	<u>123,772</u>
Capital assets, being depreciated:				
Generation – nuclear	700,915	2,439	—	703,354
Transmission and distribution	2,325,845	175,139	9,564	2,491,420
Common	4,724	12,744	13	17,455
Nuclear fuel in process and in reactor	46,513	11,174	—	57,687
Office equipment, furniture, and leasehold improvements	3,307	192	3	3,496
Generation assets under capital lease	944,398	403,431	—	1,347,829
Total capital assets being depreciated	<u>4,025,702</u>	<u>605,119</u>	<u>9,580</u>	<u>4,621,241</u>
Less accumulated depreciation for:				
Generation – nuclear	132,829	26,404	—	159,233
Transmission and distribution	320,403	96,880	14,296	402,987
Common	807	2,347	13	3,141
Nuclear fuel in process and in reactor	37,656	5,806	—	43,462
Office equipment, furniture, and leasehold improvements	2,197	386	—	2,583
Generation assets under capital lease	82,046	46,915	—	128,961
Total accumulated depreciation	<u>575,938</u>	<u>178,738</u>	<u>14,309</u>	<u>740,367</u>
Net value of capital assets, being depreciated	<u>3,449,764</u>	<u>426,381</u>	<u>(4,729)</u>	<u>3,880,874</u>
Net value of all capital assets	<u>\$ 3,540,103</u>	<u>647,134</u>	<u>182,591</u>	<u>4,004,646</u>

In 2005, depreciation expense related to capital assets was approximately \$125 million.

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

	<u>Beginning balance</u>	<u>Additions</u>	<u>Deletions</u>	<u>Ending balance</u>
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	<u>46,499</u>	<u>200,897</u>	<u>157,057</u>	<u>90,339</u>
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	<u>3,789,632</u>	<u>250,286</u>	<u>14,216</u>	<u>4,025,702</u>
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	<u>445,744</u>	<u>160,423</u>	<u>30,229</u>	<u>575,938</u>
Net value of capital assets, being depreciated	<u>3,343,888</u>	<u>89,863</u>	<u>(16,013)</u>	<u>3,449,764</u>
Net value of all capital assets	<u>\$ 3,390,387</u>	<u>290,760</u>	<u>141,044</u>	<u>3,540,103</u>

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

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(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 \$544 million and \$568 million as of December 31, 2005 and 2004, 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 \$72 million as of December 31, 2005, and is included in the balance sheet as a component of the asset retirement obligation. LIPA maintains a trust fund for its share of the decommissioning costs of NMP2, which as of December 31, 2005 and 2004, had an approximate value of \$59.0 million and \$54.1 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.

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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 additional protection (including decontamination costs) of \$1.25 billion of stand-alone excess property insurance and a \$1.0 billion shared excess policy for Nine Mile Point through the Nuclear Electric Insurance Limited (NEIL). Each member of NEIL, including LIPA, is also subject to retrospective premium adjustments in the event losses at other member facilities exceed accumulated reserves. For its share of NMP2, LIPA could be assessed up to approximately \$3.1 million per loss.

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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

The Authority and LIPA each have distinct investment policies to manage the risks associated with each of their investment objectives.

(a) Authority

The Authority's investments are managed by an external investment manager and consist of two accounts; the Operating Fund and the Rate Stabilization Fund. The Operating Fund is managed to meet the liquidity needs of the Authority and the Rate Stabilization Fund is managed to maximize the return on investment. The Authority must maintain a minimum balance of \$150 million in the Rate Stabilization Fund as required by the Authority's bond covenants, however, the Authority has set an informal policy of maintaining a minimum balance of \$250 million. Additionally, the Authority is required to maintain compensating balances of \$1.2 million.

The Authority's investment policy places limits on investments by issuer and by security type and addresses various risks described below. The Board of Trustees of the Authority may also specifically authorize, as it deems appropriate, other investments that are consistent with the Authority's investment objective. The Authority reviews its investment policy on an annual basis to ensure continued effectiveness.

Investment Risks

Credit Risk

The Authority's permissible investments and related minimum credit ratings include U.S. Treasury and Federal Agency obligations (AAA), repurchase agreements (A-1), bankers' acceptances (AA- or Aa3), commercial paper (A1 or P-1), corporate notes (AA- or Aa3), master notes (AA- or Aa3) and asset backed securities (AAA), certificates of deposit (AA- or Aa3), mutual funds (AAAm or AAAM-G), investment contracts (AA- or Aa3), municipal obligations (AA- or Aa3), and variable rate notes (no credit rating limit). The Authority's investment policy prohibits investments involving complex derivatives, reverse repurchase agreements, and short selling and arbitrage related investment activity.

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Concentration of Credit Risk

To address this risk, the Authority's investment policies have established limits such that no more than 5% of the investment portfolio may be invested in the securities of any one issuer with the exception of U.S. Treasury Obligations (100% maximum), each Federal agency (35%), repurchase agreements counterparties (less of 10% or \$50 million), mutual funds (25% maximum) and investment contracts (10%).

Custodial Credit Risk

The Authority believes that custodial credit risk related to its deposits and investments to be minimal as its guidelines stipulate that deposits and investments be held by a third-party custodian who may not otherwise be a counter-party to the transactions, and that all securities are held in the name of the Authority and that will be free and clear of any lien.

Custodial credit risk for deposits is the risk that in the event of a bank failure, the Authority's deposits may not be returned. The Authority's policy to address this risk requires that the custodian or depository bank have a long term credit rating of Aa3/AA. Custodians or depository banks not meeting this credit rating are required to provide collateral.

As of December 31, 2005 and 2004, the Authority had deposits of \$24.6 million and \$25.2 million respectively, of which approximately \$12.8 million and \$0.8 million were not collateralized or were uninsured. Uncollateralized balances were primarily the result of amounts temporarily held pending investment or disbursement. Collateral on the remaining deposits is held in the name of the Authority and range from 102% to 105% of the deposit balances.

Interest Rate Risk

The Authority's policy states that all investments have maturities of 12 months or less, generally. Investment maturities may exceed 12 months provided that the maturity does not exceed the expected disbursement date of those funds, the total average portfolio maturity is one year or less and no individual maturity exceeds three years, with the exception of U.S. Government obligations and investment contracts. The duration of the Authority's investment maturities are detailed in the chart below.

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As of December 31, 2005 and 2004 the Authority had the following investments and maturities (amounts in thousands):

<u>Investment Type</u>	<u>2005 Fair value</u>	<u>Percent of portfolio</u>	<u>Investment Maturities</u>		
			<u>Less than 3 months</u>	<u>3 months to 1 year</u>	<u>1 to 3 years</u>
U.S. Treasury obligations	\$ 9,451	2%	\$ —	9,451	—
Short term discount notes:					
Commercial paper	267,087	33	267,087	—	—
Federal agencies	153,916	57	153,916	—	—
Master notes/money markets	15,728	3	15,728	—	—
Cash & collateralized deposits	24,698	5	24,698	—	—
Total	<u>\$ 470,880</u>	<u>100%</u>	<u>\$ 461,429</u>	<u>9,451</u>	<u>—</u>

<u>Investment Type</u>	<u>2004 Fair value</u>	<u>Percent of portfolio</u>	<u>Investment Maturities</u>		
			<u>Less than 3 months</u>	<u>3 months to 1 year</u>	<u>1 to 3 years</u>
U.S. Treasury obligations	\$ 60,000	15%	\$ 10,040	49,960	—
Variable rate Federal agency obligations	9,994	2	9,994	—	—
Variable rate corporate bonds	19,998	5	9,998	—	10,000
Short term discount notes:					
Commercial paper	255,472	62	255,472	—	—
Federal agencies	38,030	9	30,123	7,907	—
Master notes/money markets	4,316	1	4,316	—	—
Cash & collateralized deposits	25,158	6	25,158	—	—
Total	<u>\$ 412,968</u>	<u>100%</u>	<u>\$ 345,101</u>	<u>57,867</u>	<u>10,000</u>

(b) LIPA

LIPA maintains a separate investment policy applicable to the long term investments in the Nuclear Decommissioning Trust (NDT) which is held to meet LIPA's obligation with respect to the eventual decommission of LIPA's 18% interest in the Nine Mile Point 2 nuclear facility. LIPA guidelines detail permissible investments and portfolio restrictions. LIPA reviews its investment policy on an annual basis, or as required, to ensure continued effectiveness.

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Investment Risks

Credit Risk

LIPA's guidelines minimize the risk by limiting permissible investments to include; obligations of the U.S. Government and its Agencies, corporate or other obligations with an A or better rating, mortgage obligations rated AA or higher, commercial paper with a rating of A1 or P1, certificates of deposit, Eurodollar certificates of deposit and bankers acceptances of domestic banks with A+ rating or better, short term money market investment accounts that conform to the aforementioned permissible investments, portfolio funds of securities designed to replicate the overall market measured by the S&P 500 Index, and futures contracts on the S&P 500 Index in the futures markets. The Board of Trustees authorized the use of equity investments as permissible vehicle within this portfolio in 2004 and limited the maximum exposure to 35%. The Nuclear Decommissioning Trust investment portfolio must be rebalanced quarterly at plus or minus 5% for equity investments. Fixed income securities held in the portfolio must maintain an average credit rating of AA or better with no more than 30% of the portfolio invested in notes and bonds rated A and no more than 20% of the portfolio invested in municipal securities.

Concentration of Credit Risk

To address this risk, LIPA's investment policies have established limits such that more than 5% of the portfolio may be invested in the securities of any one issuer with the exception of U.S. Government and its agencies securities. In addition, no more than 25% of the portfolio may be invested in securities of issuers in the same industry.

Custodial Credit Risk

LIPA does not have a policy relative to custodial credit risk of its deposits, however, as a practical matter, LIPA defers to the policies of the Authority, as discussed above. LIPA's deposits at December 31, 2004 were fully collateralized.

Interest Rate Risk

Due to the long term nature of the NDT asset, interest rate risk is managed to track the Lehman Brothers Government/Credit Bond Index. The portfolio's duration is required to fall within a range of 20% below the duration of the index and 10% above the duration of the index.

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As of December 31, 2005 and 2004 LIPA had the following investments (amounts in thousands):

Investment type	2005 Fair value	Percent of portfolio
Corporate notes and bonds	\$ 25,606	43%
Mortgage obligations	121	—
U.S. Government and its agencies obligations	22,430	38
Money market	105	—
Equity securities	11,668	19
Total	\$ 59,930	100%

Investment type	2004 Fair value	Percent of portfolio
Corporate notes and bonds	\$ 22,379	41%
Mortgage obligations	149	—
U.S. Government and its agencies obligations	17,955	33
Money market	10,308	19
Deposits	3,293	7
Total	\$ 54,084	100%

The overall duration of the three individual accounts averaged 4.6 and 4.5 years at December 31, 2005 and 2004, respectively, and is within the limits described by LIPA's investment guidelines.

(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.

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The Company's bond and note indebtedness and other long-term liabilities as of December 31, 2005 are comprised of the following obligations (thousands of dollars):

	<u>Beginning balance</u>	<u>Accretion/ additions</u>	<u>Retirements/ refundings</u>	<u>Ending balance</u>	<u>Due within one year</u>
Authority debt:					
Electric system general revenue bonds:					
Series 1998A	\$ 2,157,793	7,962	72,830	2,092,925	75,810
Series 1998B	711,580	—	—	711,580	—
Series 2000A	309,071	17,934	—	327,005	—
Series 2001A	300,000	—	—	300,000	—
Series 2001B-K	500,000	—	—	500,000	—
Series 2001L-P	316,000	—	—	316,000	—
Series 2003A	86,900	—	19,500	67,400	13,930
Series 2003B	474,600	—	74,000	400,600	112,585
Series 2003C	323,380	—	—	323,380	—
Series 2003D-O	587,225	—	—	587,225	—
Series 2004A	200,000	—	—	200,000	—
Subtotal – bonds	<u>5,966,549</u>	<u>25,896</u>	<u>166,330</u>	<u>5,826,115</u>	<u>202,325</u>
Electric system subordinate revenue bonds:					
Series 1-3	525,000	—	—	525,000	—
Series 7	250,000	—	—	250,000	—
Series 8	187,345	—	27,300	160,045	—
Subtotal – bonds net	<u>962,345</u>	<u>—</u>	<u>27,300</u>	<u>935,045</u>	<u>—</u>
LIPA Debt:					
NYSERDA notes	155,420	—	—	155,420	—
Subtotal – debt	<u>155,420</u>	<u>—</u>	<u>—</u>	<u>155,420</u>	<u>—</u>
Net unamortized discounts/premiums and deferred amortization	<u>(25,407)</u>	<u>(2,712)</u>	<u>—</u>	<u>(28,119)</u>	<u>—</u>
Total bonds and notes net of unamortized discounts/ premiums	<u>\$ 7,058,907</u>	<u>23,184</u>	<u>193,630</u>	<u>6,888,461</u>	<u>202,325</u>
Other long-term liabilities:					
Deferred credits	\$ 85,323	5,433	22,155	68,601	—
Claims and damages	20,091	17,264	10,774	26,581	—
Capital lease obligation	862,352	403,431	46,915	1,218,868	121,813
Total other long- term liabilities	<u>\$ 967,766</u>	<u>426,128</u>	<u>79,844</u>	<u>1,314,050</u>	<u>121,813</u>

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

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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):

	<u>Beginning balance</u>	<u>Accretion/ additions</u>	<u>Retirements/ refundings</u>	<u>Ending balance</u>	<u>Due within one year</u>
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	<u>5,900,544</u>	<u>225,085</u>	<u>159,080</u>	<u>5,966,549</u>	<u>166,330</u>
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	<u>989,645</u>	<u>—</u>	<u>27,300</u>	<u>962,345</u>	<u>27,300</u>
LIPA Debt:					
NYSERDA notes	155,420	—	—	155,420	—
Subtotal – debt	<u>155,420</u>	<u>—</u>	<u>—</u>	<u>155,420</u>	<u>—</u>
Net unamortized discounts/premiums and deferred amortization	<u>(23,286)</u>	<u>(2,488)</u>	<u>(367)</u>	<u>(25,407)</u>	<u>—</u>
Total bonds and notes net of unamortized discounts/ premiums	<u>\$ 7,022,323</u>	<u>222,597</u>	<u>186,013</u>	<u>7,058,907</u>	<u>193,630</u>
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	<u>\$ 953,380</u>	<u>109,608</u>	<u>95,222</u>	<u>967,766</u>	<u>89,552</u>

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

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The Company's schedule of capitalization for the years ended December 31, 2005 and 2004 is as follows (thousands of dollars):

	<u>Maturity</u>	<u>Interest rate</u>	<u>Series</u>	<u>December 31</u>	
				<u>2005</u>	<u>2004</u>
Electric system general					
Revenue bonds:					
Serial bonds	Annually to 2016	4.250% to 6.000%	a 1998 A	\$ 678,450	738,310
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	151,125	156,133
Serial bonds	Annually to 2016	4.000% to 5.250%	a 1998 B	654,435	654,435
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	327,005	309,071
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	3.250%	b 2001 B	75,000	75,000
Term bonds	May 1, 2033	3.200%	b 2001 C	25,000	25,000
Term bonds	May 1, 2033	3.200%	b 2001 D	50,000	50,000
Term bonds	May 1, 2033	3.300%	b 2001 E	50,000	50,000
Term bonds	May 1, 2033	3.150%	b 2001 F	50,000	50,000
Term bonds	May 1, 2033	3.050%	b 2001 G	50,000	50,000
Term bonds	May 1, 2033	3.150%	b 2001 H	50,000	50,000
Term bonds	May 1, 2033	3.150%	b 2001 I	50,000	50,000
Term bonds	May 1, 2033	3.150%	b 2001 J	50,000	50,000
Term bonds	May 1, 2033	2.950%	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	3.100%	b 2001 M	50,000	50,000
Term bonds	May 1, 2033	3.100%	b 2001 N	50,000	50,000
Term bonds	May 1, 2033	3.200%	b 2001 O	50,000	50,000
Term bonds	May 1, 2033	3.200%	b 2001 P	50,000	50,000
Serial bonds	June 1, 2004 to 2009	3.00% to 5.00%	a 2003 A	67,400	86,900
Serial bonds	December 1, 2003 to 2014	3.00% to 5.25%	a 2003 B	400,600	474,600
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	3.36% to 3.52%	c 2003 D-H	293,625	293,625
	December 1, 2029	2.85% to 3.25%	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	33,900
Term bonds	September 1, 2029 to 2034	5.00% to 5.10%	a 2004 A	166,100	166,100
Electric system subordinated					
Revenue bonds	May 1, 2033	3.36% to 3.56%	c Series 1A-3A	275,000	275,000
	May 1, 2033	3.65% to 3.72%	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	160,045	187,345
Total general and subordinated revenue bonds				<u>6,761,160</u>	<u>6,928,894</u>
Commercial paper notes		2.90% to 3.08%	b CP-1	<u>100,000</u>	<u>100,000</u>

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	Maturity	Interest rate	Series	December 31	
				2005	2004
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				(28,119)	(25,407)
Total long-term debt				6,988,461	7,158,907
Less current maturities				202,325	193,630
Long-term debt				6,786,136	6,965,277
Net assets				51,620	31,620
Total capitalization				\$ 6,837,756	6,996,897

a – Fixed rate

b – Variable rate (rate presented is as of December 31, 2005); Auction rate mode reset at rates as determined by auction agent.

c – Variable rate (rate presented is as of December 31, 2005); Weekly interest rate mode reset at rates as determined by remarketing agent.

d – Variable rate (rate presented is as of December 31, 2005); Daily reset rate mode as determined by remarketing agent.

The debt service requirements for the Company's bonds as of December 31, 2005 are as follows (thousands of dollars):

Due	December 31, 2005			
	Principal	Interest	Net swap payments	Total
2006	\$ 202,325	298,724	10,467	511,516
2007	214,420	288,452	10,467	513,339
2008	225,955	277,590	10,467	514,012
2009	240,730	267,230	10,467	518,427
2010	224,295	256,334	10,467	491,096
2011-2015	1,061,410	1,133,370	53,972	2,248,752
2016-2020	1,143,430	921,245	55,829	2,120,504
2021-2025	1,309,390	698,463	50,771	2,058,624
2026-2030	1,610,155	424,073	28,879	2,063,107
2031-2035	1,183,810	95,403	—	1,279,213
	7,415,920	4,660,884	241,786	12,318,590
Unamortized discounts/premiums	(28,119)	—	—	(28,119)
Unaccreted interest on CABs	(499,340)	—	—	(499,340)
Total	\$ 6,888,461	4,660,884	241,786	11,791,131

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Future debt service is calculated using rates in effect at December 31, 2005 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.

Electric System Subordinated Revenue Bonds

Series 8 (SubSeries A-H)

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

<u>This series is comprised of subseries</u>	<u>Mandatory purchase date (April 1)</u>	<u>Maturity (April 1)</u>	<u>Principal outstanding</u>	<u>Interest rate to mandatory purchase date</u>
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
8F	2006	2011	27,300	5.00
8G	2007	2012	27,300	5.00
8H	2008	2012	27,200	5.00
			<u>\$ 160,045</u>	

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, 2005 and 2004, the Authority redeemed its SubSeries 8D and 8E Bonds, respectively, each 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 remarket its SubSeries 8F Bonds on the mandatory purchase date of April 1, 2006.

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Commercial Paper Notes

The Authority's Supplemental Bond Resolution authorizes the issuance of Commercial Paper Notes, Series CP-1 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 2005, the Authority issued an additional \$50 million of Commercial Paper Notes to reimburse the Authority's treasury for capital projects. As of December 31, 2005, the Authority redeemed all of this issuance. As of December 31, 2005 and 2004, the Authority had Notes outstanding totaling \$100 million.

The Company's short-term indebtedness as of December 31, 2005 and 2004 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)	—
	<u>\$ 100,000</u>	<u>50,000</u>	<u>(50,000)</u>	<u>100,000</u>

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Fair Values of Long-Term Debt

The fair values of the Company's long-term debt as of December 31, 2005 and 2004 were as follows (thousands of dollars):

	Fair value	December 31	
		2005	2004
Electric System General Revenue Bonds, Series 1998 A	\$	2,209,940	2,312,071
Electric System General Revenue Bonds, Series 1998 B		736,457	762,682
Electric System General Revenue Bonds, Series 2000 A		389,732	360,780
Electric System General Revenue Bonds, Series 2001 A		314,299	305,863
Electric System General Revenue Bonds, Series 2001 B through K		500,000	500,000
Electric System General Revenue Bonds, Series 2001 L through P		322,162	313,736
Electric System General Revenue Bonds, Series 2003 A		69,327	90,488
Electric System General Revenue Bonds, Series 2003 B		423,017	500,441
Electric System General Revenue Bonds, Series 2003 C		340,891	331,846
Electric System General Revenue Bonds, Series 2003 D through O		587,225	587,225
Electric System General Revenue Bonds, Series 2004 A		207,989	178,644
Electric System Subordinated Revenue Bonds, Series 1-3 and 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)		165,337	199,164
Electric System Commercial Paper Notes, CP-1		100,000	100,000
NYSERDA Notes		155,420	156,440
Total	\$	7,296,796	7,474,380

(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.

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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 \$1.3 million, \$867,000, and \$426,000, for the years ended December 31, 2005, 2004, and 2003, 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. Between 2004 and 2009, the rates will be adjusted annually in accordance with the formula established in the PSA. The annual capacity charge in 2005, was approximately \$316 million, and the variable charge remained unchanged at \$0.90/Mwh.

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 \$4 million in 2005 and 2004.

(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.

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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.

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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

	<u>PPA</u>	<u>Firm transmission</u>	<u>IPPs*</u>	<u>Total business*</u>
For the years ended:				
2006	\$ 34,474	45,033	168,900	248,407
2007	34,992	47,160	154,300	236,452
2008	35,528	48,866	147,400	231,794
2009	36,083	45,331	121,000	202,414
2010	36,656	45,878	62,400	144,934
2011 through 2015	173,395	235,507	281,700	690,602
2016 through 2020	170,195	246,631	12,600	429,426
2021 through 2025	—	179,991	—	179,991
2026 through 2030	—	186,278	—	186,278
2031 through 2035	—	89,415	—	89,415
Total	<u>\$ 521,323</u>	<u>1,170,090</u>	<u>948,300</u>	<u>2,639,713</u>

* Assumes full performance by NYPA and the IPPs.

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(c) ***Additional Power Supplies***

Purchase Power Agreements

The Company has entered into Power Purchase Agreements (PPA's) with several private companies to develop and operate 17 generating units at sites throughout Long Island. All of the PPA's but one provide for 100% of the capacity, totaling approximately 735 MWs (and energy if needed), for the term of each contract, which vary in duration from three to 25 years from contract initiation date. 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 FASB Emerging Issues Task Force Issue No. 01-8, *Determining Whether an Arrangements a Lease* and SFAS No. 13, *Accounting for Leases*, 14 of the generating units, have been accounted for as capitalized lease obligations, whereas the remaining units, are accounted for as operating leases.

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

	Capital	Operating
Minimum lease/rental payments:		
2006	\$ 121,813	13,613
2007	121,380	13,639
2008	119,954	11,686
2009	119,108	1,813
2010	118,577	1,818
2011 through 2015	596,305	9,182
2016 through 2020	442,191	9,342
2021 through 2025	233,522	9,519
2026 through 2030	17,101	9,715
2031 through 2035	—	6,594
Total	1,889,951	86,921
Less imputed interest	671,083	—
Net present value	\$ 1,218,868	86,921

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(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:	
2006	\$ 1,338
2007	1,388
2008	1,440
2009	1,494
2010	1,550
2011	<u>129</u>
Total	\$ <u><u>7,339</u></u>

Rental expense for the office lease amounted to approximately \$1.4 million for the years ended December 31, 2005 and 2004.

(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.

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(12) Legal Proceedings

(a) Authority to Set Rates

Lawsuits have been commenced as class actions, and additional lawsuits threatened, challenging the steps LIPA has taken to increase its rates to reflect increases in its fuel costs. Among other allegations, the Plaintiffs contend that such increases violate certain conditions imposed on LIPA by the New York State Public Authorities Control Board in 1997. These lawsuits also repeat several criticisms directed at LIPA in a report issued by the New York State Comptroller in December 2005 which, among other things, took issue with the methodology used by LIPA in applying its FPPCA and criticized the increases in rates which have resulted from application of the FPPCA. LIPA believes that its rate structure, including the FPPCA, complies with applicable legal requirements and that the methodology it uses to calculate the FPPCA is correct. Plaintiffs seek injunctive relief and an unspecified amount of damages on behalf of themselves and other class members. LIPA will vigorously contest these cases and expects to prevail. If the Authority does not prevail in this litigation, it may influence the timing and size of rate increases implemented by the Authority and/or require (i) the modification of the plan to accelerate retirement of debt (ii) the withdrawal of funds from the Rate Stabilization Fund to avoid or minimize rate increases, or (iii) other action necessary to meet any required conditions.

(b) Environmental

In connection with the LIPA/LILCO Merger (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.

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(c) ***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 “1385 Cable”). 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. Pursuant to the June 24, 2004 Settlement Agreement (as referenced above) LIPA and CL&P agreed to undertake good faith negotiations on all contracts and other arrangements necessary for the removal and replacement of the 1385 Cable and to complete such negotiations no later than October 1, 2004. LIPA and CL&P further agreed to develop and implement a plan for such replacement on a schedule approved by the Commissioner of DEP. LIPA and CL&P have completed such negotiations, entered into two agreements with Northeast Utilities Service Company (NUSCO) relating to the use and replacement of the 1385 Cable, and submitted an implementation plan for such replacement, which was approved by the DEP. Replacement of the 1385 Cable is being procured by NUSCO on behalf of both LIPA and CL&P, and is expected to be completed in 2008.

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 1385 cable 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 insurance underwriters reached a settlement agreement with the owner of the work boat and the other parties, which was completed in 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.

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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. Nevertheless,, 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 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. 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 the two Schorsch brothers [owners who were adjudicated liable early 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 was negotiated, which did not require any monetary payment from the PRPs, but required the collective payment of \$9.6 million from the Schorsch brothers. In 2005, Final Consent Decrees were published for public comment, the public hearing was held, and the Federal Judge is expected to shortly approve the Decrees, making all the settlement terms final, and formally ending the litigation. Shortly, the Utilities Group (of which LIPA is a party) expects to submit to the EPA for its approval the Final Remedial Design Plan, and approval is expected in the first half of 2006. As a result of the entry of the Consent Decrees, the Utilities Group should be paid approximately \$4 million by the defendant Schorsch brothers, which the Utilities Group intends to retain as a reserve should a contingency arise and the \$13.25 million (funding of which is now ready to begin) by the Metal Bank successor in bankruptcy for the remedial work be insufficient. Based on the above, the Utilities Group expects remediation work to commence in 2006.

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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.

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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 a 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

East End Property Company #1, LLC, et al. v. Richard M. Kessel and The Long Island Power Authority, et al. In January 2006 litigation was commenced against the Authority, among others, contending that certain actions taken by it in connection with the power purchase agreement the Authority entered into with Caithness Long Island LLC ("Caithness"), the proposed construction by Caithness of a power plant in Brookhaven and the possible extension of the Iroquois Pipeline to the plant violate State environmental laws and other State laws and regulations. Plaintiff seeks, among other things, to annul actions the Authority has taken in connection with the power purchase agreement, to enjoin any action taken in furtherance of such agreement and to declare actions taken by the Authority in connection with the extension of the Iroquois Pipeline to be void. The Authority will file its answer to the complaint on March 1, 2006 and will vigorously contest this litigation.

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.

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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 pollutants, potentially hazardous products and by-products that are the focus of such regulation. LIPA is also subject to state laws regarding environmental approval and certification of proposed major transmission facilities.

From time to time environmental laws, regulations and compliance programs may require changes in KeySpan's operations and facilities, and may increase the cost of energy delivery service. These costs may be reduced in the future, dependent on a capacity ramp down right that is available to LIPA beginning in 2008, the same time period where several compliance obligations occur. 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 (NO_x). The U.S. Environmental Protection Agency (EPA) allocates annual sulfur dioxide emissions allowances to each of the PSA units based historical output. NO_x 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 NO_x emissions, as well as new limits on mercury and nickel emissions. However, specific control requirements have not been determined by the EPA, and the costs, if any cannot be estimated at this time.

In 2003 the State of New York promulgated separate regulations that would further limit SO₂ and NO_x beginning in 2004. The PSA units are expected to comply with the NO_x requirements without additional material expenditures, and utilize lower sulfur fuel to meet the SO₂ regulations at an approximate cost of \$20 million annually from 2005 through 2007. Further fuel sulfur reductions may be required in 2008 and beyond. In 2005, seven Northeast states signed a Memorandum of Understanding called the Regional Greenhouse Gas Initiative (RGGI) for the purpose of capping and then reducing greenhouse gas emissions from power plants. 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 but the ability of the major PSA units to burn lower CO₂ emitting natural gas provides compliance flexibility for these units.

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In March 2005, the Federal Clean Air Interstate Rule was promulgated, requiring further reduction of SO₂ and NO_x emissions. Depending on the outcome of one or more legal challenges, compliance requirements for NO_x reduction would begin in 2009, and could require capital expenditures for emission control equipment on the order of \$25 million to \$35 million from 2006-2009. SO₂ reductions if required are expected to be achieved through the use of lower sulfur fuels or the surrender of excess emission allowances. Another rule issued in March of 2005, the Clean Air Mercury Rule (CAMR) set new limits for mercury emissions from coal fueled plants. These do not apply to the PSA units, The rule making process considered, but ultimately did not determine to regulate, Nickel emissions from oil fired units which would have affected some PSA units. Some aspects of CAMR are being litigated. Accordingly, it can not be determined whether EPA's decision not to regulate nickel will be sustained or whether any future compliance obligations will be imposed.

LIPA and the DEC are parties to a 1998 Consent Order for opacity, for which LIPA pays certain fines for exceeding the opacity limits. While in the past these fines have not been material, the DEC recently issued a draft industry-wide guidance that would increase penalties to as much as \$1 million per violation.

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 ongoing analysis of the impacts and mitigation discussions with NYSDEC are completed. At this time, compliance estimates range from \$20 to \$40 million in the 2006-2010 timeframe.

(13) Subsequent Events

Strategic Organization Review

In August 2004, the Authority began an extensive analysis of its organizational structure. The purpose of the review was to decide whether the Authority, as currently organized and governed, was in the best position to provide Long Island with reliable power at the lowest possible cost over the long term. The review also evaluated whether the Authority should exercise its option to acquire the former LILCO on-Island generation consisting of 53 generating units at 13 locations totaling approximately 4,000 megawatts (the "GPRA Option"). In December 2005, the Authority announced that it would remain in its current structure as a governmental authority and retain its public/private partnership model. The Authority also announced that, in connection with this determination, it had reached an agreement in principle with KeySpan to (i) substantially amend the Management Services Agreement between the Authority and KeySpan Electric Services LLC (the "MSA") and extend its term to December 31, 2013 (ii) settle certain disputes with KeySpan and the KeySpan Subs and (iii) provide the Authority with an option to acquire two of KeySpan's generating facilities with a combined capacity of 450 megawatts (the Barrett and Far Rockaway plants).

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In January, 2006 LIPA entered into definitive agreements to amend the MSA and certain other operating agreements entered into with certain of the KeySpan Subs, subject to certain governmental approvals and other conditions. LIPA also entered into a Settlement Agreement, dated as of January 1, 2006 (the "2006 Settlement Agreement"), with KeySpan and certain of the KeySpan Subs to resolve certain outstanding disputes. LIPA will receive approximately \$120 million in payments or credits pursuant to the 2006 Settlement Agreement. LIPA has announced that it will reserve a portion of such amount to allow it to avoid increasing its electric rates through 2007, absent a world-wide energy crisis. In addition, LIPA expects to pay down approximately \$25 million of its outstanding debt and provide each residential customer with a one-time refund of \$35. LIPA also entered into an option agreement (the "2006 Option Agreement") with KeySpan Generation LLC ("GENCO") which provides LIPA with an option (the "2006 Purchase Option"), exercisable not later than December 31, 2006, to acquire the Barrett and Far Rockaway plants from GENCO. In the event that LIPA acquires either or both of such plants, LIPA and KeySpan have agreed that KeySpan, acting through a subsidiary to be designated, will operate and maintain such plants.

Such agreements are subject to approval by the New York State Comptroller and, as to form, by the New York State Attorney General and are also subject to the condition that each of the 2006 Settlement Agreement, the 2006 Option Agreement and the amendment to the Management Services Agreement must become effective or none will become effective. If such agreements become effective, the GPRA Option will expire. However, if such agreements do not become effective, the Authority will have 90 days to exercise the GPRA Option.

On February 27, 2006 KeySpan announced a definitive agreement under which KeySpan would be acquired in early 2007 by an affiliate of National Grid plc, a company organized under the laws of Great Britain. The transaction is subject to the approval of the shareholders of both companies and to various regulatory approvals. The Authority will evaluate the acquisition of KeySpan by National Grid plc and its effect on the Authority's agreements with KeySpan and the potential benefits to LIPA's customers of the acquisition. In the event there is a change of control of KeySpan, the Authority and LIPA have the option of canceling their contracts with KeySpan and the KeySpan Subs.

2006 Bond Issuance

In March 2006, the Authority issued Series 2006A Electronic System Revenue Bonds totaling approximately \$853 million to refund certain outstanding debt and 2006B Electronic System Revenue Bonds totaling approximately \$97 million to reimburse LIPA's treasury for or to fund capital expenditures for system improvements. In addition, the Authority plans to remarket its Series 8F Subordinated Bonds in April 2006.



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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, 2005, and have issued our report thereon dated March 23, 2006. 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 23, 2006