KPMG

LONG ISLAND POWER AUTHORITY

(A Component Unit of The State of New York)

Basic Financial Statements

December 31, 2006 and 2005

(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, 2006 and 2005, 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, 2006 and 2005, 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 21, 2007 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 11 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 21, 2007

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 entity 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.

LONG ISLAND POWER AUTHORITY
(A Component Unit of The State of New York)
Management's Discussion and Analysis
Years ended December 31, 2006 and 2005

The following is a summary of the Authority's financial information for 2006, 2005, and 2004 (thousands of dollars):

Balance Sheet Summary

	December 31		
	2006	**2005**	**2004**
Assets:			
Current assets:			
Cash, cash equivalents and investments	$ 709,999	470,880	412,968
Other current assets	451,998	501,018	369,636
Noncurrent assets:			
Utility plant, net	4,118,775	4,004,646	3,540,103
Promissory notes receivable	155,425	155,425	155,425
Nonutility property and other investments	69,129	464,334	120,213
Deferred charges	135,830	173,828	180,149
Regulatory assets	861,320	859,513	900,032
Acquisition adjustment, net	2,967,258	3,079,939	3,192,620
Total assets	$ 9,469,734	9,709,583	8,871,146
Liabilities and net assets:			
Regulatory liability	$ 197,918	368,666	23,675
Other current liabilities	838,093	1,100,126	765,504
Noncurrent liabilities:			
Long-term debt	6,806,290	6,686,136	6,865,277
Capital lease obligation	1,044,240	1,097,055	772,800
Other noncurrent liabilities	413,403	405,980	412,270
Total liabilities	9,299,944	9,657,963	8,839,526
Net assets (deficit):			
Capital assets net of related debt	(417,837)	(340,293)	(494,886)
Unrestricted	587,627	391,913	526,506
Total net assets	169,790	51,620	31,620
Total liabilities and net assets	$ 9,469,734	9,709,583	8,871,146

Summary of Revenues, Expenses, and Changes in Net Assets

		Year ended December 31		
		2006	**2005**	**2004**
Electric revenue	$	3,664,976	3,281,186	2,853,837
Operating expenses:				
Operations – fuel and purchased power		2,024,811	1,758,533	1,386,907
Operations and maintenance		765,569	723,774	691,937
General and administrative		43,082	43,567	40,962
Depreciation and amortization		242,206	237,863	229,316
Payments in lieu of taxes		225,077	222,609	215,312
Total operating expenses		3,300,745	2,986,346	2,564,434
Operating income		364,231	294,840	289,403
Other income, net		85,853	57,518	47,248
Interest charges		(331,914)	(332,358)	(316,651)
Change in net assets		118,170	20,000	20,000
Net assets – beginning of year		51,620	31,620	11,620
Net assets – end of year	$	169,790	51,620	31,620

Excess of Revenues over Expenses

The revenues in excess of expenses for the year ended December 31, 2006 totaled approximately $118 million compared with $20 million for 2005 and 2004.

Revenues

Revenue for the year ended December 31, 2006, increased approximately $384 million. The increase is attributable to the higher recoveries of fuel and purchased power costs totaling approximately $429 million plus higher average pricing totaling approximately $43 million. These increases were partially offset by a reduction of load totaling approximately $10 million, and the negative effects of weather estimated to be approximately $78 million.

Revenue for the year ended December 31, 2005, increased approximately $427 million over the year ended December 31, 2004. The increase is attributable to higher recoveries of fuel and purchased power 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.

Fuel and Purchased Power Costs

LIPA's tariff includes a fuel recovery provision—the Fuel and Purchased Power Cost Adjustment (FPPCA) that provides for the amount and timing of fuel and purchased power cost recoveries. During 2005, the FPPCA provided for the recovery of fuel and purchased power costs in the period incurred, in amounts sufficient to allow the Authority to earn a financial target of $20 million of excess revenue over expenses as a reserve. In April 2006, the Board approved a modification to the FPPCA increasing the financial target from $20 million to $75 million with a variance of $50 million above or below such amount in each year. Should fuel and purchased power prices change such that LIPA would exceed or fail to meet its financial target, the FPPCA would be reduced or increased accordingly. In no event, however, can LIPA recover an amount that exceeds its fuel and purchased costs incurred.

For the year ended December 31, 2006, fuel and purchased power costs increased approximately $266 million as compared to the same period in 2005. Commodity costs increased approximately $75 million compared to 2005, partially offset by lower sales volumes totaling approximately $58 million. Additional variations were due to (i) a $198 million accrual to reflect a regulatory liability for fuel recoveries in excess of amounts incurred, (ii) the recognition of previously deferred unrealized mark-to-market fuel derivative valuations totaling approximately $32 million, (iii) the application, in 2005, of customer credits totaling $20 million to partially offset fuel and purchased power costs (no such customer credits were available in 2006), and (iv) lower recoveries of the 2003 deferred fuel costs of approximately $1 million.

Fuel and purchased power costs for the year 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.

Operations and Maintenance Expense (O&M)

Operations and maintenance expenses increased approximately $42 million for the year ended December 31, 2006 due to increased power supply agreement (PSA) capacity costs totaling approximately $26 million, higher storm cost accruals totaling approximately $31 million, higher expenses related to the clean energy programs totaling approximately $5 million and additional expenses from various other items totaling approximately $1 million. These increases were partially offset by lower management services agreement (MSA) expenses totaling approximately $21 million, due to the renegotiated annual fee effective during 2006.

O&M increased approximately $32 million for the year 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 approximately $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. 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.

General and Administrative Expenses (G&A)

General and administrative expenses for the year ended December 31, 2006 remained relatively unchanged.

General and administrative expenses increased approximately $3 million for the year ended December 31, 2005 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.

Depreciation and Amortization

For the year ended December 31, 2006, depreciation and amortization increased approximately $4 million due to higher utility plant balances in 2006 when compared to 2005.

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.

Payments in Lieu of Taxes

For the year ended December 31, 2006, payments in lieu of taxes (PILOTs) increased approximately $2 million due to increased revenue 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.

Other Income, Net

Other income increased approximately $28 million primarily due to higher investment earnings of approximately $14 million resulting from higher investment balances coupled with higher interest rates, higher income of approximately $12 million from the sale of excess emissions allowances, and lower interest expense totaling approximately $2 million related to New York Independent System Operator (NYISO) prior month's re-bills.

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 excess emissions allowances totaling approximately $6 million. These increases were partially offset by lower interest income related to the NYISO prior month's re-bills totaling approximately $5 million.

Interest Charges and Credits

Total interest charges were relatively unchanged from 2005; however, interest expense on long-term debt increased approximately $3 million due to higher rates on variable rate debt. This was offset by higher allowance for borrowed funds used during construction totaling approximately $3 million as a result of higher construction work in progress balances in 2006 compared to 2005.

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.

Cash, Cash Equivalents, and Investments

The Authority's cash, cash equivalents, and investments totaled approximately $710 million, $471 million, and $413 million at December 31, 2006, 2005, and 2004, respectively. The increase from 2005 to 2006 is primarily the result of higher recoveries of fuel and purchased power costs. The increase from 2004 to 2005 is primarily the result of counterparty collateral held by LIPA. The Authority has maintained a $250 million balance in its Rate Stabilization Fund. The Authority also has the ability to issue up to $300 million of commercial paper notes, $100 million of which is outstanding as of December 31, 2006, 2005 and 2004.

Capital Assets

The Authority continued its investment in transmission and distribution (T&D) upgrades to manage reliability and to enhance capacity needed to meet growing customer demands. For the years ended December 31, 2006 and 2005, capital improvements to the T&D system totaled approximately $270 million and approximately $215 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 increased approximately $2 million from December 31, 2005 to December 31, 2006. The increase is the result of: (i) the deferral of the negative mark-to-market valuation on LIPA's fuel derivatives totaling approximately $41 million, and (ii) approximately $32 million of carrying charges on the Shoreham Property Tax Settlement Agreement related credits, partially offset by, (iii) the recovery of the 2003 deferred excess fuel and purchased power costs totaling approximately $36 million scheduled to be recovered over a ten-year period which began January 1, 2004, in accordance with LIPA's tariff, and (iv) the scheduled recovery of approximately $35 million related to the Shoreham Property Tax Settlement Agreement through a surcharge on billings for electric service to customers residing in Suffolk County (the Shoreham surcharge), which began in June 2003 (as discussed in greater detail in note 3 of notes to basic financial statements).

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 and purchased power costs (ii) the scheduled recovery of approximately $36 million related to the Shoreham Property Tax Settlement Agreement through the Shoreham surcharge (iii) partially offset by the additional carrying charges on the Shoreham Property Tax Settlement Agreement related credits totaling approximately $32 million.

Regulatory Liabilities

For the year ended December 31, 2006, the Authority recorded a regulatory liability of approximately $198 million representing the recovery of fuel and purchased power costs in excess of that incurred. This regulatory liability is currently is being returned to the customer through reductions to the FPPCA.

For 2005, the amount represents the deferral of the positive mark-to-market valuations on LIPA's fuel derivatives.

Debt

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

Debt
(Thousands of dollars)

		Balance at December 31		
		2006	**2005**	**2004**
General Revenue Bonds	$	5,982,213	5,826,115	5,966,549
Subordinated Revenue Bonds		879,725	935,045	962,345
Commercial Paper Notes		100,000	100,000	100,000
NYSERDA Notes		155,420	155,420	155,420
	$	7,117,358	7,016,580	7,184,314

During 2006, debt increased as a result of the issuance of Electric System General Revenue Bonds Series 2006A through Series 2006F. Of these issuances, Series 2006B totaling approximately $97 million and Series 2006C totaling approximately $198 million were used to reimburse LIPA's treasury for or to fund capital expenditures for system improvements in accordance with the approved capital budget. The remaining issuances totaling approximately $2.221 billion were used to refund existing Authority debt totaling approximately $2.212 billion. Also contributing to the variation was scheduled maturities of approximately $230 million partially offset by the accretion of the capital appreciation bonds totaling approximately $27 million. For a full discussion on the Authority's refunding activities during 2006, see note 9 of notes to the basic financial statements.

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.

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, 2006, the Authority did not hold any counterparty collateral. At December 31, 2005, the Authority held approximately $232 million of counterparty collateral, included in current liabilities.

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 customer bills 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 provisions of the FPPCA. Upon realization, such gains and losses are reflected in income and considered in the determination of the FPPCA. At December 31, 2006, the Authority had unrealized losses on commodity derivatives of approximately $41 million. At December 31, 2005, the Authority had unrealized gains on commodity derivatives of approximately $369 million, based on quoted market prices.

Interest rate transactions: – During 2006, the Authority entered into a floating-to-fixed rate swap agreement for a notional amount of approximately $111 million. This agreement effectively converts the underlying debt obligation from a floating rate to a fixed rate of 4.11%. This agreement became effective July 26, 2006 and is co-terminous with the underlying debt maturity of September 1, 2015.

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, 2006 and 2005, the Authority had a net unrealized market value loss of approximately $164 million and $218 million, respectively. The Authority received approximately $125 million of upfront premiums plus administrative costs totaling approximately $24 million related to certain of these derivative transactions. Those proceeds 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 consistent with the Statement of Financial Accounting Standards (SFAS) No. 71, *Accounting for the Effects of Certain Types of Regulation* (SFAS No. 71).

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 2006, the Authority completed negotiations to purchase up to 345 MW of additional capacity and varying amounts of energy from a facility located off Long Island. The agreement has been submitted to the NY State Comptroller's office for approval. Power from this facility is to be transmitted over a submarine cable running between Long Island and Connecticut which is currently being operated under the terms of a Bridge Agreement between the cable owners and the Authority. Effective July 2007 the Bridge Agreement will expire and be replaced by a 25-year lease agreement.

In addition, the Authority has entered into an agreement to purchase 660 MW of transmission capacity on an undersea high voltage cable currently under construction between New Jersey and New York. The cable is expected to be completed in 2007 thus permitting the Authority to import 660 MW of power from the Pennsylvania, New Jersey and Maryland markets (PJM-ISO). The Authority is also in negotiations with owners of a facility located in the PJM-ISO to secure a long-term supply to fully utilize the capability of this cable. The Authority also entered into an agreement to acquire 286 MW from a 326 MW plant to be constructed on Long Island and expected to be in operation no later than 2009.

During 2005 two new natural gas fired generating facilities with a combined capacity of 160 MW were constructed on Long Island by third party entities. Each of these facilities began supplying capacity and energy to LIPA in accordance with the terms of Power Purchase Agreements (PPA's) negotiated in 2004. Under the terms of these agreements, LIPA receives 100% of the output from these facilities 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.

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.

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.

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
(A Component Unit of the State of New York)

Balance Sheets

December 31, 2006 and 2005

(Dollars in thousands)

Assets		**2006**	**2005**
Current assets:			
Cash and cash equivalents	$	501,244	430,855
Investments		208,755	40,025
Accounts receivable (net of allowance for doubtful accounts of $19,485)		269,477	343,673
Other accounts receivable		9,615	23,902
Fuel inventory		138,175	104,652
Material and supplies inventory		6,871	7,365
Interest receivable		460	153
Prepayments and other current assets		27,400	21,273
Total current assets		1,161,997	971,898
Noncurrent assets:			
Utility plant and property and equipment, net		4,118,775	4,004,646
Promissory notes receivable – KeySpan Energy		155,425	155,425
Nonutility property and other investments		69,129	464,334
Deferred loss – financial derivatives		46,187	88,778
Deferred charges		89,643	85,050
Regulatory assets:			
Shoreham property tax settlement		565,392	568,316
Fuel and purchased power costs recoverable		295,928	291,197
Total regulatory assets		861,320	859,513
Acquisition adjustment (net of accumulated amortization of $1,128,253 and $1,015,572, respectively)		2,967,258	3,079,939
Total assets	$	9,469,734	9,709,583

See accompanying notes to basic financial statements.

Liabilities and Net Assets		2006	2005
Current liabilities:			
Short-term debt	$	100,000	100,000
Current maturities of long-term debt		218,605	202,325
Current portion of capital lease obligation		121,380	121,813
Accounts payable and accrued expenses		286,738	332,008
Regulatory liability – fuel and purchased power costs		197,918	368,666
Accrued payments in lieu of taxes		43,462	43,552
Accrued interest		42,771	44,780
Counterparty collateral		—	232,424
Customer deposits		25,137	23,224
Total current liabilities		1,036,011	1,468,792
Noncurrent liabilities:			
Long-term debt		6,806,290	6,686,136
Capital lease obligation		1,044,240	1,097,055
Asset retirement obligation		85,086	81,463
Deferred credits		74,367	68,601
Deferred credits – derivatives		209,973	222,996
Deferred gain – financial derivatives		12,338	6,339
Claims and damages		31,639	26,581
Commitments and contingencies (note 11)			
Total noncurrent liabilities		8,263,933	8,189,171
Net assets (deficit):			
Invested in capital assets net of related debt		(417,837)	(340,293)
Unrestricted		587,627	391,913
Total net assets		169,790	51,620
Total liabilities and net assets	$	9,469,734	9,709,583

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

Statements of Revenues, Expenses, and Changes in Net Assets

Years ended December 31, 2006 and 2005

(Dollars in thousands)

		2006	2005
Operating revenues – electric sales	$	3,664,976	3,281,186
Operating expenses:			
Operations – fuel and purchased power		2,024,811	1,758,533
Operations and maintenance		765,569	723,774
General and administrative		43,082	43,567
Depreciation and amortization		242,206	237,863
Payments in lieu of taxes		225,077	222,609
Total operating expenses		3,300,745	2,986,346
Operating income		364,231	294,840
Nonoperating revenues and expenses:			
Other income, net:			
Investing income		31,636	17,886
Carrying charges on regulatory asset		32,438	32,345
Other		21,779	7,287
Total other income, net		85,853	57,518
Interest charges and (credits):			
Interest on long-term debt, net		319,508	311,391
Other interest		17,992	23,398
Allowance for borrowed funds used during construction		(5,586)	(2,431)
Total interest charges		331,914	332,358
Total nonoperating revenues and expenses		(246,061)	(274,840)
Change in net assets		118,170	20,000
Total net assets, beginning of year		51,620	31,620
Total net assets, end of year	$	169,790	51,620

See accompanying notes to basic financial statements.

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

Statements of Cash Flows

Years ended December 31, 2006 and 2005

(Dollars in thousands)

		2006	2005
Cash flows from operating activities:			
Received from customers for the system sales, net of refunds	$	3,774,745	3,273,787
Other operating revenues received		41,556	26,979
Paid to suppliers and employees:			
Operations and maintenance		(801,155)	(745,937)
Fuel and purchased power		(1,754,621)	(1,704,529)
Payments in lieu of taxes		(327,317)	(314,511)
Margin calls on fuel derivative transactions, net		(232,424)	232,424
Net cash provided by operating activities		700,784	768,213
Investing activities:			
Net (purchases) sales of investment securities		(168,730)	37,875
Earnings received on investments		29,731	17,703
Other		17,707	2,545
Net cash (used in) provided by investing activities		(121,292)	58,123
Cash flows from capital and related financing activities:			
Capital and nuclear fuel expenditures		(297,651)	(229,691)
Proceeds from the issuance of bonds, net of issuance costs		2,630,584	—
Interest paid, net		(281,776)	(307,228)
Redemption of long-term debt		(2,560,260)	(193,630)
Net cash used in capital and related financing activities		(509,103)	(730,549)
Net increase in cash and cash equivalents		70,389	95,787
Cash and cash equivalents at beginning of period		430,855	335,068
Cash and cash equivalents at end of period	$	501,244	430,855
Reconciliation to net cash provided by operating activities:			
Operating income	$	364,231	294,840
Adjustments to reconcile excess of operating income to net cash provided by operating activities:			
Depreciation and amortization		242,206	237,863
Nuclear fuel burned		5,259	5,806
Shoreham surcharges (credits), net		35,362	36,130
Provision for claims and damages		43,301	19,824
Accretion of asset retirement obligation		4,699	6,295
Other, net		3,667	(13,893)
Changes in operating assets and liabilities:			
Accounts receivable, net		88,483	(81,897)
Fuel and material and supplies inventory		(33,029)	(37,941)
Fuel and purchased power costs		265,773	37,034
Counterparty collateral		(232,424)	232,424
Accounts payable and accrued expenses		(86,744)	31,728
Net cash provided by operating activities	$	700,784	768,213

See accompanying notes to basic financial statements.

(1) Basis of Presentation

The Long Island Power Authority (Authority) was established as a corporate municipal instrumentality of the State of New York, constituting a political subdivision of the State, created by Chapter 517 of the Laws of 1986 (the LIPA 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 (LILCO), 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 2006 and 2005, LIPA paid to KeySpan approximately $2 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 by an affiliate of National Grid plc, a company organized under the laws of England and Wales. The transaction is subject 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 Administrative Services Agreement.

(3) Summary of Significant Accounting Policies

General

The Company complies with all applicable pronouncements of the Governmental Accounting Standards Board (GASB). In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting,* the Company complies with all authoritative pronouncements applicable to 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.

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, 2006, the Company estimates that approximately $98 million of net fuel and purchased power recoverable, approximately $34 million of net deferred losses on the Company's financial derivative transactions, and the acquisition adjustment, totaling approximately $3 billion would be considered for impairment.

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.

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 fair market value.

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.

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.

Promissory Note Receivable

As part of the 1998 Merger, KeySpan issued promissory notes to LIPA of approximately $1.048 billion. As of December 31, 2006 and 2005, 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.

Nonutility Property and Other Investments

The Authority's nonutility property and other investments consist of the fair value of certain derivatives and its investment in the Nine Mile Point 2 Decommissioning Trust Fund (the Trusts). At December 31, 2006 and 2005, the value of the Trusts was approximately $63 million and $59 million, respectively. The remaining variation is due to changes in the mark-to-market valuation of certain derivative instruments. For a further discussion on the Authority's derivative instruments, and the Trusts, see footnote 4 and footnote 7, respectively.

Deferred Gains (Losses) – Financial Derivatives

The Authority uses derivative instruments to manage the impact of interest rate changes 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.

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, whose amortization is charged to fuel and purchased power costs over the period of benefit (the life of the related Power Purchase Agreement).

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 Settlement, 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, 2006 and 2005 was approximately $565.4 million and $568.3 million, respectively. The balance represents costs recorded from 1998 through 2004 including rebates and credits issued to customers, costs of administering the program plus annual debt service costs on the bonds identified above less surcharges collected since May 2003 totaling approximately $125 million.

Fuel and Purchased Power Costs Recoverable

LIPA's tariff includes a fuel recovery provision—the Fuel and Purchased Power Cost Adjustment (FPPCA) that provides for the amount and timing of fuel and purchased power cost recoveries. During 2005, the FPPCA provided for the recovery of fuel and purchased power costs in the period incurred, in amounts sufficient to allow the Authority to earn a financial target of $20 million of excess revenue over expenses as a reserve. In April 2006, the Board approved a modification to the FPPCA increasing the financial target from $20 million to $75 million with a variance of $50 million above or below such amount in each year. Should fuel and purchased power prices change such that LIPA would exceed or fail to meet its financial target, the FPPCA would be reduced or increased accordingly. In no event, however, can LIPA recover an amount that exceeds its fuel and purchased cost incurred.

Prior to 2004, LIPA deferred a portion of its excess fuel and purchased power costs and collected those costs in subsequent years. In order to transition to a current period recovery method, LIPA deferred, in 2003, approximately $365 million to be recovered over a 10-year period beginning January 1, 2004. As of December 31, 2006, the balance remaining totals approximately $255 million.

The Authority uses derivative instruments to protect its customers, earnings and cash flows from significant price fluctuations for the purchase of fuel oil, natural gas and electricity. As the Authority is subject to the provisions of SFAS No. 71, gains and losses on such derivatives are deferred until realized.

Acquisition Adjustment

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

Fair Values of Financial Instruments

The Company's financial instruments are at fair market value as of December 31, 2006 and 2005.

Capitalized Lease Obligations

Capitalized lease obligations represent 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.

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.

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, amounts determined as due to customers totaling approximately $20 million, were applied against the fuel costs.

Deferred Credits – Derivatives

Deferred credits – derivatives represents the amount that the Authority would be required to pay its derivative instrument counterparties to terminate these instruments as of December 31, 2006. The amount shown includes unamortized cash balance premiums received by the Authority at the time of entering into these instruments. The Authority is amortizing such premiums ratably over the life of the instrument.

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.

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, 2006 and 2005, LIPA received approximately 51% of its revenues from residential sales, 45% from sales to commercial and industrial customers, and the balance from sales to public authorities and municipalities.

Depreciation and amortization

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 2.96%.

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	—

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.

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.

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.

Regulatory Liability – fuel and purchased power costs

Regulatory liabilities represent amounts that are expected to be refunded to customers through the ratemaking process. In accordance with the FPPCA, LIPA must return any FPPCA revenues it recovers in excess of the fuel and purchased power costs it incurs. Any such over recoveries are recognized as regulatory liabilities. In addition, in accordance with the FPPCA gains on commodity derivatives are deferred and recognized in the period realized.

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 asset which is included in “Utility plant and property and equipment, net”. As of December 31, 2006 and 2005, the NMP2 asset retirement obligation totaled approximately $77 million and $72 million, respectively.

Additionally, during 2005, FASB Summary of Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*—an interpretation of SFAS No. 143, *Accounting for Asset Retirement Obligations*, was issued. This Interpretation clarifies that the term conditional asset retirement obligation as used in SFAS No. 143, 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 was reclassified from accumulated depreciation, where it had 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. As of December 31, 2006 the asset retirement obligation for LIPA’s utility assets totaled approximately $8 million.

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 must be recognized. An impairment is measured as 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.

Use of Estimates

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

Reclassifications

Certain prior 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 to provide executive management oversight by the Authority's energy risk management activities.

Fuel and purchased power transactions: The Authority uses derivative financial instruments as detailed in the table below:

Fuel Derivative Transactions

Type of contract		Duration		Volume per month
Oil contracts (volumes in barrels):				
Options				
Put	Short	Jan 07 – Aug 09		34,000 – 552,000
Put	Long	Jan 07 – Nov 07	(a)	125,000 – 447,000
Call	Long	Jan 07 – Aug 09		34,000 – 552,000
Swap	Long	Jan 07 – Dec 09	(b)	4,000 – 430,000
Gas Transactions (volumes in decatherms):				
Put	Short	Jan 07 – Mar 09	(c)	75,000 - 2,9450,000
Put	Long	Jan 07 – Dec 07		—
Call	Long	Jan 07 – Mar 09	(c)	75,000 – 2,9450,000
Swap	Long	Jan 07 – Dec 09	(d)	232,500 – 4,217,500
Basic transactions (volumes in decatherms):				
Swap	Long	Feb 07 – Mar 07		1,240,000 – 1,260,000

(a) No ownership August – September 2007
(b) No ownership August 2007
(c) No ownership January – May 2009
(d) No ownership January – May 2008

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	Termination date	Type of swap			December 31, 2006 Mark to market	December 31, 2006 Deferred gain (loss)
$	150,000	4/1/2025	Floating to Fixed		$	(8,976)	(8,976)
	100,000	4/1/2025	Floating to Fixed			(5,918)	(5,918)
	587,225	12/1/2029	Floating to Fixed	(a)		(117,362)	(25,349)
	100,995	9/1/2016	Fixed to Floating			(22)	(22)
	110,715	9/1/2015	Floating to Fixed			(5,922)	(5,922)
	Total				$	(138,200)	(46,187)
	100,995	9/1/2016	Fixed to Floating		$	(19)	19
	502,090	8/15/2033	Basis Swap	(c)		(12,522)	2,820
	251,045	8/15/2033	Basis Swap	(d)		(6,231)	1,439
	251,045	8/15/2033	Basis Swap	(d)		(6,110)	1,561
	116,000	5/1/2033	Fixed to Floating			5,516	5,516
	116,000	5/1/2033	Floating to Fixed	(b)		(6,218)	983
	Total				$	(25,584)	12,338

(a) The Authority received an upfront premium totaling approximately $106 million, of which $24.4 million represented reimbursement of administrative costs.
(b) The Authority received an upfront premium totaling approximately $8 million.
(c) The Authority received an upfront premium totaling approximately $17.5 million.
(d) The Authority received an upfront premium totaling approximately $8.75 million.

(5) Rate Matters

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

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

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

For a further discussion on rate matters, see note 12.

(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, 2006 (thousands of dollars):

	Beginning balance	Additions	Deletions	Ending balance
Capital assets, not being depreciated:				
Land	$ 12,174	677	—	12,851
Retirement work in progress	21,168	17,610	26,085	12,693
Construction in progress	90,430	283,380	197,749	176,061
Total capital assets not being depreciated	123,772	301,667	223,834	201,605
Capital assets, being depreciated:				
Generation – nuclear	703,354	8,000	14	711,340
Transmission and distribution	2,491,420	185,763	15,628	2,661,555
Common	17,455	3,590	791	20,254
Nuclear fuel in process and in reactor	57,687	1,691	7	59,371
Office equipment, furniture, and leasehold improvements	3,496	213	5	3,704
Generation assets under capital lease	1,347,829	—	—	1,347,829
Total capital assets being depreciated	4,621,241	199,257	16,445	4,804,053
Less accumulated depreciation for:				
Generation – nuclear	159,233	26,528	14	185,747
Transmission and distribution	402,987	101,525	41,814	462,698
Common	3,141	2,230	791	4,580
Nuclear fuel in process and in reactor	43,462	5,259	—	48,721
Office equipment, furniture, and leasehold improvements	2,583	345	—	2,928
Generation assets under capital lease	128,961	53,248	—	182,209
Total accumulated depreciation	740,367	189,135	42,619	886,883
Net value of capital assets, being depreciated	3,880,874	10,122	(26,174)	3,917,170
Net value of all capital assets	$ 4,004,646	311,789	197,660	4,118,775

In 2006, depreciation expense related to capital assets was approximately $130 million.

The following schedule summarizes the utility plant and property and equipment of the Authority as of December 31, 2005 (thousands of dollars):

		Beginning balance	Additions	Deletions	Ending balance
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		90,339	220,753	187,320	123,772
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		4,025,702	605,119	9,580	4,621,241
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		575,938	178,738	14,309	740,367
Net value of capital assets, being depreciated		3,449,764	426,381	(4,729)	3,880,874
Net value of all capital assets	$	3,540,103	647,134	182,591	4,004,646

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

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

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

LIPA's share of the rated capability of NMP2 is approximately 207 megawatts (MW). LIPA's net utility plant investment, excluding nuclear fuel, was approximately $526 million and $544 million as of December 31, 2006 and 2005, 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 maintains on-site nuclear oversight representation to provide additional support to protect LIPA's interests.

NMP2 License Renewal

In October 2006, the Nuclear Regulatory Commission (NRC) granted a license extension for the Nine Mile Point 2 facility for an additional 20 years, extending the license through October 2046.

In January 2007, LIPA's Board of Trustees agreed to participate in the extended license.

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 $77 million as of December 31, 2006, 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, 2006 and 2005, had an approximate value of $66 million and $59 million, respectively. Through continued deposits and investment returns being maintained within these trusts, the Company believes that the value of these trusts in 2046 will be sufficient to meet the Company's decommissioning obligations.

NMP2 Radioactive Waste

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

Nuclear Plant Insurance

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

In November 2002, the Terrorism Risk Insurance Act of 2002 (TRIA) 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 Secretary of the Treasury, in concurrence with the Secretary of State and Attorney General, determines 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 $15 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 $2.7 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 a new insurance policy. The policy provides a single industry aggregate limit of $200 million for occurrences of radiation injury claims against all those insured by this policy prior to January 1, 2003 and $300 million for occurrences of radiation injury claims against all those insured by this policy on or after January 1, 2003.

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 new 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 $3.0 million per loss.

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

(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.

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.

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% maximum), repurchase agreements counterparties (lesser of 10% or $50 million), mutual funds (25% maximum) and investment contracts (50% maximum).

Custodial Credit Risk

The Authority believes that custodial credit risk related to its 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 free and clear of any lien and held in the name of the Authority.

Custodial credit risk for cash 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, 2006 and 2005, the Authority had deposits of $21 million and $25 million respectively, of which approximately $3 million and $13 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.

As of December 31, 2006 and 2005 the Authority had the following investments and maturities (amounts in thousands):

			Investment Maturities		
Investment Type	**2006 Fair value**	**Percent of portfolio**	**Less than 3 months**	**3 months to 1 year**	**Over 1 year**
Short term discount notes:					
Commercial paper	$ 374,283	53%	$ 167,623	206,660	—
Federal agencies	224,379	32	224,379	—	—
Master notes/money markets	90,000	13	90,000	—	—
Cash and collateralized deposits	21,337	2	19,242	—	2,095
Total	$ 709,999	100%	$ 501,244	206,660	2,095

			Investment Maturities		
Investment Type	**2005 Fair value**	**Percent of portfolio**	**Less than 3 months**	**3 months to 1 year**	**Over 1 year**
U.S. Treasury obligations	$ 9,451	2%	$ —	9,451	—
Short term discount notes:					
Commercial paper	267,087	57	247,216	19,871	—
Federal agencies	153,916	33	153,916	—	—
Master notes/money markets	15,728	3	5,025	10,703	—
Cash and collateralized deposits	24,698	5	24,698	—	—
Total	$ 470,880	100%	$ 430,855	40,025	—

(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 at least annually to ensure that the value in the trusts in 2046, (the year in which decommissioning activities are scheduled to begin) will be sufficient to meet its decommissioning obligations.

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 a 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 no 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.

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.

As of December 31, 2006 and 2005 LIPA had the following investments (amounts in thousands):

Investment type	2006 Fair Value	Percent of Portfolio
Corporate notes and bonds	$ 24,712	37%
Mortgage obligations	118	—
U.S. Government and its agencies obligations	23,495	36
Money market	4,410	7
Equity securities	13,504	20
Total	$ 66,239	100%

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	37
Money market		105	—
Equity securities		11,668	20
Total	$	59,930	100%

The overall duration of the three individual accounts averaged 4.7 and 4.6 years at December 31, 2006 and 2005, 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.

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

The Company's bond and note indebtedness and other long-term liabilities as of December 31, 2006 are comprised of the following obligations (thousands of dollars):

		Beginning balance	Accretion/ additions		Maturities	Refundings		Ending balance	Due within one year
Authority debt:									
Electric system general revenue bonds:									
Series 1998A	$	2,092,925	7,768	(a)	75,810	1,509,775		515,108	79,110
Series 1998B		711,580	—		—	329,020		382,560	111,350
Series 2000A		327,005	18,975	(a)	—	—		345,980	—
Series 2001A		300,000	—		—	134,825		165,175	—
Series 2001B-K		500,000	—		—	—		500,000	—
Series 2001L-P		316,000	—		—	116,000		200,000	—
Series 2003A		67,400	—		13,930	—		53,470	15,795
Series 2003B		400,600	—		112,585	—		288,015	8,165
Series 2003C		323,380	—		—	67,380		256,000	—
Series 2003D-O		587,225	—		—	—		587,225	—
Series 2004A		200,000	—		—	—		200,000	—
Series 2006A		—	853,045		13,800	—		839,245	—
Series 2006B		—	96,955		—	—		96,955	—
Series 2006C		—	198,020		—	—		198,020	—
Series 2006D		—	334,710		5,940	—		328,770	590
Series 2006E		—	515,110		7,510	—		507,600	—
Series 2006F		—	518,090		—	—		518,090	3,595
Subtotal		5,826,115	2,542,673		229,575	2,157,000		5,982,213	218,605
Electric system subordinate revenue bonds:									
Series 1-3		525,000	—		—	—		525,000	—
Series 7		250,000	—		—	—		250,000	—
Series 8		160,045	26,480	(b)	27,300	54,500		104,725	—
Subtotal		935,045	26,480		27,300	54,500		879,725	—
LIPA Debt:									
NYSERDA notes		155,420	—		—	—		155,420	—
Net unamortized discounts/premiums and deferred amortization		(28,119)	23,423		—	(12,233)	(c)	7,537	—
Total bonds and notes, net of unamortized discounts/premiums	$	6,888,461	2,592,576		256,875	2,199,267		7,024,895	218,605
Other long-term liabilities:									
Deferred credits	$	68,601	6,848		1,082	—		74,367	—
Claims and damages		26,581	43,301		38,243	—		31,639	—
Capital lease obligation		1,218,868	—		53,248	—		1,165,620	121,380
Total other long-term liabilities	$	1,314,050	50,149		92,573	—		1,271,626	121,380

(a) Represents accretion of capital appreciation bonds
(b) Remarketed
(c) Represents normal amortization plus write-off of unamortized discount/premiums on refunded series.

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):

	Beginning balance	Accretion/ additions	Maturities	Ending balance	Due within one year
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	5,966,549	25,896	166,330	5,826,115	202,325
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	962,345	—	27,300	935,045	—
LIPA Debt:					
NYSERDA notes	155,420	—	—	155,420	—
Net unamortized discounts/premiums and deferred amortization	(25,407)	(2,712)	—	(28,119)	—
Total bonds and notes, net of unamortized discounts/premiums	$ 7,058,907	23,184	193,630	6,888,461	202,325
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	$ 967,766	426,128	79,844	1,314,050	121,813

The Company's schedule of capitalization for the years ended December 31, 2006 and 2005 is as follows (thousands of dollars):

	Maturity	Interest rate		Series		December 31 2006	December 31 2005
Electric system general							
Revenue bonds:							
Serial bonds	Annually to 2016	4.250% to 6.000%	a	1998 A	$	369,185	678,450
Term bonds	December 1, 2018 to 2029	5.000% to 5.750%	a	1998 A		—	1,263,350
Capital appreciation bonds	December 1, 2007 to 2028	4.400% to 5.300%	a	1998 A		145,923	151,125
Serial bonds	Annually to 2016	4.000% to 5.250%	a	1998 B		382,560	654,435
Term bonds	April 1, 2018	4.750%	a	1998 B		—	57,145
Capital appreciation bonds	June 1, 2010 to 2029	5.000% to 5.950%	a	2000 A		345,980	327,005
Serial bonds	September 1, 2013 to 2021	4.600% to 5.375%	a, f	2001 A		745	21,960
Term bonds	September 1, 2025 to 2029	5.000% to 5.375%	a, f	2001 A		164,430	278,040
Term bonds	May 1, 2033	3.650%	b	2001 B		75,000	75,000
Term bonds	May 1, 2033	3.600%	b	2001 C		25,000	25,000
Term bonds	May 1, 2033	3.600%	b	2001 D		50,000	50,000
Term bonds	May 1, 2033	3.700%	b	2001 E		50,000	50,000
Term bonds	May 1, 2033	3.450%	b	2001 F		50,000	50,000
Term bonds	May 1, 2033	3.500%	b	2001 G		50,000	50,000
Term bonds	May 1, 2033	3.250%	b	2001 H		50,000	50,000
Term bonds	May 1, 2033	3.550%	b	2001 I		50,000	50,000
Term bonds	May 1, 2033	3.600%	b	2001 J		50,000	50,000
Term bonds	May 1, 2033	3.600%	b	2001 K		50,000	50,000
Term bonds	May 1, 2033	5.375%	a, f	2001 L		—	116,000
Term bonds	May 1, 2033	3.320%	b	2001 M		50,000	50,000
Term bonds	May 1, 2033	3.550%	b	2001 N		50,000	50,000
Term bonds	May 1, 2033	3.450%	b	2001 O		50,000	50,000
Term bonds	May 1, 2033	3.450%	b	2001 P		50,000	50,000
Serial bonds	June 1, 2007 to 2009	5.000%	a	2003 A		53,470	67,400
Serial bonds	December 1, 2007 to 2014	3.00% to 5.25%	a, f	2003 B		288,015	400,600
Serial bonds	September 1, 2013 to 2028	4.25% to 5.50%	a, f	2003 C		70,480	137,860
Term bonds	September 1, 2027 to 2033	5.00% to 5.25%	a, f	2003 C		185,520	185,520
Term bonds	December 1, 2029	3.83% to 3.95%	c, f	2003 D-H		293,625	293,625
Term bonds	December 1, 2029	3.50% to 3.65%	b, f	2003 I-O		293,600	293,600
Serial bonds	September 1, 2013 to 2025	3.80% to 4.875%	a, f	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
Serial bonds	December 1, 2016 to 2026	4.00% to 5.25%	a, f	2006A		839,245	—
Serial bonds	December 1, 2035	4.500%	a	2006B		4,240	—
Term bonds	December 1, 2035	5.000%	a	2006B		92,715	—
Term bonds	September 1, 2035	5.000%	a, f	2006C		198,020	—
Serial bonds	September 1, 2007 to 2025	4.00% to 5.00%	a, f	2006D		328,770	—
Serial bonds	December 1, 2017 to 2022	4.00% to 5.00%	a, f	2006E		507,600	—
Serial bonds	May 1, 2007 to 2028	3.50% to 5.00%	a	2006F		405,510	—
Term bonds	May 1, 2033	4.250%	a	2006F		112,580	—

	Maturity	Interest rate		Series	December 31 2006	December 31 2005
Electric system subordinated						
Revenue bonds	May 1, 2033	3.87% to 3.90%	e	Series 1A-3A	$ 275,000	275,000
	May 1, 2033	3.88% to 3.98%	d, f	Series 1B-3B	250,000	250,000
	April 1, 2025	4.210%	a, f	Series 7	250,000	250,000
	April 1, 2009 to 2012	4.000% to 5.250%	a	Series 8	104,725	160,045
Total general and subordinated revenue bonds					6,861,938	6,761,160
Commercial paper notes		3.47% to 3.52%	b	CP-1	100,000	100,000
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					7,537	(28,119)
Total long-term debt					7,124,895	6,988,461
Less current maturities and short-term debt					318,605	202,325
Long-term debt					6,806,290	6,786,136
Net assets					169,790	51,620
Total capitalization					$ 6,976,080	6,837,756

a – Fixed rate

b – Variable rate issued in 1998, (rate presented is as of December 31, 2006); Auction rate mode reset at rates as determined by auction agent.

c – Variable rate (rate presented is as of December 31, 2006); Weekly interest rate mode reset at rates as determined by remarketing agent.

d – Variable rate (rate presented is as of December 31, 2006); Daily reset rate mode as determined by remarketing agent.

e - Variable rate, issued in 1998, (rate presented is as of December 31, 2006); weekly interest rate mode reset at rates determined by remarketing agent.

f - Certain bonds of this series are subject to interest rate exchange agreements - please see note 4.

The debt service requirements for the Company's bonds as of December 31, 2006 are as follows (thousands of dollars):

	December 31, 2006			
Due	**Principal**	**Interest**	**Net swap payments**	**Total**
2007	$ 218,605	291,212	10,467	520,284
2008	226,570	283,573	10,467	520,610
2009	241,370	273,188	10,467	525,025
2010	224,960	262,266	10,467	497,693
2011	238,100	251,910	10,467	500,477
2012-2016	1,126,195	1,124,359	54,718	2,305,272
2017-2021	1,061,325	919,358	55,289	2,035,972
2022-2026	1,354,435	700,695	49,611	2,104,741
2027-2031	1,690,755	430,913	19,365	2,141,033
2032-2035	1,107,640	98,683	—	1,206,323
	7,489,955	4,636,157	231,318	12,357,430
Unamortized discounts/premiums	7,537	—	—	7,537
Unaccreted interest on CABs	(472,597)	—	—	(472,597)
Total	$ 7,024,895	4,636,157	231,318	11,892,370

Future debt service is calculated using rates in effect at December 31, 2006 for variable rate bonds (3.5%). For bonds subject to floating to fixed rate swap agreements, the "net swap payments" represent the fixed swap rate payment net of the assumed future variable rate swap receipts for each agreement. For bonds subject to fixed to floating rate swap agreements, the net swap payments represents the assumed future variable rate swap payments net of the fixed swap rate receipts.

Electric System General Revenue Bonds

Series 2006

In March 2006, the Authority issued Series 2006A and 2006B Electric System General Revenue Bonds. The 2006A Bonds, totaling approximately $853 million par value were used to refund approximately $844 million par value of Series 1998A bonds. This refunding produced approximately $49 million net present value savings. The 2006A bonds have an average life of 16.5 years and an all-in cost of 4.6%. The proceeds from the Series 2006B Bonds, totaling approximately $97 million was used to reimburse LIPA's treasury for capital expenditures for system improvements. The 2006B bonds have an average life of 29 years and an all-in cost of 4.8%.

In July 2006, the Authority issued Series 2006C and 2006D Electric System General Revenue Bonds. The Series 2006C Bonds, totaling approximately $198 million par value, were used to reimburse LIPA's treasury for capital expenditures for system improvements. The Series 2006C Bonds have an average life of 29 years and an all-in cost of approximately 4.9%. The Series 2006D Bonds, totaling approximately $335 million par value, was used to refund approximately $328 million of existing Authority debt including portions of Series 1998A, Series 1998B, Series 2001A and Series 2003C Bonds. The refunding will produce debt service savings of approximately $11.6 million on a net present value basis. The average life of the Series 2006D Bonds is approximately 11 years with an all-in cost of approximately 4.5%.

The Authority also entered into a floating-to-fixed rate swap agreement on a portion of its Series 2006D Bonds for a notional amount of approximately $111 million. This agreement effectively converts the underlying debt obligation from floating rate to a fixed rate of 4.11%. This agreement became effective July 26, 2006 and is co-terminous with the underlying debt maturity of September 1, 2015.

In September 2006, the Authority issued Series 2006E Electric System General Revenue Bonds, totaling approximately $515 million par value to refund approximately $526 million par value of certain Series 1998A bonds. This refunding produced approximately $26 million net present value savings. The 2006E bonds have an average life of 13.7 years and an all-in cost of 4.4%.

In December 2006, the Authority issued Series 2006F Electric System General Revenue Bonds, totaling approximately $518 million par value to refund approximately $514 million of existing Authority debt including portions of Series 1998B, 2001A, 2003C, Series 8 Bonds and all of Series 2001L Bonds. This refunding produced an approximate $29 million net present value savings. The 2006F bonds have an average life of 12.3 years and an all-in cost of 4.2%.

During the fiscal year ended December 31, 2006, the Authority refunded $2.212 billion in existing fixed rate bonds by issuing refunding bonds in a par amount of $2.221 billion at a $111.25 million premium. The result will produce an estimated gross savings of $175.54 million with a present value savings of $115.19 million. The deferred loss on the refunding was $94 million which will be amortized into interest expense in future years. The Authority's refunding activity for 2006 is comprised of the following (thousands of dollars):

Issue description		Refunding par amount	Refunded par amount	Cash flow gain	Present value gain
Series 2006A	$	853,045	843,785	73,794	49,362
Series 2006D		334,710	328,280	17,886	11,595
Series 2006E		515,110	525,610	38,441	25,644
Series 2006F		518,090	513,825	45,420	28,586
	$	2,220,955	2,211,500	175,541	115,187

Commercial Paper Notes

The Authority's Supplemental Bond Resolution authorizes the issuance of Commercial Paper Notes, Series CP-l through CP-3 (Notes) up to a maximum amount of $300 million. The aggregate principal amount of the Notes outstanding at any time may not exceed $300 million. In connection with the issuance of the Notes, the Authority has entered into a Letter of Credit and Reimbursement Agreement which was renegotiated in 2006. Under the terms of the renegotiated Letter of Credit and Reimbursement Agreement, $250 million expires June 15, 2011 and the remaining $50 million expires on December 15, 2015, subject to right of early termination by the bank on June 15, 2012. 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 $50 million of Commercial Paper Notes to reimburse the Authority's treasury to meet short term liquidity needs. As of December 31, 2005, the Authority redeemed all of this issuance. As of December 31, 2006 and 2005, the Authority had Notes outstanding totaling $100 million.

The Company's short-term indebtedness as of December 31, 2006 and 2005 is comprised of the following obligations (thousands of dollars):

	2006			
	Beginning balance	Issuances	Retirements	Ending balance
Short term debt – CP-1	$ 100,000	—	—	100,000
	$ 100,000	—	—	100,000

	2005			
	Beginning balance	Issuances	Retirements	Ending balance
Short term debt – CP-1	$ 100,000	—	—	100,000
Short term debt – CP-2	—	50,000	(50,000)	—
	$ 100,000	50,000	(50,000)	100,000

Fair Values of Long-Term Debt

The fair values of the Company's long-term debt as of December 31, 2006 and 2005 were as follows (thousands of dollars):

Fair value

		December 31	
		2006	**2005**
Electric System General Revenue Bonds, Series 1998 A	$	552,279	2,209,940
Electric System General Revenue Bonds, Series 1998 B		388,444	736,457
Electric System General Revenue Bonds, Series 2000 A		422,230	389,732
Electric System General Revenue Bonds, Series 2001 A		172,213	314,299
Electric System General Revenue Bonds, Series 2001 B through K		500,000	500,000
Electric System General Revenue Bonds, Series 2001 L through P		200,000	322,162
Electric System General Revenue Bonds, Series 2003 A		54,487	69,327
Electric System General Revenue Bonds, Series 2003 B		308,573	423,017
Electric System General Revenue Bonds, Series 2003 C		273,221	340,891
Electric System General Revenue Bonds, Series 2003 D through O		587,225	587,225
Electric System General Revenue Bonds, Series 2004 A		209,838	207,989
Electric System General Revenue Bonds, Series 2006 A		890,858	—
Electric System General Revenue Bonds, Series 2006 B		102,103	—
Electric System General Revenue Bonds, Series 2006 C		209,517	—
Electric System General Revenue Bonds, Series 2006 D		233,254	—
Electric System General Revenue Bonds, Series 2006 E		548,074	—
Electric System General Revenue Bonds, Series 2006 F		537,165	—
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-C and F)		108,066	165,337
NYSERDA Notes		157,942	155,420
Total	$	7,230,489	7,196,796

(10) Retirement Plans

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

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

Under this plan, the Authority's required contributions and payments made to the System were approximately $1.1 million, $1.3 million, and $867,000, for the years ended December 31, 2006, 2005, and 2004, 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 benefits for Authority employees are not separately computed. 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 (PSA)

The PSA provides for the sales to LIPA by KeySpan of all of the capacity, energy and, ancillary service output 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 2006 and 2005, was approximately $334 million and $316 million, respectively, 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 2006 and 2005.

(b) Purchased Power and Transmission Agreements Assumed from LILCO

As a result of the merger with LILCO, LIPA became party to contracts with numerous Independent Power Producers (IPPs) and the New York Power Authority (NYPA) for electric generating capacity. Certain of these agreements have been renegotiated by LIPA or modified to comply with market rules instituted by the NYISO.

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.

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.

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.

As provided by LIPA's tariff, the costs of all of the facilities noted above except for those subject to the PSA 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 the purchased power and transmission contracts assumed from LILCO, as renegotiated or modified (thousands of dollars):

		PPA	Firm transmission	IPPs*	Total business*
For the years ended:					
2007	$	34,227	30,607	152,600	217,434
2008		34,727	30,725	147,700	213,152
2009		35,217	26,919	121,400	183,536
2010		35,696	25,772	62,200	123,668
2011		36,191	25,969	61,900	124,060
2012 through 2016		167,022	132,891	226,600	526,513
2017 through 2021		129,316	127,659	—	256,975
2022 through 2026		—	52,856	—	52,856
2027 through 2031		—	60,591	—	60,591
2032 through 2035		—	38,691	—	38,691
Total	$	472,396	552,680	772,400	1,797,476

* Assumes full performance by NYPA and the IPPs.

(c) Additional Power Supplies 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 associate energy as 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 is 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.

In 2000, the Company negotiated 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 owner 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. As 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. However, LIPA and the cable owner have negotiated the terms of a Bridge Agreement, which allows LIPA to utilize the cable through July 1, 2007. 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 while the owner of the cable attempted to obtain its operating license. 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, to become effective upon expiration of the Bridge Agreement if the cable owner had obtained its operating license.

In 2006, the Authority has completed negotiations with owners of a facility located in New England, to provide up to 345 MW of additional capacity. The power from this agreement will be transmitted to Long Island over the submarine cable running between Long Island and Connecticut, discussed above.

In 2005, LIPA has entered into an agreement to purchase 660 MW of transmission capacity on an undersea high voltage cable currently under construction between New Jersey and New York. The cable is expected to be completed in 2007 thus permitting LIPA to import 660MW of power and energy from the Pennsylvania, New Jersey and Maryland markets (PJM-ISO). The Authority is currently negotiating with the owners of a facility located in PJM to secure a long term power supply to fully utilize the capability of this cable. LIPA also entered into an agreement to acquire 286 MW from a 326 MW plant to be constructed on Long Island which is expected to be in operation no later than 2009.

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

Additional Power Supply Agreements

		Capitalized leases	Other
Minimum lease/rental payments:			
2007	$	121,380	33,499
2008		119,954	33,152
2009		119,108	23,494
2010		118,577	23,717
2011		118,383	23,941
2012 through 2016		598,933	123,157
2017 through 2021		372,172	129,133
2022 through 2026		194,458	135,423
2027 through 2031		5,173	142,042
2032 through 2035		—	18,254
Total		1,768,138	685,812
Less imputed interest		602,518	—
Net present value	$	1,165,620	685,812

(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:		
2007	$	1,388
2008		1,440
2009		1,494
2010		1,550
2011		129
Total	$	6,001

Rental expense for the office lease amounted to approximately \$1.5 million and \$1.4 million, respectively, for the years ended December 31, 2006 and 2005.

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

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

(12) Legal Proceedings

Authority to Set Rates

In February and March 2006, four class action lawsuits were filed in Supreme Court, Nassau County, alleging that LIPA's imposition of fuel and purchased power surcharges on its customers' bills was improper, since LIPA did not obtain Public Service Commission approval prior to the imposition of the surcharges. The lawsuits sought hundreds of millions of dollars in damages as well as an injunction against the continued imposition of the charges. These lawsuits were consolidated into one putative class action and LIPA filed a motion to dismiss on May 17, 2006. The Supreme Court granted LIPA's motion and dismissed the action on September 27, 2006. A notice of appeal was filed on November 1, 2006.

On May 3, 2006, the Authority voluntarily filed two petitions seeking PSC review of LIPA's FPPCA surcharge including the appropriateness of its charges to customers and seeking a confirmation that LIPA is treating fuel and purchased power costs properly and similar to other New York electric companies. The first petition sought a declaratory ruling regarding the PSC's interpretation of its rule on escalation clauses, that the PSC allows utilities to automatically recover increased fuel and purchased power and other costs through escalation clauses. The second petition asked the PSC to confirm the appropriateness of the actual costs that LIPA recovers through its fuel and purchased power cost adjustment clause. With respect to the first petition, the PSC, on June 20, 2006, issued a Declaratory Ruling which confirmed that the PSC permits the use of adjustment clauses to allow utilities to adjust their rates to reflect changes in fuel and other costs. With respect to the second petition, the PSC issued an Order on June 20, 2006, declining the Authority's request that it review the appropriateness of LIPA's recovery of fuel and purchased power costs through the FPPCA. The PSC noted that LIPA is not subject to PSC jurisdiction except in very limited circumstances unrelated to ratemaking, and LIPA's rates, services and practices are not governed by, and need not comply with, the provisions of the Public Service Law and the PSC's regulations. A Petition for Rehearing of the PSC's Order was filed on July 19, 2006. On November 13, 2006, the PSC issued an Order Denying Petition for Rehearing. The PSC stated in the Order that the relief sought by the Petition for Rehearing--full review of LIPA's rates and practices, is not within the PSC's jurisdiction, and authority to grant that relief has not been granted to the PSC by the legislature.

Suffolk County has initiated a lawsuit challenging the order of the PSC issued on June 20, 2006 in which the PSC declined to review the reasonableness of LIPA's recovery of fuel and purchased power costs through the FPPCA.

In March 2007, an Article 78 proceeding was filed against LIPA, the PSC and certain PSC officials, in Supreme Court, Albany County, seeking to, among other things, annul the PSC's determination that it lacked jurisdiction to review LIPA's fuel and purchased power surcharge, and compel the PSC to conduct an evidentiary hearing regarding such surcharge. This lawsuit does seek monetary damages. LIPA's opposition is due on April, 20 2007.

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.

Environmental Matters Retained by LIPA

Long Island Sound Transmission Cables – The Connecticut Department of Environmental Protection (DEP) and the New York State Department of Environmental Conservation (DEC) separately have issued Administrative Consent Orders (ACOs) in connection with releases of insulating fluid from an electric transmission cable system located under the Long Island Sound (the 1385 Cable) that LIPA owns jointly with the Connecticut Light and Power Company (CL&P). The ACOs require the submission of a series of reports and studies describing cable system condition, operation and repair practices, alternatives for cable improvements or replacement, and environmental impacts associated with prior leaks of fluid into the Long Island Sound. Pursuant to a June 24, 2004 Settlement Agreement between LIPA and CL&P, among others, 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 was procured by NUSCO on behalf of both LIPA and CL&P, and work related to the replacement has commenced and is expected to be completed in 2008.

A large natural gas pipeline project resulted in an 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. A 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, and expect to go to trial on the matter before the end of 2007.

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. On July 7, 2006, the DEC formally closed out this matter indicating that its goals and objectives had been satisfied and that no enforcement actions would be pursued.

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 approved the Decrees, making all the settlement terms final, and formally ending the litigation. The Utilities Group (of which LIPA is a party) submitted a Revised Remedial Design Plan and a Revised Remedial Work Plan to the EPA, both of which are expected to be approved shortly. After such approval, the field remediation work will begin. As a result of the entry of the Consent Decrees, the Utilities Group were paid approximately $4 million by the defendant Schorsch brothers, which the Utilities Group currently holds in investment accounts and payments toward the $13.25 million remediation funds have commenced by the Union Trust, as the successor in bankruptcy to Metal Bank.

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, signed a second consent order that obligates them to clean up and restore the two contaminated properties. LIPA has been determined to be responsible for less than 1% of the materials that were shipped to this site. Although LIPA is currently unable to determine its precise liability for costs to remediate these sites, LIPA does not believe that this liability will have a material adverse effect on its financial position, cash flows or results of operations.

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

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

Asbestos Proceedings

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

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

Other Superfund Sites. On February 2, 2007, LIPA settled the North Sea Landfill site in the Town of Southampton in an Order on Consent with the Attorney General. LIPA's share of the settlement was $169,206. The Attorney General is in negotiations with LIPA and other parties to achieve settlements at two other municipal landfills where LILCO allegedly disposed of hazardous substances. The landfills are located in Towns of North Hempstead (thePort Washington Landfill) and Islip (the Blydenburgh Landfill). At the Port Washington Landfill, LIPA has signed a number of tolling agreements to extend the statute of limitations so that a settlement can be reached before the initiation of litigation by the Attorney General. At the Blydenburgh Landfill, LIPA was sued in June 2006 by four third-party plaintiffs who had been sued by the Attorney General. The litigation is currently stayed pending settlement negotiations. 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.

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

In 2003 the State of New York promulgated separate regulations that would further limit SO2 and NOx beginning in 2004. The PSA units are expected to comply with the NOx requirements without additional material expenditures, and utilize lower sulfur fuel to meet the SO2 regulations at a projected cost of $24 million annually from 2006 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.

In March 2005, the Federal Clean Air Interstate Rule (CAIR) was promulgated, requiring further reduction of SO2 and NOx emissions. Depending on the outcome of one or more legal challenges, compliance requirements for NOx reduction would begin in 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.

KeySpan and the DEC are parties to a 1998 Consent Order for opacity, for which certain fines are assessed for exceeding the opacity limits. Improvements in plant infrastructure and plant operating practices have significantly reduced the amount of fines in recent years.

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 expenditure cannot be determined until ongoing analysis of the impacts and mitigation discussions with NYSDEC are completed. At this time, estimates for compliance upgrades are expected to cost up to $60 million.

Other Matters

In January 2006, litigation was commenced in Supreme Court, Nassau County, 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. Plaintiffs seek, 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. On August 22, 2006, the court dismissed the lawsuit in its entirety. Among other things, the court found that the environmental review process was procedurally and substantively proper and that Plaintiffs lacked standing to bring claims under other State laws. On February 7, 2007, Plaintiffs filed an appeal with the Appellate Division, Second Department. The Authority's response brief is due to be filed on March 14, 2007. The Authority expects the Appellate Division will affirm the lower court's dismissal of Plaintiffs' claims. These same Plaintiffs also filed a second lawsuit in Supreme Court, Suffolk County against the Town of Brookhaven and Caithness (the Suffolk Lawsuit), challenging the Town of Brookhaven's issuance of local zoning approvals to Caithness. Plaintiffs joined the Authority as an additional Defendant in the Suffolk Lawsuit, asserting the same claims they made in the Nassau County litigation, which were dismissed. This Suffolk Lawsuit has been fully briefed, and the Authority expects to prevail in this one as well.

On March 14, 2007 an Article 78 proceeding was filed in Supreme Court, Albany County, seeking to reverse, annul and vacate two orders issued by the Public Service Commission (PSC) in November 2006 and March 2007 related to the Caithness Long Island Energy Center, and require the PSC to conduct a hearing on the matter. This lawsuit raises many of the same environmental issues previously raised by petitioners, and successfully challenged by the Authority, the case brought in Supreme Court, Nassau County, which is currently on appeal. The Authority's response is due April 27, 2007.

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.

(13) Other Significant Events

Proposed Acquisition of KeySpan

On February 27, 2006 KeySpan announced a definitive agreement under which KeySpan would be acquired by an affiliate of National Grid plc, a company organized under the laws of Great Britain. The transaction is subject to various regulatory approvals. The Authority will evaluate the proposed 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 right to cancel any of their contracts with KeySpan and the KeySpan Subs.

Strategic Organization Review

In December 2005, the Authority, after an extensive analysis, 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 MSA between the Authority and KeySpan Electric Services LLC 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 one or both of KeySpan's Barrett and Far Rockaway generating facilities with a combined capacity of 450 megawatts. In January 2006, prior to the KeySpan proposed acquisition by National Grid PLC, LIPA entered into definitive agreements with certain of the KeySpan Subs to amend the MSA and certain other Operating Agreements. 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 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 until the later of December 31, 2007, or 180 days following the effective date of the Operating Agreements (defined below), to acquire the Barrett and/or 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 plant(s) until it is retired or repowered.

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 Authority's existing 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) will expire. However, if such agreements do not become effective, the Authority will have 90 days to exercise the GPRA Option. The Authority does not expect the Comptroller or the Attorney General to take action on this matter until the Authority completes its evaluation of the proposed acquisition of KeySpan by National Grid.

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

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, 2006, and have issued our report thereon dated March 21, 2007. 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 as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Authority's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Authority's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the Authority's financial statements that is more than inconsequential will not be prevented or detected by the Authority's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the Authority's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

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

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

KPMG LLP

March 21, 2007