Long Island Power Authority

Biennial Report
of the
Consulting Engineer and Rate Consultant

for the Period
January 1, 2000 through December 31, 2001

August 31, 2002

NAVIGANT CONSULTING, INC.

Navigant
CONSULTING, INC.

August 31, 2002

Long Island Power Authority
Board of Trustees
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Chairman and Members of the Board of Trustees:

Navigant Consulting, Inc. ("Navigant Consulting") has been retained by the Long Island Power Authority (the "Authority") as the Authority's Consulting Engineer and Rate Consultant (as such terms are defined in the General Bond Resolution and the General Subordinated Resolution) for the purpose of an examination of, and preparation of a report on, the properties and operations of the System. This report (the "Biennial Report") is to be prepared no less frequently than every other Fiscal Year, commencing with Fiscal Year 1999 (the 12 months ended December 31, 1999) pursuant to Section 702(b) of the General Bond Resolution and Section 7.02 of the General Subordinated Resolution. Navigant Consulting submits this Biennial Report for the Fiscal Years 2000 and 2001 period stating its findings, assumptions, and recommendations.

In preparation of the Biennial Report, Navigant Consulting has reviewed the operation, maintenance and repair of the System historically and anticipated for the two Fiscal Years ending December 31, 2003. Navigant Consulting has also reviewed the rates, fees, rents, charges, and surcharges of the Authority. For purposes of this assignment, Navigant Consulting has made investigations and analyses, including discussions with staff and representatives of the Authority and KeySpan Corporation d/b/a "KeySpan", among others, and examinations of reports and projections prepared by consultants and advisors to the Authority, which Navigant Consulting deemed necessary and appropriate to reach its conclusions, including such investigations conducted previously in connection with issuance of the Authority's Electric System General Revenue Bonds, Series 2001A.

Respectfully submitted,

Patrick S. Hurley
Managing Director

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SECTION 1

INTRODUCTION

The Long Island Power Authority (the "Authority") is a corporate municipal instrumentality and political subdivision of the State of New York authorized under the Long Island Power Authority Act (the "Act"). The Authority became the retail supplier of electric service in most of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens County (the "Service Area") on May 28, 1998 by acquiring the Long Island Lighting Company ("LILCO") as a wholly owned subsidiary of the Authority through a merger (the "LIPA/LILCO Merger"). Since the LIPA/LILCO Merger, LILCO has done business under the name LIPA. Before the LIPA/LILCO Merger, LILCO was a publicly traded, shareholder-owned corporation that, since the early 1900's, was the sole supplier of both retail electric and gas service in the Service Area. LIPA (LILCO) no longer provides gas service in the Service Area. For the period prior to the LIPA/LILCO Merger, LILCO is referred to herein as "LILCO" and, for the subsequent period, is referred to herein as "LIPA."

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

LIPA provides retail electric service to approximately 1.1 million customers within the Service Area. During 2001, the maximum annual peak demand experienced by LIPA totaled approximately 4,781 megawatts ("MW"), inclusive of firm sales for resale. During this period, LIPA's total annual revenues approximated $2.4 billion, of which over $2.2 billion was derived from retail electric sales.

Purpose of the Report

The Authority had a total of approximately $7.4 billion of senior lien, subordinate lien, and subsidiary debt outstanding as of August 31, 2002. As of such date, approximately $4.9 billion of fixed rate senior lien bonds and approximately $700 million of variable rate senior lien bonds issued under the Authority's Electric System General Revenue Bond Resolution (the "General Bond Resolution") were outstanding, including approximately $369.7 million of Electric System General Revenue Bonds, Series 2000A, issued in May 2000 (the "2000A Bonds") and $300 million of Electric System General Revenue Bonds, Series 2001A, issued in March 2001 (the "2001A Bonds). The Authority also had outstanding approximately $1.2 billion of variable rate subordinate lien bonds, issued under the Authority's Electric System General Subordinated Revenue Bond Resolution (the "General Subordinated Resolution"), and approximately $270.0 million of Debentures and $332.4 million of New York State Energy Research and Development Authority Financing Notes for which it is responsible. Subordinate lien Series 8A and Series 8B Bonds were remarketed in April 2001 and April 2002, respectively. Subordinate lien Series 1 through 6 Bonds ($1.5 billion) were refinanced or remarketed in May 2001 with senior lien Series 2001B through Series 2001P Bonds and subordinate lien Series 1A through 3B Bonds, respectively. Under the General Bond Resolution and General Subordinated Resolution, the Authority has covenanted to undertake certain actions on an annual or periodic basis. One such action involves the performance by the Authority's Consulting Engineer and Rate Consultant (as such terms are defined in the General Bond Resolution and the General Subordinated Resolution) of an examination of, and preparation of a report on, the properties and operations of the System. This report (the "Biennial Report" or "Report") is to be prepared no less frequently than every other Fiscal Year, commencing with Fiscal Year 1999 (the 12 months ended December 31, 1999).

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

(i) "The Consulting Engineer's advice and recommendations as to the proper operation, maintenance, and repair of the System during the ensuing two Fiscal Years, and an estimate of the amounts of money necessary for such purposes;

(ii) The Consulting Engineer's advice and recommendations as to improvements which should be made during the ensuing two Fiscal Years, and an estimate of the amounts of money necessary for such purposes, showing the amount projected to be expended during such Fiscal Years from the proceeds of Bonds and Subordinated Indebtedness issued under or pursuant to the Resolution;

(iii) The Rate Consultant's recommendation as to any necessary or advisable revisions of rates, fees, rents, charges and surcharges and such other advice and recommendation as it may deem desirable; and

(iv) The Consulting Engineer's findings as to whether the System has been maintained in good repair and sound operating condition, and its estimate of the amount, if any, required to be expended to place such properties is such condition and the details of such expenditures and the approximate time required therefore."

Navigant Consulting, Inc. ("Navigant Consulting") has been retained by the Authority to serve as the Consulting Engineer and the Rate Consultant to perform the examination of the properties and operations of the System, as required by the General Bond Resolution and General Subordinated Resolution, and to render its findings and recommendations with respect to the above subject matter. This Biennial Report covers the Fiscal Years 2000 and 2001 period and the Fiscal Years 2002 and 2003 forecast period. Information presented herein with respect to LIPA's historical operations is limited to financial and operating results known to have occurred as of December 31, 2001, except as otherwise noted. Additional information and items of a material nature have been included in this Report based on information available to Navigant Consulting through the date of this Report.

Navigant Consulting, Inc.

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

In addition to serving as the Authority's Consulting Engineer and Rate Consultant, Navigant Consulting provides day-to-day assistance to the Authority on various issues, including operations, management, and expansion of its facilities, power supply resource development, rates and charges, environmental compliance, financial forecasting, and budget review and development, among other areas.

SECTION 2

DESCRIPTION OF THE SYSTEM

The Service Area encompasses the bulk of Long Island in New York State, and is comprised of Nassau and Suffolk Counties and the Rockaway Peninsula of Queens County, an area of approximately 1,230 square miles, excluding areas served by three existing municipal utilities: the villages of Freeport, Greenport, and Rockville Centre. Suffolk County is the easternmost county within the Service Area and covers an area of approximately 911 square miles, followed by Nassau County with a 287 square mile area, and the Rockaway Peninsula with an area of approximately 32 square miles. The Service Area is bounded by the Atlantic Ocean on the south and east, by the Long Island Sound on the north and by portions of New York City on the west. Based on LIPA's Long Island Population Survey for 2002, the population of the Service Area was approximately 2.89 million people as of January 1, 2002.

Climatic Factors

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

Customer Base

Approximately 99 percent of LIPA's total revenues are derived from electric sales to retail customers. As of December 31, 2001, LIPA served approximately 1.1 million retail electric customers, of whom approximately 90 percent were residential users. During the year ending December 31, 2001, residential customers provided approximately 50 percent of LIPA's annual retail electric revenues and commercial and industrial customers provided approximately 48 percent of annual retail electric revenues. The balance of retail electric revenues is derived from electric sales for public lighting and sales to public authorities.

Although commercial and industrial customers provide a significant portion of annual electric sales revenues, these customers account for only 10 percent of the retail electric customers served by LIPA. In general, individual commercial and industrial customers are relatively small; with approximately 94 percent of these customers having peak demands less than 75 kilowatts ("kW"). Furthermore, the Service Area contains little traditional "industrial" loads, and customers served under this rate classification are primarily large commercial customers. The single largest customer in the Service Area accounts for less than one percent of total electric sales. Overall, the 20 largest electric customers, in aggregate, accounted for approximately 5 percent of total retail energy sales and revenues during 2001.

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

Table 1 provides summary information on annual retail energy sales and retail electric revenues within the Service Area during the 1997 through 2001 period. Included in Table 1 is information on numbers of retail electric customers for this historical period, as well as annual peak demand for electricity and annual energy requirements. Electric sales during 2001 approximated 18,228,036 megawatt hours ("MWh"), an increase of approximately 2.4 percent over the 2000 level. Due to the LIPA rate reductions that became effective May 28, 1998, annual revenues under LIPA operations are not comparable to revenues under the prior LILCO operations.

Table 1
Historical Statistics (1) (2)

	1997	1998	1999	2000	2001
Peak Demand (MW)	4,140	4,208	4,622	4,252	4,781
Energy (MWh) (3)					
Residential	7,184,305	7,544,915	8,060,322	7,949,549	8,351,224
Commercial and Industrial	8,336,826	8,738,934	9,061,933	9,423,224	9,449,745
Other	415,790	405,507	417,668	424,175	427,067
Total Sales	15,936,921	16,689,356	17,539,923	17,796,948	18,228,036
Company Service	55,313	58,387	43,154	56,760	55,193
Lost and Unaccounted For	1,205,085	1,217,678	1,279,737	1,296,167	1,327,433
Total Energy Requirements	17,197,319	17,965,421	18,862,814	19,149,875	19,610,662
System Load Factor (%)	47.4	48.7	46.6	51.3	46.8
Customers (4)					
Residential	926,878	933,727	941,434	949,840	957,738
Commercial and Industrial	105,557	104,157	108,255	109,565	110,606
Other	4,690	4,842	4,882	4,924	4,966
Total Customers	1,037,125	1,042,726	1,054,571	1,064,329	1,073,310
Revenues ($000) (5)					
LILCO	$2,448,827	$ 892,686	$ --		
LIPA	$ --	$1,282,345	$2,139,834	$2,092,923	$2,250,223

(1) Amounts prior to May 29, 1998, reflect LILCO operations.
(2) Amounts may not total due to rounding.
(3) Excludes Sales for Resale.
(4) Average numbers of customers for the year.
(5) Excludes unbilled service and certain credits. Includes fuel and purchased power adjustment clause revenues.

Transmission and Distribution System

The T&D System is an integrated transmission and distribution system with electricity delivered to and from the Service Area over five transmission interconnections that are owned in part by or are under contract to LIPA. A sixth transmission interconnection owned by the Cross Sound Cable Company, LLC and under contract to LIPA, the Cross Sound Cable, is expected to be in service prior to the 2003 Summer Period subject to resolution of issues concerning the depth to which the cable is buried under the Long Island Sound. These interconnections link the T&D System to utilities outside the Service Area. LIPA's transmission system includes approximately 1,282 circuit miles of overhead and underground lines with voltage levels ranging from 23 kilovolt ("kV") to 345 kV. The distribution system consists of approximately 47,347 conductor miles of overhead lines and 11,264 cable miles of underground lines, operating at voltages of 4 kV and 13 kV. A more complete description of the T&D System is provided in Section 4 of this Biennial Report.

SECTION 3

MANAGEMENT AND OPERATION OF THE SYSTEM

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

Authority Management and Organization

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

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

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

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

- Review of actual costs incurred under outsourcing agreements, including related incentive/disincentive compensation provisions;
- Review of electricity and fuel procurement practices;
- Review and evaluation of annual operating and capital budgets;
- Solicitation and evaluation of new capacity and energy supplies;
- Review of system dispatch and off-system sales and purchases;
- Review and evaluation of various regional and federal electricity market design proposals;

- Review of on-going programs to ensure compliance with applicable environmental, health, and safety requirements; and
- Review and evaluation of budget proposals associated with the MSA, PSA, and EMA.

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

Services Outsourced to KeySpan

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

In addition to providing services to the Authority, KeySpan provides a full range of energy-related services to other parties through operations and investments in selected areas of the energy industry. KeySpan's operations include the natural gas business formerly known as Brooklyn Union Gas, as well as the natural gas operations formerly owned by LILCO. KeySpan's gas operations form the fifth largest gas utility in the United States, with 1.6 million customers in New York City and Long Island and 800,000 customers in Massachusetts and New Hampshire. KeySpan owns and operates more than 6,200 MW of electric power generation on Long Island and in New York City. Of this, approximately 4,000 MW of on-Island capacity is under long-term contract to LIPA through the PSA. An additional 160 MW of generation capacity owned by KeySpan on Long Island is purchased by LIPA under separate agreements. The unregulated business units of KeySpan market energy and provide energy facility design, construction, financing and management, and energy equipment installation and repair. Through its investments, KeySpan has additional domestic and international interests in natural gas exploration, production, processing, transportation and storage.

Generally, KeySpan has provided services adequate for the continued operation and maintenance of the System . However, there have been instances where perceived or potential conflicts of interest, as well as delays in the performance of certain planning functions, could result in future operational problems if not given attention by LIPA. LIPA is addressing these issues in continuing discussions with KeySpan management. Further discussion of these issues can be found in Section 4 of this Biennial Report.

With respect to the primary purposes of this Biennial Report, the day-to-day operation of the T&D System is provided for under terms of the MSA and, in part, the EMA, which provisions expire December 31, 2008. The term of the MSA was extended by agreement dated March 29, 2002 from the original expiration date of May 28, 2006. The MSA provides for a mandatory competitive bidding of the subject services following December 31, 2005. This schedule allows approximately two years for the potential transfer of critical functions to one or more replacement contractors, or to the Authority itself. Such a change requires careful planning and execution. Additional information regarding the performance of KeySpan, as it pertains to the purposes of this Biennial Report, is provided in subsequent sections.

SECTION 4

TRANSMISSION AND DISTRIBUTION SYSTEM

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

Transmission Interconnections

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

TABLE 2

SERVICE AREA TRANSMISSION INTERCONNECTIONS

Name	Off System Terminal Location	Interconnecting Utility (1)(2)	Voltage Level (3)	Summer Normal Rating (4)
Dunwoodie to Shore Road………..	Westchester County, NY	Con Edison	345kV	599MW
East Garden City to Sprainbrook…	Westchester County, NY	NYPA	345kV	637MW
Northport to Norwalk Harbor…….	Norwalk, CT	CL&P (5)	138kV	286MW (6)
Jamaica to Lake Success………….	Queens, NY	Con Edison	138kV	238MW
Jamaica to Valley Stream…………	Queens, NY	Con Edison	138kV	272MW

(1) These utilities own the portion of the interconnections not owned by LIPA, except for the interconnection with NYPA, which is entirely owned by NYPA.
(2) Con Edison = Consolidated Edison Company of New York, Inc.; CL&P = Connecticut Light and Power.
(3) Kilovolt or "kV."
(4) Megawatts or "MW".
(5) CL&P is a wholy owned operating subsidiary of Northeast Utilities.
(6) Limited to 200MW due to transmission constraints in Connecticut.

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

The Dunwoodie to Shore Road line, an 18-mile 345 kV cable designated as the "Y-50" line and placed in operation in August 1978, is jointly owned with Consolidated Edison Company of New York, Inc. ("Con Edison"). This cable is of pipe-type construction in which dielectric fluid is circulated to cool the conductors and maintain the electrical insulation. In December 2000 and again in April 2001, cable failures were experienced on the Long Island land portion, later attributed to thermo-mechanical bending ("TMB"). Between January and May 2002, the Long Island land portion of Y-50 was replaced. In May 2002, the submarine portion of the cable between Davids Island and Pea Island (Con Edison portion) failed. Preliminary analysis indicates that the submarine section experienced mechanical failure, possibly through thermo-mechanical bending, but experts do not agree on the exact cause of the failure, and investigation is continuing. The cable was repaired and returned to service in June 2002, and as a precaution, the cable was derated (from 600 MW to 400 MW) for Summer 2002 operation to minimize thermal bending. The cable is expected operate at its full rating for Summer 2003, provided no additional failures occur.

The East Garden City to Sprainbrook 345 kV interconnection was installed in 1991 and is approximately 23 miles long. This tie is comprised of a submarine portion and a land-based portion. The submarine portion is constructed of self-contained dielectric fluid-filled cables that operate under high pressure, while the land-based portion is of conventional pipe-type construction. This line is owned entirely by NYPA (the "NYPA Line" or "Y-49") and is used by LIPA under the terms of a contract with NYPA. The agreement for use, by LIPA, of the NYPA Line provides that LIPA will reimburse NYPA for the costs it incurs in connection with the NYPA Line, including, but not limited to, debt service, reserves, and operation and maintenance expenses. LIPA is contractually obligated to pay such costs based on the full capacity of the NYPA Line; however, to the extent that NYPA allocates capacity to other parties, LIPA's payment obligations are proportionately reduced. Unlike Y-50, which has experienced failures in the cable itself, failures on Y-49 have been limited to the terminal equipment. In May 1999, a short circuit in the tap changer in one of the 345/138 kV transformers in East Garden City reduced the capability of Y-49 by half until the replacement transformer could be installed in April 2000. In May 2002, a failure on Y-49 was due to a bridging capacitor in the interruptor of one of the shunt reactor's circuit breakers at East Garden City. Preliminary reports from General Electric ("GE") and Hitachi indicate that this was a unique failure and the precise cause is unknown at this time. The breaker was repaired and will be completely overhauled before Summer 2003. Subsequent to the breaker failure at East Garden City, there was a catastrophic failure of a reactor at Sprainbrook. Additionally, another reactor at Sprainbrook was found to have combustible gas buildup and was removed from service as a precautionary measure. In total, five reactors are normally available for service on Y-49 (two at East Garden City, one at the East transition station, and two at Sprainbrook), of which three are ordinarily required when the line is in service. NYPA has ordered two replacement reactors, but delivery is estimated at 24 months. Due to the failures and suspect condition of the reactors in 2002 along with the lengthy delivery time of replacement reactors, a modified switching and operating procedure has been developed in the event that one of the remaining reactors fails prior to installation of the replacement equipment.

The third interconnection, the Northport to Norwalk Harbor line (the "NUSCO Cable"), is a double circuit 138 kV submarine cable. This tie, installed in 1969, extends approximately twelve miles under the Long Island Sound from the Northport Electric Generating Station ("Northport") in Suffolk County, NY to Norwalk Harbor, Connecticut. LIPA owns that portion of the line from Northport to the New York-Connecticut state boundary. Due to the deteriorated condition of the line, resulting from periodic damage sustained by ship and barge anchors, LIPA and Northeast Utilities are considering the replacement of the submarine cables.

The two remaining Service Area transmission interconnections are linked to the Con Edison transmission system in Queens County, New York. LIPA owns these facilities to the border of Nassau and Queens Counties, at which point ownership transfers to Con Edison. These ties are primarily for delivering power to Con Edison from their portion of energy flowing across Y-50.

A sixth transmission interconnection, the "Cross Sound Cable" or "CSC" is currently under construction. The CSC is a 24-mile, +/-150 kV bi-directional high voltage direct current

("HVDC") system utilizing voltage source converter technology with a capability of 330 MW. The Cross Sound Cable is connected between the converter stations installed adjacent to United Illuminating's 345 kV East Shore substation in Connecticut and at LIPA's Shoreham 138 kV substation. The Cross Sound Cable is owned by the Cross Sound Cable Company, LLC, a limited liability company controlled by TransEnergie US, Ltd. LIPA has entered into an agreement for 330 MW of firm transmission capacity rights of this line for twenty (20) years with an option to purchase all or only the New York portion of the Cross Sound Cable at the end of the term. Although substantially completed, commercial operation of the CSC is delayed by the Connecticut Department of Environmental Protection due to cable burial at less than required depth for portions of the route under Long Island Sound. Completion of the CSC is complicated by a moratorium imposed by the State of Connecticut on new permits for energy facilities located in Long Island Sound and seasonal restrictions on construction in Long Island Sound, Navigant Consulting cannot currently predict when these issues will be resolved and the CSC commissioned for normal service.

System Import Constraints

Through 2001, the import capability into Long Island was rated at approximately 1,200 MW under normal conditions. When the Cross Sound Cable becomes operational, the import capability under normal conditions will increase to approximately 1,500 MW. This assumes that Y-49 is operated at its dynamic rating of 660 MW, Y-50 is operated at 510 MW through rapid circulation for cooling, NUSCO is operated at 200 MW, Cross Sound Cable is operated at 330 MW, and the wheel through to Con Edison is 200 MW. The maximum emergency import capability into Long Island during peak summer conditions will be 2,086 MW according to the New York Independent System Operator ("NYISO") emergency ratings on the interconnections.

There are several proposed transmission projects that would interconnect with the Service Area as early as 2005. Among these are the: (i) Neptune project, a 600 MW HVDC connection from New Jersey to Newbridge Road; (ii) Cross Sound Cable, Phase II, a 300 MW HVDC connection from Connecticut to either the Pilgrim or Ruland Substations; and (iii) Northeast Utilities, a 660 MW HVDC connection from Connecticut to Shore Road. These additional off-Island interconnections, if constructed and placed in service, would increase the maximum import capability to Long Island and provide access to additional power supply resources, including those located in the Pennsylvania, New Jersey, Maryland Interconnection ("PJM") and the Independent System Operator – New England ("ISO-NE"). Additionally, new interconnections would serve to increase competition between power supply resources on- and off-Island and thereby provide LIPA with greater resource contracting flexibility.

Transmission Facilities

The transmission facilities provide for the delivery of capacity and energy from the transmission interconnections and the on-Island generating stations to LIPA's electric distribution system. The transmission system includes approximately 1,282 miles of overhead and underground lines. Table 3 provides a summary of LIPA's transmission line statistics, inclusive of transmission lines associated with LIPA's transmission interconnections.

The on-Island transmission system has been constructed following standards similar to those employed by other major electric utilities in the Northeast and includes wood poles, steel poles, and lattice steel towers. Many of the existing transmission structures support distribution circuits and/or connections for telephone, cable television, or fiber optics.

Thirty-six transmission substations are in service and utilized on the T&D System. The combined capability of these substations is approximately 7,181 million volt-amperes ("MVA"). The transmission system also includes transformation equipment at 17 generating sites that is used to step up the generation voltage to transmission voltage levels. With the exception of certain facilities at the GENCO generating facilities (e.g., auxiliary and starting transformers), transformation equipment at these sites is owned by LIPA.

TABLE 3

CIRCUIT MILES OF TRANSMISSION LINE (1)

Voltage Level	Overhead	Underground	Total
345kV……………………	-	8	8
138kV……………………	237	110	347
69kV……………………	574	76	650
33kV……………………	92	3	95
23kV……………………	134	48	182
Total…………………	1,037	245	1,282

(1) Miles as of December 31, 2002 - estimated.

Distribution Facilities

The distribution system is comprised of 13kV and 4kV facilities. These facilities are a combination of overhead and underground equipment. There are currently 141 substations throughout the Service Area that step the voltage down from transmission to distribution levels. These distribution substations have a combined transformation capability of approximately 6,709 MVA. The distribution system also includes 58,611 cable miles of overhead and underground line and 205,685 line transformers with a total capacity of approximately 18,839 MVA. About 43.5 percent of the poles on which LIPA's distribution facilities have been installed are owned by Verizon (formerly Bell Atlantic) and used by LIPA pursuant to a joint-use agreement. Table 4 provides a summary of LIPA's distribution line statistics.

TABLE 4

CABLE MILES OF DISTRIBUTION LINES (1)

Type of Construction	Cable Miles
Overhead (2)…………………………………	47,347
Underground………………………………	11,264
Total………………………………………	58,611

(1) Miles as of December 31, 2002 - estimated.
Dividing by 3 provides approximate circuit miles.
(2) Includes primary, secondary, and service.

Management Services Agreement

Pursuant to the MSA, LIPA relies on the Manager to operate and maintain the T&D System in accordance with all applicable laws, good utility practices, and the policies and procedures established by the Authority. The Manager's responsibilities under the MSA include, but are not limited to: (i) the day-to-day operation and maintenance of the T&D system, including emergency repairs, customer service, billings, and meter readings; (ii) routine facility additions and improvements, including customer connections, procurement of goods and services from third paties, and inventory management; (iii) preparing and monitoring budgets, developing load and energy forecasts, and the acquisition, maintenance and use of power resource models and plans; and (iv) maintaining an operation and maintenance manual for the T&D system.

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

In exchange for services rendered under the MSA, the Manager is entitled to receive an annual service fee as compensation. The service fee is paid on a monthly basis and is calculated based on five components, consisting of: (i) fixed direct fee; (ii) third party cost reimbursement component; (iii) variable payment; (iv) cost incentive fee; and (v) non-cost performance component. In addition to the service fee, the Manager is reimbursed for all approved third-party costs and is paid or reimbursed for certain capital and unforeseeable costs.

The Manager is entitled to incentive payments for cost savings and is subject to penalties for cost overruns on both the operating and capital budgets. With respect to operations, $5 million of the Manager's annual fee of $15 million is contingent upon achieving a comparable amount of cost savings each year. In addition, the Manager is entitled to payments equal to 50 percent of any savings in excess of this amount, provided that no incentive is payable for savings in excess of 15 percent of the operating budget. To the extent costs exceed the operating budget, excluding the Manager's fee, the Manager must absorb overruns up to a maximum total of $15 million. With regard to the capital budget, the Manager is entitled to incentive payments for cost savings and penalties for cost overruns equal to 50 percent of all variances between budgeted and actual capital expenditures, provided that no additional incentive payment will be earned, nor penalty incurred, for cost variances in excess of 15 percent of the capital budget.

The Manager earned cost-based incentives of approximately $5.7 million in 2000, and an estimated[1] $3.8 million in 2001. In addition to the cost savings incentives, the Manager is eligible for certain annual non-cost performance incentives, including T&D system reliability, meter reading accuracy, and worker safety. The MSA provides for additional non-cost incentives related to customer call answering, accounts receivable, and payments-in-lieu of taxes ("PILOT"); however, the Authority and the Manager have not agreed to the incentive mechanisms for these areas of performance. The Manager has generally met or exceeded the

[1] 2001 cost-based incentive has not been audited and is only an estimate.

MSA non-cost performance incentive maximum allowances, having earned $7.4 million and $7.4 million in 2000 and 2001, respectively.

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

The Manager's Performance Under the MSA

Navigant Consulting believes the Manager's performance in operating and maintaining the System has been adequate during 2000 and 2001. The following sections provide a summary of the Manager's performance in key areas during this time period.

Reliability

LIPA is continuing and expanding a program originally commenced in 1992 that is intended to improve the reliability and quality of electric service within the Service Area. For the distribution system, this program is focused on three major areas: (i) circuit reconfiguration and reinforcement; (ii) pole replacement; and (iii) circuit conversion and reinforcement projects to serve new customer loads. For the transmission system, the improvement program is focused on: (i) transmission system reliability; (ii) substation reliability improvements; (iii) transmission breaker replacements; and (iv) structure inspection program. These program elements are a key part of LIPA's efforts to achive reductions in both the frequency and duration of customer outages.

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

For 2000, the system-wide SAIFI index was 0.76 (or 15.7 months between interruptions), and the CAIDI index was 63.6 minutes. For 2001, the system-wide SAIFI index was 0.78 (or 15.4 months between interruptions), and the CAIDI index was 63.6 minutes. The composition of these reliability indices by LIPA operating district is provided in Table 5. The 2000 and 2001 SAIFI and CAIDI indices resulted in incentive payments of $4.0 million and $3.96 million, respectively, by LIPA to the Manager for exceeding the prescribed reliability targets set forth in the MSA.

TABLE 5

T&D SYSTEM RELIABILITY (1)(4)

	MSA Incentive Minimum	Year 2000	Year 2001
SAIFI (2)			
Queens……………………	1.23	0.48	0.65
Central……………………	1.40	0.71	0.68
W. Suffolk………………..	1.60	0.90	0.95
E. Suffolk………………..	2.10	0.87	0.80
System Average…….		0.76	0.78
CAIDI (3)			
Queens……………………	67.2	54.5	44.5
Central……………………	81.0	73.1	72.2
W. Suffolk………………..	72.6	61.8	63.8
E. Suffolk…………………	71.4	60.5	66.7
System Average………		63.6	63.6

(1) Excludes interruptions of less than five minutes and interruptions during major storms.
(2) System Average Interruption Frequency Index
(3) Customer Average Interruption Duration Index
(4) Lower values are more favorable.

The five-year average (1997 through 2001) SAIFI for LIPA was 0.77 (or 15.6 months between interruptions), as compared to 0.90 (or 13.3 months between interruptions) for all of the New York State utilities (excluding Con Edison). Similarly, the five-year average CAIDI for LIPA was 68.4 minutes, while the average for all New York State utilities (excluding Con Edison) was 100.8 minutes. The capital budgets reflected elsewhere in this Report are sufficient to maintain similar levels of reliability in the future.

Maintenance

The Manager's substation maintenance group is responsible for the operation and maintenance of the transmission and distribution substations throughout the Service Area. The preventive maintenance program calls for the inspection and major maintenance of over 2,000 individual pieces of substation equipment annually. During the Fiscal Years 2000 and 2001 , the substation maintenance group completed approximately 99 percent of the scheduled preventive maintenance each year. A completion rate over 90 percent falls within the range of that achieved by other similarly situated utilities.

The Manager, prior to 2002, used a time-based system (e.g., maintenance of specific equipment items at pre-determined intervals, such as every three years) based on hardcopy documentation and stand-alone computer records. Acknowledging that a system in which each equipment item is maintained according to its criticality, load, number of operations, age, and test diagnostics, would be beneficial, the Manager purchased a new computerized maintenance inspection and record-keeping system, known as Maximo, for the substation group. Maximo was fully integrated by the end of 2001 for both demand and preventive maintenance. This new maintenance system will be used for work order management, planning and scheduling, asset management and tracking, resource management, reports and analysis, and integration with the

Manager's financial system. The computerized maintenance system should provide for more targeted maintenance programs in the future.

Storm Restoration

Under the terms of the MSA, the Manager is responsible for storm response and storm restoration programs. During these restoration efforts, the Manager utilizes, as necessary, appropriately trained personnel not normally assigned to field duties, as well as gas and generation department personnel, in order to perform electric distribution emergency restoration services. This utilization of personnel increases the availability of field forces to restore service to customers affected by the storm damage. The Manager, on behalf of LIPA, also relies on standard electric utility industry mutual aid programs wherein neighboring and regional utilities provide emergency assistance to one another in the event of widespread outages due to major storms. Table 6 below provides a summary of the total cost of storm damage within the Service Area for the 1997 through 2001 period.

TABLE 6

HISTORICAL STORM EXPENDITURES FOR THE T&D SYSTEM

Year	Expenditure ($000)
1997	$ 12,493
1998	8,625
1999	17,093
2000 (1)	10,809
2001 (2)	7,443

(1) Amount does not reflect FEMA reimbursement of approximately $3.8 million received in 2000 for 1998 storm costs.
(2) Subject to review.

The Authority relies on a combination of reserves and insurance to provide for the funding of storm damage restoration. Under the MSA, approximately $4.4 million is included in the annual budget for the Manager to provide storm restoration services. This allowance is intended to cover the cost of direct labor, excluding overtime pay, incurred by the Manager for storm restoration services. The Authority has included in revenue requirements an annual storm allowance of $9 million, which is available to cover storm restoration costs other than the Manager's direct labor costs. Storm losses not covered by insurance are self-insured by LIPA. Depending on the extent of damage, the Authority may also be eligible for funds from the Federal Emergency Management Agency ("FEMA"). In 2000, the Authority received approximately $4 million of funding from FEMA for prior storm damage occurring within the Service Area.

Condition of the Facilities

During February 2001, Navigant Consulting conducted limited on-site observations of principal and representative facilities comprising the T&D System. These observations consisted of visual examinations of facilities that Navigant Consulting deemed adequate to allow it to assess the general condition of the facilities. In addition to field observations, Navigant

Consulting reviewed historical operation and maintenance records for the T&D System to assess past performance levels and examined written maintenance procedures to evaluate the adequacy of existing maintenance practices. Based on the observations and assessments conducted by Navigant Consulting and the measured reliability of the T&D System as discussed above, the T&D System is considered by Navigant Consulting to be in good condition.

Capital Expenditures

During the Fiscal Year 1997 through 2001 period, an average of approximately $145 million per year was spent on additions and improvements to the T&D System. These expenditures included monies for reliability enhancements, capability expansion, new customer connections, facility replacements, and public works projects**.**

Amounts budgeted for 2002 approximated $318 million for T&D System additions and improvements. The Authority has also approved a capital budget of approximately $229 million for the T&D System in 2003. The 2002 T&D System capital expenditure program includes $115 million for system upgrades necessary to support the interconnection of capacity resource projects (generation and transmission), while the 2003 capital expenditure budget includes approximately $20 million to support the interconnection of new capacity resources. The remainder of the 2002 and 2003 capital budgets includes monies for reliability enhancements, capacity expansion, new customer connections, facility replacements, and public works projects at similar funding levels as in 2001. The 2001 T&D System capital expenditure program included increases over 2000 levels in the following areas: (i) $5.5 million for transmission reliability; (ii) $8.3 million for substation reliability; (iii) $7.0 million for underground distribution reinforcements; and (iv) $1.6 million for overhead distribution reinforcements.

Table 7 provides a breakdown of the 2002 budgeted capital expenditure program by principal activity, together with information on the historical level of capital expenditures during the 1997 through 2001 period.

TABLE 7

T&D SYSTEM CAPITAL EXPENDITURES
(Millions of Dollars)

	Historical					Budget
Expenditure Category	**1997** (1)	**1998**	**1999**	**2000**	**2001**	**2002**
System Enhancements (2)…………..	$ 81	$ 97	$ 92	$ 153	$ 171	$ 284
New Customers………………………	24	20	20	20	26	31
Public Works…………………………	4	5	3	8	2	3
Total …..………….…………………	$ 109	$ 122	$ 115	$ 181	$ 199	$ 318

(1) Amounts for 1996 and 1997 include allowance for funds used during construction and certain other costs totaling approximately $10 million annually that are not included beginning 1998.

(2) Includes reliability projects, increase in capacity of overhead and underground lines and substations, and replacements. Amounts for 2000 include an expenditure of approximately $60 million for a 22-mile underground 69-kV transmission line in eastern Long Island. Amounts for 2001 include expenditures of $17 million for additional capacity resources (net of reimbursements to LIPA through cost sharing and other contributions). Amounts for 2002 include approximately $115 million of system upgrades to support interconnection of new capacity projects (generation and transmission).

The total expenditures for 2001 were approximately $18 million over the 2000 expenditure level, and the budgeted amount for 2002 is approximately $119 million over the 2001 historical expenditures. This increase is driven, in part, by the significant increases in T&D System peak loads in recent years, along with a continuing emphasis on reliability. Navigant Consulting believes that the T&D System is in good condition as described in "Condition of Facilities" in this section of the Report, and that the expenditure levels are not indicative of an unusual degree of disrepair or degradation.

Future Capital Expenditures

The Authority anticipates that future annual T&D System capital expenditures may continue at levels greater than the average annual expenditure levels generally experienced from the 1997 through 1999 period. The increase experienced during the Fiscal Years 2000 and 2001 reflects the need for capacity additions and transmission upgrades to meet increased customer demands and reliability goals.

T&D System capital expenditures will continue to be subject to the Authority's annual approval process under the terms of the MSA. In 2001, LIPA initiated a new capital planning process and proposed capital expenditure review process. The capital planning process is essential to ensure sound capital investment decisions and will, if followed by the Manager, allow LIPA to identify, rank, fund, and manage capital investments. The process involves three phases: (i) selection, in which capital projects are screened, ranked, and selected; (ii) control, whereby an ongoing monitoring process manages selected capital projects to ensure that each investment continues to be required and is completed on schedule and within budget; and (iii) evaluation wherein projects are reviewed upon completion to determine if the capital investment realized its expected mission and business performance goals, and provide feedback to continually improve the capital planning and execution process. The 2002 proposed budget was reviewed and approved using an industry-accepted process of ranking projects according to the probability of the occurrence of an outage, the number of customers that would be affected by the outage, and the outage's duration. By utilizing this process, capital investments may be targeted to the most critical projects.

Issues Facing LIPA with Respect to the MSA in 2000 and 2001

Operation of the T&D System during 2000 and 2001 was generally consistent with historical experience, and no material adverse conditions or occurrences were noted. Such results reflect the relative success of the Manager in operating and maintaining the T&D System under the MSA. Despite these results, however, LIPA is faced with a number of issues that will need to be addressed during the Fiscal Years 2002 and 2003 if it is to achieve a continuation of these positive results.

Compliance with Contractual Provisions

KeySpan, as the Manager, has failed to perform certain activities required under the MSA, including, but not limited to: (i) establishment of a mutually agreeable procedure for the retention or transfer of easements from KeySpan to LIPA; (ii) strengthening its procedures for the accounting of storm expenses; (iii) delivery of revisions to the T&D System operation and maintenance manuals to LIPA; and (iv) a requirement that the Manager request authorization from LIPA for all T&D budget variations of 50 percent from a budgeted expenditure, or $500,000, whichever is less.

Capital Budgeting

LIPA and KeySpan have had ongoing discussions regarding the capital budgeting process under the MSA. LIPA has asked KeySpan to provide it with a priority-based capital budget, cost/benefit analyses in support of capital budget decision-making, and increased reliance on preventive/predictive maintenance measures in-lieu of spending for new capital projects. LIPA has also requested that KeySpan expand the use of an external bidding/contracting program for new major capital projects. As a result of these discussions, KeySpan has made some progress in these areas. Additional progress, however, is warranted and would benefit LIPA through enhanced control over its capital budgeting process.

Customer Billing System

Notwithstanding plans in place at the time of the acquisition of the System, LIPA continues to rely on the billing system employed by LILCO in 1998. Although this system has been modified periodically, it is outdated and inadequate for LIPA's current and future needs. As a result, LIPA's ability to improve customer service, provide enhanced billing formats, and incorporate new products and services has been hampered and delayed. This represents an impediment to LIPA in meeting its customers' expectations and providing leading-edge services that are being offered by other electric utilities. LIPA has undertaken an internal initiative to assess its information technology needs.

Planning Related Issues

The Authority is taking an active role in identifying the issues and types of analyses which KeySpan's planners need to study. In general, the planning personnel at KeySpan have reluctantly adapted to the changes in direction and focus put forth by the Authority. However, issues currently exist in the planning arena that limit the effectiveness of KeySpan in performing planning studies for the Authority that relate to significant future capital expenditures. These include the following:

1. **Conflict of Interest** – Besides serving the Authority, KeySpan is also a generation developer on Long Island. As such, it performs internal transmission planning studies intended to provide strategic information on where to interconnect new plants and to develop the costs for these interconnections. The same KeySpan personnel also perform the transmission planning studies for the Authority, the results of which are used by the Authority in negotiations with the various generation developers (including KeySpan) interested in interconnecting with the Authority. As a result, there is the potential for the transmission studies to be biased in favor of new KeySpan generation projects.

2. **Staff Limitations** – Over the past two years, the workload of KeySpan planning personnel has increased as the Authority's consideration of power supply alternatives and related issues have increased. At the same time, KeySpan has indicated to Navigant Consulting that it has experienced difficulty completing planning assessments due to reductions in the overall number of people assigned to perform transmission and distribution planning analyses.

3. **Adoption of New Planning Tools and Techniques** – The marketplace for the power industry is in the midst of dramatic change, moving from a heavily regulated industry to an open market structure. This change is prompting utilities throughout the industry to re-evaluate the methods and tools used for system planning. New planning techniques have been developed to specifically incorporate risk management into the planning process in order to more cost effectively meet the reliability and expansion needs of each utility's transmission and distribution system. A risk management approach allows a utility to more efficiently allocate its limited capital funds to projects that are most required. KeySpan's use of this and other new tools could provide LIPA with significant opportunities to improve the utilization of the T&D System, while maintaining reliability and mitigating pressure on increased annual revenue requirements.

SECTION 5

NINE MILE POINT NUCLEAR POWER STATION, UNIT 2

Nine Mile Point Nuclear Power Station, Unit 2 (“NMP2”) is part of a two-unit nuclear power station (“Nine Mile Point”) located on the south shore of Lake Ontario near the City of Scriba, New York. The plant began commercial operation in April 1988 under an NRC license that expires in 2026. NMP2 uses a boiling water reactor (“BWR”) and turbine generator supplied by General Electric Corporation. The plant has a rated capacity of 1,144 MW.

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

NMP2 Ownership and Management

LIPA has an undivided 18% interest in NMP2. Until November 6, 2001, NMP2 was operated by Niagara Mohawk Power Corporation (“NMPC”). On November 7, 2001, Constellation Nuclear LLC (“Constellation”) purchased 100% of NMP1 and 82% of NMP2, with LIPA retaining its 18% interest in NMP2. LIPA’s share of the rated capability of NMP2 is approximately 205 MW. [2]

Due to the cotenants sale of their respective interests in NMP2, LIPA entered into an amended and restated operating agreement with Constellation for NMP2. Among other things, the revised agreement provides for a management committee comprised of one representative from each co-tenant. Constellation controls the operating and maintenance decisions of NMP2 in its role as operator. The annual NMP2 business plan and the operating and capital budgets are developed by Constellation and submitted to LIPA for review and approval. LIPA receives output from NMP2 and is responsible for operating and capital costs in proportion to its ownership interest. In addition to its involvement through the management committee, LIPA employs a nuclear oversight consultant to provide additional on-site support to protect its interests.[3]

NMP2 Performance

Table 8 sets forth capacity factors and generation levels associated with LIPA’s 18% share of NMP2 for the period 1997 through 2001. This Table also presents comparative industry data for all nuclear generating units in the United States. Over the 1999 through 2001 period, NMP2 has typically performed below industry averages.

In 2000 NMP2 achieved a capacity factor of 79.1%. The capacity factor for 2000 was impacted by the refueling outage being extended for 13 days and 10 days of lost generation due to two forced outages. There was also a planned outage for noble metal chemical addition (“NMCA”), which resulted in approximately 8 days of lost generation. The need for NMCA is discussed further in the “NMP2 Maintenance Programs and Condition ” section of this Biennial Report.

[2] LIPA 2001 Annual Report, page 16
[3] ibid, page 16

NMP2 achieved a capacity factor of 87.9% in 2001. The 2002 business plan capacity factor goal is 86.9%.

Table 8
Historical NMP2 Performance

	NMP2			
Calendar Year	**Annual Net Generation (MWh) (1)**	**Annual Net Capacity Factor (2)**	**Three-Year Average Net Capacity Factor (3)**	**Industry Average Net Capacity Factor (4)**
1997	1,598,046	89.2%	84.3%	79.6%
1998	1,315,288	73.4%	83.2%	84.3%
1999	1,580,814	86.9%	83.2%	88.5%
2000………………………………………..	1,440,274	79.1%	79.8%	89.6%
2001………………………………………..	1,590,814	87.9%	84.6%	90.7%

(1) LIPA's 18 percent share of NMP2 net output.
(2) Net capacity factor is a measure of the utilization of NMP2's theoretical maximum annual output.
(3) The three-year average smoothes the effects of refueling outages.
(4) Source: Nuclear Energy Institute. Includes all nuclear plants operating during the respective year.
Note: In 1995, the design electrical rating of NMP2 was increased from 1,062 MW to 1,144 MW.

NMP2 Maintenance Programs and Condition

In 2000, the Nuclear Regulatory Commission (NRC) established a Reactor Oversight Process that replaced the SALP Program. Under this new process, the NRC evaluates plant performance in eighteen areas or Performance Indicators (PI). Performance is graded "Green", "White", "Yellow" or "Red". Green signifies satisfactory performance requiring minimal NRC resources for oversight. At the opposite end, Red signifies unsatisfactory performance requiring the most NRC resources for oversight. In 2000, both Nine Mile Point units were graded as Green in all areas. Since that time, the NRC consistently graded Green in all areas until, in its Annual Assessment Letter, dated March 4, 2002, they noted that for NMP2 , the initiating events PI for "Unplanned Scrams," had changed to White. In the NRC's August 23, 2002, mid-cycle performance review letter they indicated that this one PI had returned to Green as of the second quarter 2002.

The Institute of Nuclear Operations (INPO) is a nuclear industry assessment organization. In 1999 INPO identified numerous areas needing improvement at NMP2. In response, NMP2 management developed an improvement plan directed at (1) preventive and predictive maintenance optimization; (2) corrective action program enhancements; (3) work management and maintenance planning process improvements; (4) revising the configuration management change process; (5) training improvements; and (6) improving equipment reliability.

During 2000 the corrective maintenance backlog decreased to 398 and continued to decline to 196 at the end of 2001.

There was no INPO evaluation of NMP2 in 2001. The next INPO plant evaluation is scheduled for September 2002, at which time all aspects of plant operation will be evaluated.

During normal inspections associated with a scheduled refueling outage of NMP2 in 1998, Niagara Mohawk discovered indications of inter-granular stress corrosion cracking of the reactor shroud. The reactor shroud is a hollow cylinder surrounding the reactor core that serves to channel cooling water re-circulation flow. The shroud cracking is a generic issue facing BWR plants and was anticipated by Niagara Mohawk prior to the inspection. Niagara Mohawk reported that the cracking indications were not of any safety significance and the NRC allowed NMP2 to resume operations with no restrictions. During 1999, Niagara Mohawk initiated actions to institute a water chemistry program, noble metals chemical addition ("NMCA"), to reduce the rate at which the cracking progresses. The results of an inspection conducted during the 2002 spring refueling outage confirmed that NMCA has been successful in arresting shroud crack growth.

Capital Expenditures

NMP2's historical capital expenditure levels vary with the schedule of refueling / maintenance outages for the facility. Major maintenance activities, including replacement of major plant components and facility improvements, are undertaken concurrent with the refueling outages. Table 9 provides a summary of historical capital expenditures for NMP2.

Table 9

NMP2 Historical Capital Expenditures
LIPA's 18 % Share
($000)

	1997	1998	1999	2000	2001
Plant Modifications	1,095	4,210	2,020	6,200	4,800
Nuclear Fuel	699	9,752	1,074	7,600	1,900
Total	1,794	13,962	3,094	13,800	6,700

Amounts shown in Table 9 for nuclear fuel reflect the capital cost of fuel purchased during the year shown. Nuclear fuel purchases are capitalized and subsequently expensed based on actual generation levels at NMP2.

Annual capital expenditures for NMP2 will continue to reflect the cyclical nature of the two-year refueling schedule. The capital cost forecast for NMP2 totals approximately $13.4 million for 2002 and $4.7 million for 2003. These funds are intended to support a substantial number of projects aimed at maintaining NMP2 in good operating condition and satisfying regulatory requirements.

Other Matters

In 1997, the NRC issued a policy statement on the Restructuring and Economic Deregulation of the Electric Utility Industry ("Policy Statement"). The Policy Statement addressed the NRC's concerns regarding the adequacy of decommissioning funds and the potential impact on operational safety and reserves that may result from industry restructuring. In this Policy Statement, the NRC expressed the right, in highly unusual situations where adequate protection of public health and safety would be compromised, to consider imposing joint and several liability on minority co-owners when one or more co-owners have defaulted on their contractual obligations. On January 5, 1999, the NRC commenced review of a petition for rulemaking filed by a group of utilities which are non-operating joint owners of nuclear plants. These utilities requested that the enforcement provisions of the NRC regulations be amended to clarify NRC policy regarding the potential liability of joint owners if other joint owners become financially incapable of bearing their share of the burden for safe operation or decommissioning of a nuclear power plant. On July 25, 2000, the NRC denied the petition and reaffirmed its position recognizing joint and several regulatory responsibility on co-owners. Navignat Consulting is unable to predict how this ruling may ultimately affect the results of operations or financial position.[4]

NMP2 Decommissioning Funding

LIPA is providing for decommissioning costs for NMP2 based on a site-specific study performed in 1995. LIPA's share of the total decommissioning costs for both the contaminated and non-contaminated portions is estimated to be approximately $145 million in 1996 dollars. LIPA maintains a trust fund for its share of the decommissioning costs of the contaminated portion of NMP2, which at December 31, 2001, had an approximate value of $33.1 million. LIPA established a separate decommissioning fund for its share of the non-contaminated portion of NMP2, which had a value at December 31, 2001, totaling approximately $4.6 million. Through continued deposits and investment returns on these trusts, LIPA believes that the value of these trusts will, in 2026, be sufficient to meet the Company-s decommissioning obligations.

[4] LIPA 2001 Annual Report, page 17

SECTION 6

ADEQUACY OF RATES AND CHARGES

LIPA's retail rates became effective May 29, 1998, and reflect an average 16.6 percent across-the-board reduction in base retail electric rates that were in effect prior to the LIPA/LILCO Merger. On an annualized basis for 1998, these reductions, together with certain credits, amounted to approximately $250 for an average residential customer and totaled approximately $498 million for all retail customers. These new retail rates, together with certain credits, were designed to produce average revenues from retail electric sales ("Average System Rate") of 12.25 cents per kWh (compared to average revenues of 15.23 per kWh under LILCO). LIPA expects to maintain its base average rates at this initial level through May 2003.

LIPA's Retail Rates

The rates implemented by the Authority generally reflect traditional rate designs and were based in large part on LILCO's previous rate designs to avoid potential confusion on the part of customers and to allow for a smooth and timely transition to LIPA billing. LIPA's rate design includes fixed customer charges for all customer classes, seasonal energy rates for all customer classes except lighting, and seasonally differentiated demand charges for the non-residential customer classes (greater than seven kW). Voluntary time-of-use rates are available to all residential and nonresidential customers. Mandatory time-of-use rates apply to nonresidential customers with demands in excess of 145 kW in the summer or 500 kW in the non-summer months. The summer months are June through September, inclusive. Economic development and load retention incentives are provided to a small number of commercial customers. Miscellaneous service charges, pole attachment charges, and rental rates were maintained at their levels prior to the LIPA/LILCO Merger.

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

Fuel and Purchased Power Cost Adjustment Clause

LIPA's Tariff includes a fuel recovery provision – the Fuel and Purchased Power Cost Adjustment Clause ("FPPCA") that is applicable to all Service Classifications. The FPPCA mechanism was designed to allow LIPA to recover from or return to customers any fuel and purchased power costs, including load reduction program costs, that fall outside an established base fuel and purchased power cost tolerance band. The tolerance band was designed to increase in 1% increments annually until such time as the fuel and purchased power costs increased in excess of 5% cumulatively over the original base cost. Should fuel and purchased power costs increase in excess of 5% cumulatively over the original base cost, the FPPCA was designed to recover, from that year forward, all costs in excess of the original base cost.

The tolerance band for the year ended December 31, 1999 was 1% above or below the base cost of fuel and purchased power. The tolerance band for the year ended December 31, 2000 was 2% above or below the base cost of fuel and purchased power. Actual fuel and purchased power costs for the twelve months ended December 31, 2000 were more than 5% in excess of the original base cost and as such, effective January 1, 2001, no tolerance band exists. Accordingly, the FPPCA is designed to recover or return, in subsequent years, all costs incurred in each such period which are above or below LIPA's base cost of fuel.

As discussed in succeeding portions of this Section, beginning in 2000, fuel and purchased power costs have and are projected to continue to significantly exceed the levels that are included in base rates. These excess fuel costs are attributable to many factors including: higher delivered fuel prices (residual oil and natural gas) used in GENCO facilities; increases in the cost of energy purchases; and, the additional costs associated with new power supply resources which have been added to meet the growth in customer peak load and energy requirements that has occurred since 1998.

Shoreham Property Tax Settlement Rider

The Authority and certain taxing jurisdictions in Suffolk County have reached an agreement settling various matters related to previous property tax assessments on Shoreham. The Shoreham property tax settlement will result in a rate differential between non-Suffolk County ratepayers (Nassau County and Rockaway Peninsula) and ratepayers in Suffolk County. Initially, this differential is attributable to smaller Shoreham credits provided to Suffolk County ratepayers. Beginning in May 2003, the differential will be entirely attributable to a Shoreham surcharge on Suffolk County ratepayers.

LIPA's rates include a rider that implements the Shoreham property tax settlement. The rider describes the calculation of percentage factors to be applied to bills, including the FPPCA portion thereof. Separate factors are established for Nassau County and the Rockaway Peninsula, and for Suffolk County to accomplish the goals of the Shoreham property tax settlement. Under this rider, LIPA has provided credits averaging approximately $80 million during each 12 month period ending May 2001 and May 2002, respectively, and is currently providing credits that are expected to yield $80 million in the 12 months ending May 2003.

PILOT Payment Recovery Rider

LIPA's rates include a revenue tax factor to collect gross receipts taxes to be paid by LIPA in the form of PILOTs. Gross receipts taxes vary within the Service Area according to taxing jurisdiction. This rider is designed to recover the applicable gross receipts tax from each ratepayer. The PILOT payments recovery rider also accommodates a Metropolitan Transportation Authority Temporary Surcharge that LIPA pays as a PILOT.

The charges that LIPA assess for the PILOT payments which it makes have been unbundled into separate rates for commodity and delivery. Similarly, these charges have been split between residential and non-residential customers. The effective gross receipts tax has declined in the past two years and is currently passed on directly to the customer.

LIPA's Rates and Charges

Based on a review of the underlying cost of service allocations and rate design analyses prepared prior to the Closing by LILCO and examined by the New York Public Service Commission ("NYPSC"), Navigant Consulting believes LIPA's rates and charges provided a reasonable level of revenue recovery from each rate class. Furthermore, as discussed below, LIPA's currently effective rates and charges, including adjustments and riders, provide for adequate revenue recovery to meet its annual revenue requirements and to satisfy the debt service coverage requirements set forth in the General Bond Resolution, absent the approval of waivers limiting cost recovery.

LIPA's Tariff for Electric Service has kept pace with many of the developments that have affected large investor owned utilities in New York State. A number of small changes have been made to the LIPA Tariff, to keep the terms and conditions of service reasonably comparable to neighboring utilities. Among these changes are net metering provisions for residential small solar generators, extension of eligibility for residential service to Veterans organizations, and the extension of certain Economic Development programs through November 2000. LIPA continues to monitor developments at the NYPSC as well as the major investor owned utilities in New York State and appears to be well positioned to address emerging issues as they arise.

Waiver of Certain FPPCA Provisions

As noted above, LIPA's Tariff includes an FPPCA that provides for the recovery of fuel and purchased power costs in excess of the base cost of fuel ("excess fuel costs"). In February 2001, the Authority announced that in 2000 it had incurred excess costs for fuel and purchased power of approximately $307 million (net of the $22 million over-recovery from 1998). Inasmuch as this amount exceeded the 5% cumulative threshold contained under the provisions of the FPPCA, such additional costs were to be recovered in full from customers beginning in 2001. However, on March 1, 2001, the Trustee's approved a waiver of the FPPCA, limiting recovery to approximately $126 million of the additional amount through a fuel surcharge expected to equal approximately 5.8% of base rate revenue for the 12 month period commencing March 7, 2001. The Authority charged to expense approximately $181 million of the excess unrecovered fuel costs during the year ended December 31, 2000.

In February 2002, the Authority announced that in 2001 it had incurred excess costs for fuel and purchased power of approximately $206.6 million. Under the terms of the FPPCA, such additional costs were to be recovered in full from customers beginning in 2002. On February 28, 2002, the Trustees again approved a waiver of the FPPCA, limiting cost recovery to approximately $124.5 million of the additional amount through a fuel surcharge of approximately 5.8% of base rate revenue for the 12 month period commencing March 7, 2002. The Authority charged to expense, as of December 31, 2001, approximately $77.9 million of the previously unrecovered excess fuel costs.

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

Open Access Transmission Tariff

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

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

Unbilled Service

The financing agreement ("Financing Agreement") between the Authority and LIPA Acquisition Corp., a subsidiary of the Authority formed in connection with the acquisition of LILCO, generally prohibits LIPA from providing services of the System without reasonable compensation. Through discussions with KeySpan, Navigant Consulting has identified situations where LIPA is providing electric service at rates below retail tariff levels. These include electricity consumed at certain KeySpan facilities and use of LIPA's transmission and distribution resources by KeySpan for the attachment of KeySpan-owned telecommunication facilities.

Electric service at certain KeySpan locations is metered (or estimated), but not billed at retail tariff rates. Rather, a rate of 4.6 cents per kWh (plus an allowance for county-specific taxes) is imputed for this consumption, and LIPA's invoices from KeySpan under the MSA are credited for this amount. LIPA is reviewing this issue.

Historically, KeySpan has attached telecommunications facilities to the T&D System's poles for use in the conduct of the electric and gas operations on Long Island. In recent years, KeySpan has also begun the installation of telecommunications facilities (such as fiber optic cable) for resale to third-party users. Under the Agreements, KeySpan has the right to attach telecommunications facilities to LIPA's transmission and distribution poles, subject, however, to appropriate and reasonable compensation by KeySpan for the use of such poles. In Sept 2001, LIPA and KeySpan reached an agreement governing KeySpan's attachment of telecommunications facilities to LIPA's poles.

Service Requested by Suffolk County Electrical Agency (SCEA)

In 1996, SCEA filed a request with the Federal Energy Regulatory Commission (FERC) under Section 211 of the Federal Power Act to provide 200 MW per hour of energy to residential customers in Suffolk County. The request was filed with the FERC because LILCO refused to provide the necessary transmission, distribution and retail services that would be required by SCEA to realize its proposed service. LIPA is presently engaged in hearings before the FERC on the appropriate rates, charges and terms for the requested service. SCEA has requested rates that represent a significant discount from the amount that LIPA presently collects from residential customers under the Long Island Choice program. The level of service that SCEA seeks to provide constitutes approximately 35% to 45% of the total energy requirements of residential customers in Suffolk County.

LIPA filed its evidence in August 2002. It has been LIPA's position that FERC should not order it to provide the requested service, and that if the FERC does order LIPA to provide the requested service, it should be at rates which are comparable to LIPA's retail rates. Any other outcome, in LIPA's opinion, would result in a significant amount of cost shifting to other customers on LIPA's system. The procedural schedule anticipates a final decision by FERC in early 2003. Implementation of the program, if so ordered by FERC, would be delayed while LIPA constructs the necessary systems and procedures to accommodate the service, and depends ultimately on SCEA's ability to enroll customers and obtain energy supplies that meet their stated objective of reducing energy costs to residential customers on Long Island.

Financial Results – Reasonableness of Rates

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

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

The Resolution itself however is silent regarding the criteria or standards upon which the recommendations of the Rate Consultant are to be based. As a general matter Navigant Consulting believes there are many quantitative and qualitative factors to consider when assessing rates, fees, charges and surcharges (collectively, the "Tariff") including: adequacy of total revenue produced to cover all costs; each rate's (service classification's) ability to produce revenue sufficient to cover an appropriate portion of total costs; timeliness of cost recovery; regional competitiveness, understandability; stability and predictability. Among these, the single most important factor is whether the Tariff will produce revenue that are adequate to cover all costs reasonably anticipated to be incurred during the period during which the Tariff will be in effect. This is predominately a forward-looking test.

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

> *"The Authority shall establish and maintain System fees, rates, rents, charges and surcharges sufficient in each Fiscal Year so that Revenues reasonably expected to be produced in such Fiscal Year, will be at least equal to the sum of (i) 120% … of Debt Service, and amounts under all Parity Contract Obligations, payable by the Authority in such Fiscal Year, (ii) 100% of the Operating Expenses payable in such Fiscal Year, (iii) 100% of the amount necessary to pay all PILOTS payable in such Fiscal Year, and (iv) 100% of the amount necessary to pay other Required Deposits, all other payments required pursuant to the Resolution and the Financing Agreement, and all other payments required for the System, for such Fiscal Year; …"*

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

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

For purposes of preparing this portion of the Biennial Report relating to the revenue adequacy of the currently effective system of rates and surcharges, Navigant Consulting, as Rate

Consultant, utilized the provisions established in the aforementioned Section 701(a) as the basis of its determinations. Specifically, the test was whether the requirements (minimum standards or Rate Covenants) set forth in Section 701(a) of the General Bond Resolution have been satisfied historically (2000-2001) and can reasonably be expected to be satisfied in the future (2002-2003). In conducting this test it is important to note that Navigant Consulting utilized the currently effective Tariff for Electric Service in developing its level of revenue each Fiscal Year. To the extent the Authority's Trustees have approved waivers of certain provisions of the Tariff, the effect of these waivers on the reported results and related findings have been recognized in the appropriate Fiscal Years. Navigant Consulting's analysis for the prospective period (2002-2003) is based upon the assumption that no provision of the currently effective Tariff is waived. This assumption permits an evaluation of whether the currently effective system of rates fees, charges and surcharges is likely to produce adequate revenues and provide one basis for the advice and recommendations the Rate Consultant may make in accordance with the Resolution. To the extent that the Trustees approve additional waiver(s) that would impact either the amount or timing of the recovery of any incurred expense in a Fiscal Year, such waiver(s) would have a direct effect on the results of the revenue adequacy test and the related advice and recommendations derived therefrom. The results of the analyses for the historic and prospective periods are shown on Exhibits 1 and 2, respectively.

Exhibit 1 sets forth the Authority's annual Statement of Operations for the historical two-year period 2000 and 2001. In accordance with the Authority's accounting practices, annual operating results shown in Exhibit 1 are presented on an accrual basis and include operating expenses, depreciation and amortization, interest income, PILOTS and interest charges, among other expenses.
As shown in Exhibit 1, the actual level of revenue recovered from the Authority's retail electric rates, including the effects of the waivers of the FPPCA approved by the Trustees (see "Waiver of Certain FPPCA Provisions"), were sufficient to during 2000 and 2001 to meet the Authority's operating expenses, PILOTS, and other financial obligations and provide debt service coverage levels in excess of 120% of debt service payments on outstanding senior lien bonds, parity reimbursement obligations and parity contract obligations.

In conjunction with the preparation of this Biennieal Report, Navigant Consulting has prepared an estimate of the Authority's annual operating results for calendar years 2002 and 2003, which are included in Exhibit 2. These estimates are based on numerous assumptions with respect to the Authority's future operations and activities. These assumptions are summarized below.

1. The Authority will issue additional senior lien bonds ("Additional Bonds") to fund capital improvements and other uses during 2003. Annual debt service payments on the Additional Bonds, along with debt already issued by the Authority, will be as set forth in Exhibit 2

2. KeySpan and its subsidiaries will carry out their obligations in accordance with the terms of the Agreements.

3. LIPA will fund repairs, renewals, and replacements to the T&D System, and the Manager will make such repairs, renewals, and replacements in accordance with prudent utility practices and the MSA, as may be required to continue the safe and reliable operation of the T&D System.

4. The Authority will retain staff, advisors, and consultants, as necessary, to carry out its responsibilities for financing, contract administration, planning, public relations, and other matters in connection with the ownership, operation, and maintenance of the System.

5. The Authority will approve reasonable capital expenditures by GENCO, and GENCO will make repairs, renewals, and replacements in accordance with prudent utility practice and the PSA, as may be required to continue the reliable operation of GENCO's generating facilities.

6. LIPA and Constellation will provide operating and capital funds in a timely manner as needed and required by contract to maintain the reliable, cost effective operation of NMP2 and to meet applicable regulations, including environmental and safety standards.

7. KeySpan will indemnify LIPA against all liabilities arising from LILCO's former manufactured gas plant operations and LIPA will have no financial responsibility for the remediation or other correction of contamination from any LILCO manufactured gas plant site operation, nor liabilities associated with environmental contamination on, or emanating from, previous LILCO gas system properties or facilities.

8. Natural gas transportation facilities to deliver gas to and within the Service Area will, during the 2002-2003 period, be maintained, improved, and expanded to enable operation of the on-island generating facilities as forecast by the Manager in its resource planning calculations and as provided in the PSA for the GENCO facilities, as well as for the IPPs, NYPA's Flynn plant and the new power supply resource additions in 2002 and those expected in 2003.

9. LIPA will incur fuel and purchased power expenses as set forth in Exhibit 2.

10. Third party costs, PILOTs, incentive payments, and escalation rates for labor and other costs, as applicable, associated with the MSA, PSA, and EMA will be as reflected in Exhibit 2.

11. Regulatory and other legal liabilities for which LIPA is ultimately responsible, if any, as a result of the allocation of liabilities between LIPA and KeySpan at Closing will be fully satisfied from insurance proceeds.

12. LIPA's share of NMP2 decommissioning costs will increase from ABZ's estimate of 1996 costs at an average rate of no more than 3.0 percent per year and will be funded through annual deposits by LIPA of approximately \$3.2 million and \$1.3 million for the contaminated and non-contaminated portions, respectively, of NMP2. Annual earnings on the decommissioning funds held by or on-behalf of LIPA will average 5.0 percent.

13. LIPA will maintain the Rate Stabilization Fund at the levels shown in Exhibit 2 of this Report.

14. The Rate Stabilization Fund will be used for the purposes and in the amounts shown in Exhibit 2 of this Report for the 2002 through 2003 period.

15. LIPA will realize earnings on its invested funds, including the decommissioning funds, equal to the interest rates provided by the Authority's financial advisor, as reflected in Exhibit 2.

16. There will be no changes in applicable federal, State, or local laws that will establish new limits on the operation and maintenance of the GENCO or NYPA's Flynn generating facilities during the 2002-2003 period.

17. The Authority will maintain regulations, policies, procedures, and rates and charges that will preclude the undue shifting of fixed costs among retail customers or rate classes as a result of individual customers or groups of customers electing to select power suppliers other than LIPA.

18. There will be no changes in regulations or policies of federal, State, or local agencies with jurisdiction over NMP2 that will cause new capital additions or operation and maintenance costs to exceed the estimated amounts of such costs reflected in Exhibit 2 of this Biennial Report.

19. NMP2 will operate at annual capacity factors comparable to the 1998 through 2001 period. All generic issues, including the reactor internals cracking issue discussed in Section 5 of this Biennial Report, will continue to be successfully addressed within the NMP2 plant modification budget forecast NMP2's regulatory performance will be sufficient to make increased NRC regulation of NMP2 unnecessary.

20. Any legislation enacted by the federal government that provides for the restructuring of the electric utility industry will not preclude the use of tax-exempt debt by the Authority for the funding of capital improvements or for other purposes contemplated during the 2002-2003 period and will not preclude LIPA from owning or operating the System as contemplated in this Biennial Report.

As shown on Exhibit 2, the level of revenue projected to be recovered from the Authority's retail rates are sufficient during 2002 and 2003 to meet the Authority's estimated operating expenses, PILOTS, and other financial obligations and provide debt service coverage levels in excess of 120% of debt service payments on outstanding senior lien bonds, parity reimbursement obligations and parity contract obligations.

SECTION 7

FINDINGS AND RECOMMENDATIONS

The results of the analyses performed in the preparation of this Biennial Report and the recommendations presented herein are predicated upon the general condition that the assumptions presented herein are reasonable and will continue, as stated, for the period covered by the analyses, without major modification or change except as noted herein. Although Navigant Consulting believes the assumptions made are reasonable, Navigant Consulting makes no representation that the assumed conditions will, in fact, occur. In addition, Navigant Consulting's studies, analyses, investigations, and projections have been based upon its understanding of certain documents and information provided to Navigant Consulting by the Authority, the Authority's legal, financial, and accounting advisors, KeySpan, and others. While Navigant Consulting believes these sources to be reliable, unless otherwise noted herein, they have not been independently verified for either accuracy or validity, and no assurances are offered with respect thereto. To the best of Navigant Consulting's knowledge, the data and summaries presented herein accurately reflect the information furnished to Navigant Consulting by the Authority, the Authority's legal, financial, and accounting advisors, KeySpan, and others. Further, Navigant Consulting has assumed that all contracts, agreements, or ordinances that have been relied upon in the conduct of its investigations will be fully enforceable in accordance with their terms and conditions. Navigant Consulting makes no representations or warranties, and provides no opinion concerning the enforceability or legal interpretations of such contractual and legal requirements.

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

Operation, Maintenance, and Repair of the System

1. For the period January 1, 2000 through December 31, 2001, KeySpan has provided services adequate for the continued operation and maintenance of the System under the terms of the Agreements.
2. Operation of the T&D System during the Biennial Period was generally consistent with historical operating experience. Navigant Consulting did not note any materially adverse conditions or occurrences during the Biennial Period.
3. The historically experienced high-level of T&D System reliability has remained steady during the Biennial Period.
4. The Manager's intended use, in 2002 and beyond, of a computerized maintenance inspection and record-keeping system for T&D System maintenance is expected to enhance the overall effectiveness of the Manager's on-going preventive and predictive maintenance program.
5. LIPA is faced with several critical issues that will need to be addressed during the 2002 through 2003 period if it is to achieve a continuation of the operational performance that has occurred during the Biennial Period. These include:
   a. Ensuring performance by KeySpan of issues required under the MSA, including: (i) establishment of a mutually agreeable procedure to establish the retention or transfer of easements from KeySpan to LIPA; (ii) establishment of a procedure for accounting for storm expenses; (iii) delivery of updated copies of the T&D System operation and maintenance manuals to LIPA; and (iv) a requirement that the Manager request

authorization from LIPA for all T&D budget variations of 50 percent from a budgeted expenditure, or $500,000, whichever is less;

b. Securing KeySpan's cooperation and assistance with respect to capital budgeting issues, including: (i) development of priority-based budgets; (ii) submission of cost/benefit analyses in support of capital budget decision-making; (iii) increased reliance on preventive and predictive maintenance measures in-lieu of spending for new capital projects; and (iv) increased use of an external bidding/contracting program for major new capital projects;

c. Defining LIPA's requirements and implementing a plan for the development and use of a customer billing system compatible with its business needs and customer service goals; and

d. Resolving issues related to short and long-term planning activities, including: (i) potential conflicts of interest within KeySpan's various business units; (ii) availability of planning personnel necessary to ensure timely completion of critical LIPA planning studies; (iii) use of new planning tools to enhance the determination of needed capital projects.

LIPA has initiated discussions with KeySpan on each of the above issues and is actively seeking resolution.

6. LIPA should also address: (i) compliance with Phase III of the Clean Air Act; and (ii) compliance with the Acid Deposition Reduction Program. LIPA is expected to continue to work with and rely on input from KeySpan with respect to the resolution of issues arising in connection with these air quality compliance requirements.

The amounts shown in Exhibit 2 to this Biennial Report for operation and maintenance expense are expected to be adequate to properly operate, maintain, and repair the System during the 2002 through 2003 period.

Improvements to the System

1. During the Biennial Period, LIPA's capital improvement programs: (i) achieved improvements in system reliability and quality of service; (ii) provided reasonable levels of expenditures for capability expansion, new customer connections, facility replacement, and public works projects; and (iii) provided adequate funding of power supply resource improvements and additions.
2. LIPA has approved capital expenditure programs for 2002 (and is expected to approve capital programs for 2003) intended to: (i) maintain system reliability and quality of service; (ii) continue to provide adequate levels of expenditures for capability expansion, new customer connections, facility replacement, and public works projects; and (iii) provide adequate funding of power supply resource improvements and additions.
3. The capital expenditure levels reported previously in this Biennial Report are expected to be adequate to fund the capital improvement programs approved by LIPA for 2002 and provide a reasonable estimate of funding anticipated for 2003.
4. The amounts expected to be expended from the proceeds of Bonds and Subordinated Indebtedness for capital improvement programs during the 2002 through 2003 period can reasonably be expected to approximate the levels shown in Exhibit 2 to this Biennial Report.

Rates, Fees, Charges, and Surcharges

1. LIPA's rates and surcharge mechanisms as contained in its currently effective Tariff for Electric Service provide for a reasonable level of revenue recovery from each rate class.
2. LIPA's rates and charges were sufficient during the Biennial Period (2000 and 2001) to satisfy 100 percent of its annual operating expenses, PILOTs, and other financial obligations, and produce net revenues in excess of the minimum 120 percent annual coverage requirement on annual debt service payments associated with outstanding senior lien bonds, parity reimbursement obligations and parity contract obligations.
3. During the 2002-2003 period, LIPA's currently effective system of rates and surcharges (if applied without waiver) are likely to be sufficient to satisfy 100 percent of its annual operating expenses, PILOTs, and other financial obligations, and produce net revenues equal to at least 120 percent of annual debt service payments on outstanding senior lien bonds, parity reimbursement obligations and parity contract obligations.
4. To the extent the Trustees choose to approve a waiver of the FPPCA limiting the recovery of excess fuel costs, the amount permitted for recovery should be established at a level sufficient to satisfy, in the aggregate, the provisions of Sections 701 of the General Bond Resolution. Additionally, such satisfaction should be achieved without need to withdraw from the Rate Stabilization Fund.
5. LIPA will need to implement a new customer billing system, or succeed in obtaining appropriate modifications to KeySpan's existing billing system, if it is to meet its goals of improving customer service, providing enhanced billing formats, and implementing new products and services.
6. LIPA should modify existing billing procedures in connection with electric usage at Common Facilities to ensure that its standard and applicable retail rates are applied.

Condition of the System

1. The System is in adequate condition for the transmission and delivery of capacity and energy to LIPA's customers.
2. Existing repair and maintenance practices employed by the Manager, together with anticipated improvements in these practices and the amounts expected to be expended by LIPA for maintenance and repair activities, are expected to be adequate to maintain the T&D System in reasonable condition during the 2002 through 2003 period.
3. Maintenance and performance initiatives adopted by Constellation , together with capital expenditure programs in place for 2002 and 2003, are expected to be successful in maintaining NMP2 in good operating condition during the 2002 through 2003 period.

Exhibit 1
Actual Operating Results
Statement of Operations
($000)

	Audited Historical (1)	
	2000	**2001**
Sales of Electricity, MWh	17,634,337	18,330,836
Total Electric Revenues	$ 2,199,741	$ 2,356,351
Expenses		
Fuel and Purchased Power Costs	$ 885,732	$ 881,335
Operations and Maintenance Expenses	636,568	719,853
General and Administration Expense	33,162	36,746
Operating Taxes/Payments in lieu of taxes	230,319	219,579
Depreciation and Amortization	208,295	212,283
Capital Recovery Amortization	34,209	-
Regulatory Asset Amortization	-	-
Total Expenses	$ 2,028,285	$ 2,069,796
Excess of operating revenues over expenses	$ 171,456	$ 286,555
Other Income and Deductions, Net	$ 50,136	$ 72,049
Excess of revenues over expenses before interest charges and credits	$ 221,592	$ 358,604
Interest Charges	343,820	338,056
Excess of Revenues Over Expenses	$ (122,228)	$ 20,548
Gain on Early Extinguishment of Debt	1,688	-
Excess of Revenues Over Expenses	$ (120,540)	$ 20,548

Totals may not equal sum of components because of independent rounding.

Debt Service Coverage

	Audited Historical (1)	
	2000	**2001 (2)**
Coverage on Senior Lien Debt Service	1.39	1.85
Coverage on Senior Lien and Subordinate Debt Service	1.13	1.64
Coverage on Total Debt Service	1.00	1.63

Notes:

(1) For additional details and footnotes, please refer to: Long Island Power Authority And Subsidiaries Consolidated Financial Statements, December 31, 2001 and 2000.

(2) 2001 revenues restated for $11.9 million due to KeySpan revenue error.
Please refer to the LIPA Financial Statements, December 31, 2002 and 2001 for further details.

Exhibit 2
Projected Operating Results
Statement of Operations
($000)

	Estimated 2002		Estimated 2003	
Sales of Electricity, MWh (1)		18,792,819		19,097,365
Electric Revenues (2)	$	2,424,333	$	2,601,413
Expenses				
Fuel and Purchased Power Costs (3)	$	811,048	$	978,835
Operations and Maintenance Expenses (4)		711,868		671,172
General and Administration Expense (5)		39,561		42,073
Payments in lieu of Taxes/Operating Taxes (6)		215,861		214,417
Depreciation and Amortization (7)		216,500		233,018
Capital Recovery Amortization (8)		-		-
Total Expenses	$	1,994,838	$	2,139,516
Operating Income	$	429,495	$	461,898
Other Income and Deductions, Net (9)	$	42,716	$	46,103
Income from Continuing Operations Before Interest Charges	$	472,211	$	508,001
Interest on LIPA Bonds and Commercial Paper (10)	$	348,221	$	348,162
Other interest and fees (11)		12,323		17,952
Total Interest Charges	$	360,544	$	366,114
Promissory Note Receipts (12)		(42,801)		(42,801)
Net Interest Charges	$	317,743	$	323,313
Excess of Revenues Over Expenses	$	154,467	$	184,688
Gain on Early Extinguishment of Debt (13)		-		-
Excess of Revenues Over Expenses	**$**	**154,467**	**$**	**184,688**

Note: Totals may not equal sum of components because of independent rounding.

Exhibit 2
Projected Operating Results
Debt Service Coverage
($000)

	Estimated 2002	Estimated 2003
Excess of Revenues Over Expenses (14)	$ 154,467	$ 184,688
Add:		
Amortization of Deferred Shoreham Property Settlement Credits (15)	$ -	$ 13,385
Deferred Fuel Costs (16)	(284,401)	(436,685)
Deferred Fuel Cost Reconciliation (17)	126,227	260,586
Depreciation & Amortization (18)	216,500	233,018
PSA Property Taxes -- Accrual Net of True-up (19)		5,800
Carrying Charge -- Regulatory Asset (20)	(27,057)	(30,480)
Interest Charges (21)	360,544	366,114
Proceeds from the Shoreham Property Tax Settlement Securities (22)	80,000	25,265
Payments in-Lieu of Taxes/Operating Taxes (23)	215,861	214,417
Capitalized Leases (24)		93,370
Promissory Note Receipts Used to Offset NYSERDA Bonds in Interest Charges (25)	-	-
Subtotal	$ 687,674	$ 744,790
Less:		
Prepaid Fuel Hedging Program Costs -- Net of Amortization (26)		18,782
Prepaid Nine Mile Point 2 Refueling Outage Costs (27)		(3,569)
Funding for NMP2 Plant Decom (28)	4,500	4,500
Bank and Related Fees (29)	10,325	13,967
Shoreham Settlement Credits (30)	80,000	25,265
Subtotal	$ 94,825	$ 58,945
Total Available for Coverage	$ 747,317	$ 870,533
Senior Lien Debt Service (31)	$ 381,918	$ 389,567
Coverage on Senior Lien Debt	**1.96x**	**2.23x**
Senior Lien and Subordinate Debt Service (32)	$ 417,798	$ 425,319
Coverage on Senior Lien and Subordinate Debt	**1.79x**	**2.05x**
Total Debt Service (33)	$ 460,599	$ 468,120
Coverage on Total Debt Service	**1.62x**	**1.86x**

Note: Totals may not equal sum of components because of independent rounding.

Exhibit 2
Funds Available for Optimal Defeased/Tendered Debt,
Working Capital, Capital Improvements, and Other Purposes
($000)

	Estimated 2002	Estimated 2003
Funds Provided from:		
Excess of Revenues Over Expenses (34)	$ 154,467	$ 184,688
Add Back:		
Amortization of Deferred Shoreham Property Settlement Credits (35)		13,385
Shoreham Settlement Credits (36)	(80,000)	(25,265)
Deferred Fuel Costs (37)	$ (284,401)	$ (436,685)
Deferred Fuel Cost Reconciliation (38)	126,227	260,586
Depreciation & Amortization (39)	216,500	233,018
PSA Property Taxes -- Accrual Net of True-up (40)		5,800
Carrying Charge -- Regulatory Asset (41)	(27,057)	(30,480)
Debt Service Interest Expense (42)	360,544	366,114
Proceeds of Bonds and Notes (43)	-	200,000
KeySpan Promissory Note Reimbursement (44)	-	-
Total Sources of Funds	$ 466,281	$ 771,161
Funds Used For:		
Prepaid Fuel Hedging Program Costs-Net of Amortization (45)		18,782
Prepaid Nine Mile Point 2 Refueling Outage Costs (46)		(3,569)
Debt Service Payments (47)	460,599	468,120
Transfer to Construction Funds (48)	260,000	245,663
Funding for Nine Mile Point 2 Plant Decommissioning (49)	4,500	4,500
Bank and Related Fees (50)	10,325	13,967
Total Uses of Funds	$ 735,424	$ 747,463
Current Year, after financing and cap ex, Cash Equivalent Flows	$ (269,143)	$ 23,699
Beginning Cash Balance (Incl Rate Stabilization Fund Balance (51))	688,369	419,226
Total Funds Available for Optional Defeased/Tendered Debt, Working Capital, Capital Improvements, and Other Purposes	$ 419,226	$ 442,924
Funds Used for Optional Defeasance/Tendering of Debt	-	-
Ending Cash Balance	$ 419,226	$ 442,924
Less Rate Stabilization Fund Balance	250,000	250,000
Funds Available for Optional Defeased/Tendered Debt and Working Capital Capital Improvements, and Other Purposes	$ 169,226	$ 192,924

Note: Totals may not equal sum of components because of independent rounding.

Exhibit 2
Projected Operating Results
Rate Covenant Calculations
($000)

	Estimated 2002		Estimated 2003	
Total Available for Coverage (52)	$	747,317	$	870,533
Less: PILOTs/Operating Taxes (53)		(215,861)		(214,417)
Less: Capital Lease Payments (54)		-		(93,370)
Operating Cash Available for Debt Service and Coverage	**$**	**531,456**	**$**	**562,746**
Debt Service				
Senior Lien Debt Service (55)	$	381,918	$	389,567
20% Coverage on Senior Lien Debt Service (56)		76,384		77,913
Subordinate Debt Service (57)		35,881		35,751
Subsidiary Unsecured Debt Service (58)		42,801		42,801
Subtotal	**$**	**536,983**	**$**	**546,033**
Revenue Excess/(Deficiency)	**$**	**(5,527)**	**$**	**16,713**
Transfers from Rate Stabilization Fund (RSF) (59)		5,527		-
Revenue Excess/(Deficiency) after RSF transfers	**$**	**-**	**$**	**16,713**

Exhibit 2
Projected Operating Results

Footnotes:

(1) Includes bundled and Long Island Choice electric sales. Sales are based on econometric models and average 2.0 percent annual sales growth.

(2) Includes bundled services and Long Island Choice services, and Shoreham property tax settlement credits and surcharges. Fuel and purchased power costs recoverable are also included. RICO credits ceased in May 2000. Fuel and purchased power cost recovery was a 5.8 percent fuel surcharge in 2001. For 2000 and 2001, LIPA did not fully recover its fuel costs that were recoverable under its existing "Fuel and Purchased Power Cost Adjustment" rider. LIPA's Board approval of the FPPCA waiver of full collection has a 12-month duration and in the past, has been reviewed at year-end for 2000 and 2001. The estimated fuel and purchased power costs recoverable for 2002 has been assumed to remain at the 5.8 percent fuel surcharge level. For 2003, it was assumed that LIPA would recover 100 percent of 2002 excess fuel costs over a 12 month period beginning March 1, 2003 and ending February 28, 2004. Revenues from sales for resale and wheeling are included. Revenues from rents, pole attachment fees, postage-paid remittance envelope reimbursement, late payment charges and other miscellaneous revenues are included.

(3) Includes LIPA's cost for fossil and nuclear fuel, cost of purchased capacity and energy, wheeling charges, ISO charges, hedging costs, and deferred fuel cost recovery. Computer simulations of the economic dispatch for PJM, NYISO, and NEPOOL form the basis for these projections.

(4) Includes costs in accordance with the MSA, PSA, NMP2 operation and maintenance expenses, Clean Energy Program costs, assessments, research and development, storm damage reserve, uncollectible accounts, customer service economic development, postage-paid envelopes and other miscellaneous expenses. Costs were escalated at 3.5 percent (in accordance with agreements when appropriate).

(5) Includes LIPA's general and administrative expenses, such as employee salaries and benefits, utilities, rent and legal and consulting fees. Costs were escalated at 3.5 percent.

(6) Includes payments in lieu of property taxes to various taxing jurisdictions for NMP2, the T&D System, and Shoreham, and gross receipts taxes. The Shoreham PILOTs phased out in 2002.

(7) Consists of amortization of the acquisition adjustment, depreciation of plant-in-service, and payments to the NMP2 decommissioning fund.

(8) Additional amortization of the Acquisition Adjustment resulting from early retirement of acquisition-related debt.

(9) Primarily consists of interest earned on investments from available cash balances and carrying charges related to the Shoreham property tax settlement regulatory asset. An investment rate of 2.50 percent per year was assumed for the cash balances.

(10) Interest expense on the Bonds, Subordinate Indebtedness, Commercial Paper, the Debentures, and NYSERDA Financing Notes. Includes accretion of capital appreciation bonds and amortized interest expense. The 2001L interest expense is reduced by net receipts resulting from a fixed rate to variable rate swap. The Series 7 Bonds were effectively converted from floating to fixed (4.2 percent) through interest rate swap agreements.

(11) Bank and letter of credit fees, debt administration costs, interest on customer deposits, amortization of costs associated with bond issuance and redemptions, and reduction for capitalized interest.

(12) Receipts from KeySpan Promissory Notes held by LIPA for repayment of certain assumed debt. The Audited Financial Statements reflect these receipts as an offset to interest expense.

(13) Realized gain on early extinguishment of debt.

(14) From Exhibit 2, Page 1 of 6.

(15) Shoreham Property Tax Surcharge.

(16) Fuel and Purchased Power Costs to be credited or charged to customers the following year.

(17) Recognition of deferred fuel costs as an expense in the year during which the corresponding fuel and purchased power costs are billed.

(18) See Note 7.

(19) Accrued PSA Property Taxes in excess of the true-up level.

(20) Annual carrying charges recorded on the Shoreham property tax settlement regulatory asset.

Exhibit 2
Projected Operating Results

Footnotes (continued):

(21) From Exhibit 2, Page 1 of 6. See Notes 10 and 11.

(22) Portion of the proceeds of the Electrice System General Revenue Bonds, Series 2000A, attributable to the Shoreham property tax settlement credits each year.

(23) From Exhibit 2, Page 1 of 6. See Note 6.

(24) The capacity payments for power supply agreements that satisfy the conditions for capital leases.

(25) See Note 12. Receipts are used to offset NYSERDA notes interest expense so they are not included again.

(26) Cash outlays for hedging contracts less what is reflected in expense.

(27) Amortization of Nine Mile Point 2 Refueling charges.

(28) Deposits to the NMP2 decommissioning fund.

(29) Bank fees, letter of credit fees, bond administration costs, and interest on customer deposits.

(30) Credits issued in accordance with the Shoreham property tax settlement.

(31) Debt service on the Bonds (after net Swap receipts on 2001L bonds and Series 7 floating to fixed rate swap).

(32) Note 31 plus the debt service on the Subordinated Indebtedness. The Subordinated Indebtedness consists of variable rate debt and commercial paper assumed at 1.9 percent for 2002 and 2003, exclusive of letter of credit and remarketing fees.

(33) Note 32 plus the debt service on the Debentures and NYSERDA Financing Notes.

(34) From Exhibit 2, Page 1 of 6.

(35) See Note 15.

(36) Set Note 30.

(37) See Note 16.

(38) See Note 17.

(39) See Note 7.

(40) See Note 19.

(41) See Note 20.

(42) See Notes 10 and 11.

(43) Proceeds of Bonds and Notes for capital projects. 2003 assumes $245.6 million in capital expenditures.

(44) See Note 25.

(45) See Note 26.

(46) See Note 27.

(47) Debt service on the Bonds (after net Swap receipts on 2001L bonds of $3.6 million in 2002 and $3.3 million in 2003), Subordinated Indebtedness (includes Series 7 floating to fixed rate swap with a total notional amount of $250 million), Commercial Paper, the Debentures, and NYSERDA Financing Notes.

(48) Transfer of proceeds from Proceeds of Bonds and Notes to the Construction Fund.

(49) See Note 28.

(50) See Note 29.

(51) As defined in the General Bond Resolution and consistent with the Plan of Finance approved by the Board.

(52) From Exhibit 2, Page 2 of 6.

(53) See Note 6.

(54) See Note 24.

(55) See Note 31.

(56) 20 percent additional coverage on Senior Lien Debt Service.

(57) Subordinated Indebtedness consists of variable rate debt and commercial paper assumed at 1.9 percent for 2002 and 2003, exclusive of letter of credit and remarketing fees.

(58) The debt service on the Debentures and NYSERDA Financing Notes.

(59) Transfers from the Rate Stabilization Fund to remove the deficiency of Revenues.

Appendix A

SUMMARY OF CERTAIN PROVISIONS OF THE MANAGEMENT SERVICES AGREEMENT

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

General

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

Ownership of the T&D System

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

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

Operation of the T&D System

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

Operation and Maintenance. The Agreement provides that, commencing on the LIPA/LILCO Merger Closing Date, the Manager will provide Operation and Maintenance Services and Construction Work for the T&D System on behalf of LIPA in accordance with the Contract Standards. The Manager will be responsible for the safe and reliable operation and maintenance of the T&D System, management and/or performance of construction of improvements thereto and delivery of Power and Energy to LIPA's customers and will be responsible for the following tasks and services, among others: (a) day-to-day operation and maintenance of the T&D System; (b) construction activities performed by the Manager's work force; (c) supervision of routine and major capital improvements; (d) preparation of recommended and monitoring of approved annual capital and operating expenditure budgets, load and energy forecasts and long and short range system and strategic plans; (e) preparation of long and short range transmission and distribution planning analyses; (f) performance of accounting and tax and payment in lieu of tax reporting functions and preparation of monthly reports concerning the T&D System; (g) operation of the T&D System in compliance with applicable provisions of the bond resolutions, and with other requirements pertaining to qualification of the bonds for tax-exemption under the Code; (h) other actions necessary to safely and reliably operate the T&D System in accordance with Prudent Utility Practice; (i) administration and management, at the direction of LIPA, of LIPA's interest in NMP2; and (j) billing and collection, in accordance with LIPA's direction, of all fees and charges in connection with the use or availability of the T&D System for wheeling services.

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

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

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

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

Customer Services, Rates and Rules of Service. The Agreement provides that the Manager shall perform normal and customary customer services in a manner designed to achieve the highest level of customer service, including, but not limited to: customer account service and maintenance; service restorations account inquiry work; customer assistance, credit and collection services; cashiering; account connection and disconnection; and conservation advice.

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

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

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

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

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

Manager's Reporting Requirements

Monthly Reports. The Manager will provide LIPA and the Consulting Engineer with monthly reports no later than 15 Business Days after the end of each month, which include the following data: (1) on a monthly and year-to-date basis, the actual T&D System costs versus the Annual T&D Budget and the prior year's costs at such time, (2) a description and explanation of significant variations (at least $1,000,000 and 3%) from the Annual T&D Budget or the prior year's results, (3) a description of partial or total shutdowns for maintenance and repairs during the prior month and anticipated during the current month, (4) any known or anticipated adverse conditions which may be expected to arise during the next 30 day period that may affect the ability of the Manager to transmit and distribute Power and Energy in accordance with the Performance Guarantees and the annual operating plan established for the T&D System, (5) identification of those costs which are classified as capital versus operating in sufficient detail in order to allow LIPA to determine which costs qualify for bonding under the Resolution and which are to be recovered through T&D System rates, and (6) any other information or statement which is requested by LIPA and which may be reasonably produced from records maintained by the Manager in the normal course of business. The Manager will also provide a quarterly forecast of projected expenditures by line item through year-end.

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

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

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

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

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

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

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

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

Major Capital Improvements

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

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

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

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

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

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

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

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

Compensation and Budgets

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

$$SF = FDF + TPC + VP + CIF + NCPI$$

Where

SF	=	Service Fee
FDF	=	Fixed Direct Fee
TPC	=	Third Party Costs
VP	=	Variable Payment
CIF	=	Cost Incentive Fee
NCPI	=	Non-cost Performance Incentives and Disincentives

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

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

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

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

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

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

Limitations. The Agreement provides that the ratio of (1) the sum of the Variable Payment plus the Cost Incentive Fee plus the sum of the Non-cost Performance Incentives and Disincentives (as discussed below under the heading "Non-Cost Performance Incentives and Disincentives") plus the

Overrun Payment divided by (2) the sum of (a) the amounts described in (1) above and (b) the Fixed Direct Fee, will not be greater than twenty percent (20%) in any Contract Year.

Annual T&D Budget and Five Year Planning Budget Process

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> (a) due to any gross negligence or willful misconduct by the Manager during the period commencing six months prior to the LIPA/LILCO Merger Closing Date to the extent LILCO knew or should have known of such gross negligence or willful misconduct and during the term of the Agreement in carrying out its obligations thereunder,
>
> (b) due to any violation of or failure of compliance with Applicable Law by the Manager (except as provided below) during the period commencing six months prior to the LIPA/LILCO Merger Closing Date to the extent LILCO knew or should have known of such violation or failure of compliance and during the term of the Agreement which materially and adversely affects
>
> (i) the condition or operations of the T&D System,
>
> (ii) the financial condition of LIPA,
>
> (iii) the performance or ability of the Manager to perform its obligations under the Agreement, or
>
> (iv) the cost of providing electric service to the customers of the T&D System, provided, however, that Manager will not be responsible and liable to LIPA under the provisions of the Agreement described in this clause (b) with respect to any violation of, failure of compliance with, or liability under, Environmental Laws (as defined in the LIPA/LILCO Merger Agreement) for which LIPA or the Manager may be strictly liable provided that Manager (or for actions prior to the LIPA/LILCO Merger Closing Date, LILCO) acted in a manner consistent with Prudent Utility Practice. Notwithstanding the foregoing, Manager will in all events be liable for any fine or penalty arising by reason of any violation of or failure of compliance with Applicable Law for acts or omissions of the Manager not consistent with Prudent Utility Practice,
>
> (c) due to any criminal violation of Applicable Law by the Manager (or for actions prior to the LIPA/LILCO Merger Closing Date, LILCO), or
>
> (d) due to an event which gives rise to a cost not included in the Direct Cost Budget or Third Party Cost Budget or a cost incurred with respect to Major Capital Improvements or Public Works Improvements, that is incurred by reason of actions or omissions of the Manager not consistent with Prudent Utility Practice.

Default, Termination For Cause And Dispute Resolution

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

Events of Default by the Manager

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Non-Binding Mediation; Arbitration

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

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

Provisional Relief

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

Term

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

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

Miscellaneous Provisions

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

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

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

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

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

Appendix B

SUMMARY OF CERTAIN PROVISIONS OF THE POWER SUPPLY AGREEMENT

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

General

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

Power Supply

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

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

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

Purchase Price and Payment

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

(i) a capacity charge to compensate GENCO for its fixed costs of generating electricity from the GENCO Generating Facilities,

(ii) a variable charge based on the variable operation and maintenance costs as established by the Agreement, multiplied by the actual MWh of operation of the GENCO Generating Facilities,

(iii) a charge for any costs incurred by GENCO in providing certain Ancillary Services to LIPA, if any such services are required by LIPA which are not otherwise compensated by the charges described in items (i) and (ii) above,

(iv) a charge for non-variable related expenses net of insurance proceeds, that cannot be planned for with any certainty and are outside the control of GENCO, and

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

Budgets

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

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

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

Capacity Ramp Down Option

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

Term and Termination

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

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

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

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

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

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

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

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

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

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

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

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

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

Non-binding Mediation; Arbitration

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

Affiliate

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

Credit Enhancement in Certain Circumstances

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

Allocation of Risk of Certain Costs and Liabilities

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

Appendix C

SUMMARY OF CERTAIN PROVISIONS OF THE ENERGY MANAGEMENT AGREEMENT

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

General

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

Scope of Energy Management Services

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

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

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

Fuel Management

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

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

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

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

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

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

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

Off-System Sales

The Agreement provides that the Energy Manager will use best efforts to market to Off-System Sales customers, on LIPA's behalf, Electricity from the System Power Supply that is not otherwise needed by the Electricity Customers in a manner which will reduce the net cost of Electricity provided to the Electricity Customers. The Energy Manager will receive 33 percent of the revenue net of incremental costs from Off-System Sales of Electricity from the System Power Supply and LIPA will receive 67 percent of the revenue net of incremental costs from these Off-System Sales of Electricity from the System Power Supply. The incremental costs for such Off-System Sales will be based upon the incremental cost of energy for such Electricity sales including any other costs or charges (including applicable taxes) incurred to produce and deliver the Electricity and/or Ancillary Services for sale by the Energy Manager. The incremental costs associated with capacity sales will include the cost of replacement capacity incurred as a result of the sale, if any, and any other costs or charges related to the sale, including startup, no-load operation, transmission, and applicable taxes.

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

System Power Supply Management

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

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

(i) schedule deliveries of and Dispatch energy from the System Power Supply;

(ii) arrange for LIPA's purchase of Electricity to the extent the System Power Supply is insufficient to meet the requirements of the T&D System;

(iii) continually monitor the market for LIPA's sale and purchase of wholesale Electricity and purchase Electricity, on LIPA's behalf, on the wholesale market to displace System Power Supply if such purchases, including the cost of transmission services to deliver such Electricity, will reduce total power supply costs;

(iv) sell Electricity on LIPA's behalf from the System Power Supply that is surplus to the requirements of the T&D System whenever such sales, including consideration of any incremental cost of Transmission for delivery of such sales, are advantageous to LIPA;

(v) arrange for such additional transmission services and capacity as will be necessary for the purchase or sale of Electricity by LIPA; and

(vi) with the prior written consent of LIPA, subcontract with power marketers or brokers, or similar entities, to assist in the acquisition of Electricity and the marketing and sale of excess Electricity.

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

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

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

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

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

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

Records; Information

Account Records; Collection of Monies; Availability of Energy Manager

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

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

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

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

Books and Records. The Energy Manager will prepare and maintain proper, accurate and complete books, records and accounts regarding Fuel and System Power Supply to the extent necessary (1) to enable LIPA to prepare LIPA's financial statements in accordance with generally accepted accounting principles, (2) to verify data with respect to any operations or transactions in which LIPA has a financial or other material interest under the Agreement, (3) to prepare periodic performance reports and statements relating to purchase of Fuel and System Power Supply, which will be submitted by the Energy Manager to LIPA and (4) to enable LIPA to administer any fuel adjustment clause or similar provision applicable to Electricity sales. The Energy Manager will, upon notice and demand from LIPA, produce for examination and copying by representatives of LIPA, any documents showing all acts and transactions relating to the Agreement, any Subcontract or any transactions in which LIPA has or may have a financial or other material interest under the Agreement, and will produce such operation books and records for examination and copying in connection with the costs for which LIPA may be responsible under the Agreement.

Fiscal Affairs, Accounting and Record Keeping

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

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

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

Allocation of Risk of Certain Costs and Liabilities

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

Term; Events of Default

Term. The term of the Agreement commenced on May 28, 1998 and, except as otherwise provided ^ **therein**, will remain in full force and effect for an initial term of (i) fifteen (15) years from such date with respect to the Fuel Services and (ii) eight (8) years from such date with respect to System Power Supply Services.

Events of Default; Procedures for Termination

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

LIPA Emergency Assumption of Fuel and System Power Supply Management Services. Should the Energy Manager, due to Uncontrollable Circumstances or any other reason whatsoever, fail, refuse or be unable to provide any or all Fuel and System Power Supply Services contemplated hereby and LIPA or any Governmental Body finds that such failure endangers or menaces the public health, safety or welfare, then, in any of those events and to the extent of such failure, LIPA will have the right, upon notice to the Energy Manager, during the period of such emergency, to perform the services which the Energy Manager would otherwise be obligated to perform under the Agreement. The Energy Manager agrees that in such event it will fully cooperate with LIPA to effect such a temporary assumption. The Energy Manager agrees that, in such event, LIPA may take and use any or all of the operating assets of the Energy Manager necessary for the above-mentioned purposes without paying the Energy Manager or any other person any additional charges or compensation whatsoever for such possession and use; provided, however, that if such emergency is due to Uncontrollable Circumstances, LIPA will reimburse the Energy Manager for its Cost-Substantiated costs incurred due to such a transfer of the operating assets.

Energy Manager's Reporting Requirements

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

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

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

Indemnification

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

Miscellaneous Provisions

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

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

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

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

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

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