

**KEYSPAN GENERATION LLC
AND SUBSIDIARIES**

**CONSOLIDATED FINANCIAL STATEMENTS
FOR THE PERIOD
JANUARY 1, 2007 THROUGH MARCH 31, 2008
AND INDEPENDENT AUDITORS' REPORT**

KEYSPAN GENERATION LLC AND SUBSIDIARIES

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**KEYSPAN GENERATION LLC
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF INCOME
COMPREHENSIVE INCOME**

<i>(In Thousands of Dollars)</i>	Successor For The Period August 25, 2007- March 31, 2008	Predecessor For The Period January 1,2007 - August 24,2007	Predecessor For The Twelve Months Ended December 31, 2006
Operating Revenues	\$ 237,172	\$ 254,944	\$ 388,820
Operating Expenses			
Operations	59,872	63,441	78,376
Maintenance	27,834	33,614	34,554
Depreciation and amortization	37,151	39,724	60,528
Operating taxes	90,537	97,569	142,892
Total Operating Expenses	215,394	234,348	316,350
Gain on Sale of Assets	-	-	159
Operating Income	21,778	20,596	72,629
Interest Charges	(15,966)	(16,881)	(22,508)
Other Income and (Deductions)	5,906	7,456	11,679
Earnings Before Income Taxes	11,718	11,171	61,800
Income Taxes			
Current	9,190	4,884	19,073
Deferred	(5,795)	(1,803)	74
Total Income Taxes	3,395	3,081	19,147
Net Income before Extraordinary Items	\$ 8,323	\$ 8,090	\$ 42,653
Extraordinary charge (net of tax)	\$ -	\$ (25,492)	\$ -
Net Income	\$ 8,323	\$ (17,402)	\$ 42,653
Accrued Unfunded Post Retirement Obligation (net of tax)	\$ -	\$ (34,096)	\$ 167
Comprehensive Income (Loss)	\$ 8,323	\$ (51,498)	\$ 42,820

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

**KEYSPAN GENERATION LLC
AND SUBSIDIARIES**

CONSOLIDATED BALANCE SHEET

(In Thousands of Dollars)

March 31, 2008

December 31, 2006

ASSETS

Current Assets

Cash	\$	-	\$	-
Accounts receivable		4,689		7,124
Allowance for doubtful accounts		(2,979)		(600)
Unbilled revenue		29,306		17,016
Accounts receivable, affiliates, net		79,084		35,960
Emission Credits		243,415		-
Materials and supplies, at average cost		36,344		36,139
Prepaid assets and other		12,951		45
		402,810		95,684

Property, Plant and Equipment

Plant		1,720,853		1,577,771
Accumulated depreciation		(967,428)		(906,837)
		753,425		670,934

Deferred Charges and Other Assets

Contractual receivable - Pension and OPEB (See Note 3)		42,111		133,690
Deferred Income Taxes		-		129
Intangibles, net of amortization		44,700		-
Other		9,261		17,615
		96,072		151,434

Total Assets

	\$	1,252,307	\$	918,052
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The accompanying notes are an integral part of these consolidated financial statements.

KEYSPAN GENERATION LLC AND SUBSIDIARIES

<i>(In Thousands of Dollars)</i>	Successor For the Period August 25, 2007- March 31, 2008	Predecessor For the Period January 1, 2007 - August 24, 2007	Predecessor For the Twelve Months Ended December 31, 2006
<i>Operating Activities</i>			
Net income	\$ 8,323	\$ (17,402)	\$ 42,653
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation and amortization	37,151	39,724	60,528
Deferred income tax	(5,795)	(1,803)	74
Extraordinary charge, net of taxes	-	25,492	-
Changes in assets and liabilities			
Accounts receivable, net	(7,104)	14,411	(5,868)
Materials and supplies	410	(616)	(1,784)
Accounts payable and accrued expenses	11,999	(39,467)	22,042
Other	(11,172)	13,197	(6,901)
Net Cash Provided by Operating Activities	<u>33,812</u>	<u>33,536</u>	<u>110,744</u>
<i>Investing Activities</i>			
Capital expenditures	(26,117)	(27,321)	(36,554)
Cost of removal	(4,714)	(3,706)	(8,247)
Net Cash Used in Investing Activities	<u>(30,831)</u>	<u>(31,027)</u>	<u>(44,801)</u>
<i>Financing Activities</i>			
Accounts payable affiliates	(2,981)	(2,509)	(65,943)
Net Cash Used in Investing Activities	<u>(2,981)</u>	<u>(2,509)</u>	<u>(65,943)</u>
Net increase in cash and cash equivalents	-	-	-
Cash and cash equivalents at beginning of period	-	-	-
Cash and cash equivalents at end of period	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Interest paid	\$ 12,823	\$ 13,781	\$ 20,946

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

**KEYSPAN GENERATION LLC
AND SUBSIDIARIES**

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

<i>(In Thousands of Dollars)</i>	Successor For the Period August 25, 2007- March 31, 2008	Predecessor For the Period January 1, 2007- August 24, 2007	Predecessor For the Twelve Months Ended December 31, 2006
Balance at beginning of period	124,525	141,927	99,274
Net income for period	8,323	8,090	42,653
Extraordinary charge, net of taxes	-	(25,492)	-
Purchase accounting adjustment	(124,525)	-	-
Balance at end of period	8,323	124,525	141,927

**KEYSPAN GENERATION LLC
AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CAPITALIZATION**

<i>(In Thousands of Dollars)</i>				March 31, 2008	December 2006
Total Member's Equity				\$ 458,995	\$ 436,975
Long-Term Debt.	Maturity	Interest Rate	Series		
Authority Financing Notes					
Pollution Control Revenue Bonds	October 1, 2028	Variable	1999 A	41,125	41,125
Electric Facilities Revenue Bonds	December 1, 2027	Variable	1997 A	24,880	24,880
Total Authority Financing Notes				<u>66,005</u>	<u>66,005</u>
Promissory Notes to LIPA*					
Pollution Control Revenue Bonds	March 1, 2016	5.15%	1985 B	27,900	27,900
Electric Facilities Revenue Bonds	November 1, 2023	5.30%	1993 B	29,600	29,600
	October 1, 2024	5.30%	1994 A	2,600	2,600
	August 1, 2025	5.30%	1995 A	15,200	15,200
Total Promissory Notes to LIPA				<u>75,300</u>	<u>75,300</u>
Advance from Parent	June 1, 2006	6.15%		<u>131,868</u>	<u>131,868</u>
Tax-exempt Bonds					
Nassau County Industrial Development Revenue Bonds	June 1, 2027	5.25%		53,275	53,275
Suffolk County Industrial Development Revenue Bonds	June 1, 2027	5.25%		75,000	75,000
Long-Term Debt				<u>401,448</u>	<u>401,448</u>
Fair Value Adjustment				(2,859)	-
Total Long-Term Debt				<u>398,589</u>	<u>401,448</u>
Total Capitalization				<u>\$ 857,585</u>	<u>\$ 838,423</u>

*The Promissory Notes to LIPA have been allocated to KeySpan Generation LLC from the Parent. (See Note 4 to the Consolidated Financial Statements "Long-term Debt").
The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Summary of Significant Accounting Policies

A. Organization

KeySpan Generation LLC is a wholly owned subsidiary of KeySpan Corporation d/b/a KeySpan Energy (the “Parent”, “KeySpan”), the successor to Long Island Lighting Company (“LILCO”), as a result of a transaction with the Long Island Power Authority (“LIPA”) (the “LIPA Transaction”). KeySpan Generation was formed on May 7, 1998 as a limited liability corporation, and on May 28, 1998 acquired the net generation related assets of the Parent immediately prior to the LIPA Transaction. KeySpan Generation owns and operates an aggregate of 53 electric generation units throughout Long Island, 20 of which can be powered either by oil or natural gas at our election. The wholly-owned subsidiaries, KeySpan Glenwood Energy Center LLC (“Glenwood”) and KeySpan Port Jefferson Energy Center LLC (“Port Jefferson”) sell capacity, energy conversion and ancillary services to LIPA. The Consolidated Financial Statements reflect the accounts of KeySpan Generation LLC and its subsidiaries Glenwood and Port Jefferson. KeySpan Generation LLC and subsidiaries is referred to in these notes as “Keyspan Generation”, “we,” “us” and “our”.

KeySpan Generation has an agreement with LIPA (“The Power Supply Agreement”) (“PSA”) for which it provides for the sale to LIPA all of the capacity and, to the extent LIPA requests, energy from the generating facilities. LIPA represents our only customer of capacity and energy conversion services. Capacity refers to the ability to generate energy and, pursuant to New York Power Pool (“NYPP”) requirements, must be maintained at specified levels (including reserves) regardless of the source and amount of energy consumption. By contrast, energy refers to the electricity actually generated for consumption by customers. Such sales of capacity and energy conversion services to LIPA are made under terms of the PSA at cost-based wholesale rates regulated by the Federal Energy Regulatory Commission (“FERC”). These rates may be modified in the future in accordance with the terms of the PSA for (i) agreed-upon labor and expense indices applied to the base year; (ii) a return of and on the capital invested in the generating facilities; and (iii) reasonably incurred expenses that are outside of our control. (See Note 5 “Commitments and Contingencies” for additional information on the PSA.)

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC are not cost-of-service rate regulated by FERC. They have entered into a 25 year Power Purchase Agreements (the “PPAs”) with LIPA. Under the terms of the PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Both plants are designed to produce 79.9 megawatts. Under the PPAs, LIPA pays a monthly capacity fee, which provide for recovery of each plant’s construction costs, as well as an appropriate rate of return on investment. The PPAs also obligate LIPA to pay for each plant’s costs of operation and maintenance. These costs are billed on a monthly estimated basis and are subject to true-up for actual costs incurred.

B. Basis of Presentation

The Consolidated Financial Statements reflect the accounts of KeySpan Generation LLC and its subsidiaries. All significant intercompany transactions have been eliminated.

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Our accounting records are maintained in accordance with the Uniform System of Accounts prescribed by FERC. Our financial statements reflect the ratemaking policies and actions of FERC in conformity with GAAP for rate-regulated enterprises. Glenwood Energy Center LLC and Port Jefferson Energy Center LLC are not regulated by FERC.

In our opinion, the accompanying audited Consolidated Financial Statements contain all adjustments necessary to present fairly KeySpan Generation LLC's financial position as of March 31, 2008 and December 31, 2006 and the results of operations and cash flows for the fifteen months ended March 31, 2008 and the twelve months ended December 31, 2006.

C. Revenues

Electric revenues are derived from billings to LIPA for all of the electric generation capacity and, to the extent requested, energy conversion services from our existing oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under terms of the Power Supply Agreement with rates approved by FERC. (See Note 5, "Commitments and Contingencies" for additional information on the PSA.)

Revenues for Glenwood and Port Jefferson are derived from a monthly capacity fee paid by LIPA, which provides for recovery of each plant's construction costs, as well as a rate of return on investment. LIPA is also obligated to pay for each plant's costs of operation and maintenance. These costs are billed on a monthly estimated basis and are subject to true-up for actual costs incurred. The monthly capacity fee and reimbursement for costs of operation and maintenance made under the terms of the Power Purchase Agreements are not cost-of-service rate regulated by FERC. (See Note 5, "Commitments and Contingencies" for additional information on the PPA's.)

D. Property - Depreciation and Maintenance

Property is stated at original cost of construction, which includes allocations of overheads and taxes and an allowance for funds used during construction. Capitalized interest was \$0.2 million and \$0.3 million for the period January 1, 2007 through August 24, 2007 and August 25, 2007 through March 31, 2008, respectively. In total capitalized interest was \$0.5 million and \$0.4 million as of March 31, 2008 and December 31, 2006, respectively. The interest component in the allowance for funds used during construction rate for the periods was 2.2%. At March 31, 2008, KeySpan Generation had \$1.7 billion of plant and \$31.1 million of construction work in progress on the balance sheet.

Depreciation is provided on a straight-line basis in amounts equivalent to composite rates on average depreciable property. The annualized composite rate on average depreciable property for the period was approximately 3.73%. The cost of property retired, plus the cost of removal less salvage is charged to

accumulated depreciation. The cost of repair and minor replacement and renewal of property is charged to maintenance expense when incurred.

E. Recent Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board (“FASB”) issued SFAS 161 “Disclosures about Derivative Instruments and Hedging Activities.” This Statement amends and expands the disclosure requirements of SFAS 133 with the intent to provide users of financial statements with an enhanced understanding of (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedged items are accounted for; and (c) how derivative instruments and related hedged items affect an entity’s financial position, financial performance and cash flows. This Statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses of derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements. This Statement shall be effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. This Statement will have no impact on results of operations, financial position or cash flows, and KeySpan Generation LLC has no outstanding derivative instruments.

In December 2007, the FASB issued SFAS 141R “Business Combinations.” The objective of SFAS 141R is to improve the relevance and comparability of the financial information that a reporting entity provides in its financial reports about a business combination and its effects. This Statement establishes principles and requirements for how the acquirer recognizes and measures the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree; recognizes and measures the goodwill acquired in business combination; and determines what information to disclose. This Statement shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. This Statement has no impact on our current results of operations, cash flows or financial position.

In December 2007, the FASB issued SFAS 160 “Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin 51 “Consolidated Financial Statements.” The objective of SFAS 160 is to improve the relevance, comparability and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. SFAS 160 shall be effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008. We currently do not have any noncontrolling interests in a subsidiary.

In February 2007, Financial Accounting Standards Board (“FASB”) issued SFAS 159 “The Fair Value Option for Financial Assets and Financial Liabilities.” This statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement requires a business entity to report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. An entity may decide whether to elect the fair value option for each eligible item on its election date, subject to certain requirements described

in the statement. This statement shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007. We have not elected the fair value method.

On September 15, 2006, the FASB issued SFAS 157 "Fair Value Measurements." This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value. SFAS 157 expands the disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value, the recurring fair value measurements using significant unobservable inputs and the effect of the measurement on earnings (or changes in net assets) for the period. The guidance in SFAS 157 also applies for derivatives and other financial instruments measured at fair value under Statement 133 "Accounting for Derivative Instruments and Hedging Activities" at initial recognition and in all subsequent periods. This Statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently reviewing the requirements of SFAS 157, and at this point in time cannot determine what impact, if any, SFAS 157 will have on its results of operations or financial position. This Statement will have no impact on cash flow.

In July 2006, the FASB issued Interpretation No. 48 "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes" and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. See Note 2 "Income Tax" for a discussion of FIN 48.

Note 2. Income Tax

KeySpan Generation LLC joins in the filing of a consolidated federal and state income tax return with the Parent. A tax sharing agreement between us and the Parent provides for the allocation of a realized tax liability or benefit based upon separate return contributions by us to the Parent's taxable income or loss in the Parent's income tax returns. At March 31, 2008, we had a \$26.9 million liability due to the Parent. This amount is recorded in Accounts Payable to Associated Companies on the Balance Sheet. Income tax expense is reflected as follows in the Income Statement:

<i>(In Thousands of Dollars)</i>	August 25, 2007- March 31, 2008-	January 1, 2007- August 24, 2007	Year Ended December 31, 2006
Current income tax			
Federal	\$ 6,701	\$ 3,849	\$ 10,440
State and Local	2,489	1,035	8,633
Total Current	\$ 9,190	\$ 4,884	\$ 19,073
Deferred income tax			
Federal	(4,273)	(1,243)	4,624
State and Local	(1,522)	(560)	(4,550)
Total Deferred	(5,795)	(1,803)	74
Total income tax	\$ 3,395	\$ 3,081	\$ 19,147

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered

or settled.

For income tax purposes, we use accelerated depreciation and shorter depreciation lives, as permitted by the Internal Revenue Code. Deferred federal and state taxes are provided for the tax effects of all temporary differences between financial reporting and taxable income. Significant items making up deferred tax assets and liabilities at March 31, 2008 are as follows:

<i>(In Thousands of Dollars)</i>	March 31, 2008	December 31, 2006
Reserves not currently deductible	\$ 402	\$ (4,652)
State Income Taxes	(3,222)	(13,358)
Property-related differences	(22,694)	69,732
Employee Benefits and Compensation	2,324	(10,282)
Property Taxes	(14,959)	(49,844)
Asset Retirement Obligations	2,788	4,972
Prior Period Adjustments	(10,653)	5,401
Other items - net	(6,245)	(1,840)
Net Deferred Tax (Liability) Asset	\$ (52,259)	\$ 129

The following is a reconciliation between reported income tax and tax computed at the statutory rate of 35%:

<i>(In Thousands of Dollars)</i>	August 25, 2007- March 31, 2008	January 1, 2007- August 24, 2007	Year Ended December 31, 2006
<i>Book Income</i>	\$ 11,718	\$ 11,171	\$ 61,800
Computed at the statutory rate	\$ 4,101	\$ 3,910	\$ 21,630
Adjustments related to:			
State income tax, net of benefit	625	308	2,351
AFUDC Equity	(67)	(167)	(184)
Removal costs	(870)	(491)	(2,059)
Medicare Income	(134)	(298)	(401)
Manufacturing Deduction	(290)	(196)	-
Other items - net	30	15	(2,190)
Total income tax	\$ 3,395	\$ 3,081	\$ 19,147
	29%	28%	31%

In July 2006, the Financial Accounting Standards Board (“FASB”) issued Financial Interpretation (“FIN”) 48, “Accounting for Uncertainty in Income Taxes,” which clarifies the accounting for uncertainty in income taxes recognized in the financial statements in accordance with Statement of Financial Accounting Standards (“SFAS”) 109, “Accounting for Income Taxes.” FIN 48 provides that a tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, assuming the taxing authority has full knowledge of all relevant information and that any dispute with a taxing authority is resolved by the court of last resort. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. Recognized tax benefits are measured as the largest amount of tax benefit that is more likely than not to be realized upon settlement with the taxing authority, assuming the taxing authority has full knowledge of all relevant information. This interpretation also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

KeySpan Generation adopted the provisions of FIN 48 on January 1, 2007 and has not recorded any change to the liability for unrecognized tax benefits or retained earnings as a result of the implementation of FIN 48.

The following is a tabular reconciliation of the total amounts of unrecognized tax benefits for the year:

<i>(In Thousands of Dollars)</i>	
Unrecognized Tax Benefit - January 1, 2007	\$ 29,717
Gross increases - tax positions in prior period	-
Gross decreases - tax positions in prior period	-
Gross increases - tax positions in current period	10,002
Gross decreases - tax positions in current period	-
Settlements	-
Lapse of statute of limitations	-
Unrecognized Tax Benefit - March 31, 2008	\$ 39,719

Included in the balance of unrecognized tax benefits at March 31, 2008 are tax positions for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. Because of the impact of deferred income tax accounting, other than for interest and penalties, the disallowance of the shorter deductibility period would not affect the effective income tax rate but would accelerate the payment of cash to the taxing authority to an earlier period. Included in the balance of unrecognized tax benefits at March 31, 2008 are \$.5 million of tax benefits that, if recognized, would affect the effective tax rate.

KeySpan Generation recognizes interest and penalties related to unrecognized tax benefits within the interest expense line and other expense line, respectively, in the accompanying consolidated statement of operations for the periods ended August 24, 2007 and March 31, 2008. Accrued interest and penalties are included within the related liability lines in the consolidated balance sheet as of March 31, 2008. We have accrued interest of \$2.4 million and \$3.0 million during the periods January 1, 2007 through August 24, 2007 and August 25, 2007 through March 31, 2008, respectively, and have accrued no penalties related to the unrecognized tax benefits noted above. In total, KeySpan Generation has recognized a liability for interest of \$7.9 million as of March 31, 2008.

We believe that it is not reasonably possible that the tax liability for unrecognized tax benefits will significantly increase or decrease by March 31, 2009.

KeySpan Generation is subject to taxation in the US and New York. Tax years for 2000 forward are subject to examination by the federal and state tax authorities.

Note 3. Postretirement Benefits

Pension Plans: The employees of KeySpan Generation, as well as other former employees of LILCO, are members of a consolidated defined benefit pension plan, under the Parent. Benefits are based on years of service and compensation. Pension costs are allocated to KeySpan Generation; related pension obligations and assets are commingled and are not allocated to individual sponsors. Pension expense allocated to us was \$3.8 million and \$1.4 million for the period January 1, 2007 through August 24, 2007 and August 25, 2007 through March 31, 2008, respectively. In total Pension expense was \$5.2 million and \$9.5 million as of March 31, 2008 and December 31, 2006, respectively and is included in operating expenses on the Statement of Income.

Other Postretirement Benefits: KeySpan Generation employees and other former employees of LILCO are members of a noncontributory defined benefit plan under which is provided certain health care and life insurance benefits for all former LILCO retired employees. The Parent has been funding a portion of future benefits over employees' active service lives through Voluntary Employee Beneficiary Association ("VEBA") trusts. Contributions to VEBA trusts are tax deductible, subject to limitations contained in the Internal Revenue Code.

Other postretirement costs are allocated to us; related other postretirement obligations and assets are commingled and are not allocated to individual sponsors. Other postretirement expense allocated to us was \$11.3 million and \$7.4 million for the period January 1, 2007 through August 24, 2007 and August 25, 2007 through March 31, 2008, respectively. In total other postretirement expense was \$18.7 million and \$12.4 million as of March 31, 2008 and December 31, 2006, respectively and is included in operations expense on the Statement of Income.

In 1993, LILCO adopted the provisions of SFAS No. 106, "Employer's Accounting for Post-Employment Benefits Other Than Pensions," and reported an accumulated postretirement benefit obligation and corresponding regulatory asset of \$376 million. Upon consummation of the LIPA Transaction, the portion of this regulatory asset associated with LILCO's electric operations of approximately \$285 million became an obligation of LIPA to the Parent. KeySpan Generation's allocated portion of this contractual receivable at March 31, 2008 was \$37.1 million and is recorded in deferred charges. We are recovering, on a monthly basis from LIPA, costs related to postretirement benefits of the electric business unit employees.

Note 4. Long-Term Debt and Advances from Parent

Authority Financing Notes: We can issue tax-exempt bonds through the New York State Energy Research and Development Authority. At March 31, 2008, \$41.1 million of Authority Financing Notes 1999 Series A Pollution Control Revenue Bonds due October 1, 2028 were outstanding. The bonds are currently in the 7-Days auction rate mode and are backed by bond insurance. The recent credit rating agency downgrades of the bond insurers have resulted in some periods of higher than typical interest rates. The interest rate during the fifteen months, January 1, 2007 through March 31, 2008 ranged from 3.00% to 17.75%. The average rate for the 15 month period is 3.77% excluding the 17.75% rate experienced for one week. The effect on interest expense has not been material at this time. At March 31, 2008, the interest rate was 6.85%. Interest expense related to these notes was \$1.0 million and \$1.2 million for the period January 1, 2007 through August 24, 2007 and August 25, 2007 through March 31, 2008, respectively. In total interest expense was \$2.2 million and \$1.4 million as of March 31, 2008 and December 31st, 2006, respectively.

We also have outstanding \$24.9 million variable rate 1997 Series A Electric Facilities Revenue Bonds due December 1, 2027. The interest rate on these bonds is reset weekly and during the fifteen months ranged from 1.23% to 5.60%. At March 31, 2008, the interest rate was 3.60%. Interest expense related to these notes was \$0.6 million and \$0.5 million for the period January 1, 2007 through August 24, 2007 and August 25, 2007 through March 31st, 2008, respectively. In total interest expense was \$1.1 million and \$0.9 million as of March 31, 2008 and December 31, 2006, respectively.

Industrial Development Revenue Bonds: At March 31, 2008, we had outstanding \$128.3 million of 5.25% tax-exempt bonds due June 1, 2027 - \$53.3 million of these Industrial Development Revenue Bonds were issued through the Nassau County Industrial Development Authority for the construction of the Glenwood electric-generation peaking plant and the balance of \$75 million was issued by the Suffolk County Industrial Development Authority for the Port Jefferson electric-generation peaking plant. KeySpan Corporation has fully and unconditionally guaranteed the payment obligations of its subsidiaries with regard to these tax-exempt bonds. The face value of these notes is included in long-term debt on the Consolidated Balance Sheet

Promissory Notes: The Parent has issued promissory notes to LIPA representing an amount equivalent to certain Authority Financing Notes. The Parent then allocated a portion of these notes to us. At March 31, 2008 we had outstanding \$75.3 million of such notes, consisting of \$27.9 million, 5.15% notes due March 1, 2016 and \$47.4 million, 5.30% notes with maturities ranging from November 1, 2023 to August 1, 2025.

All currently outstanding debt matures beyond five years.

Advances from Parent: At March 31, 2007 the 6.15%, \$131.9 million allocated debt due to the Parent remains outstanding.

Fair Value of Financial Instruments: The fair values and carrying amounts of the long-term debt at March 31, 2008 were as follows:

(In Thousands of Dollars)	Carrying Value	Fair Value
Authority Financing Notes	\$ 66,005	\$ 66,005
Promissory Notes	75,300	76,062
	\$ 141,305	\$ 142,067

All other financial instruments on the balance sheet such as accounts receivable and accounts payable are stated at amounts that approximate fair value.

Note 5. Commitments and Contingencies

Fixed Obligations: Substantially all leases are the obligations of the Parent. KeySpan Generation records as intercompany expenses, costs incurred for the use of leased equipment such as buildings, office equipment, vehicles, and powered operated equipment. These intercompany expenses are reflected in operations expense on the Statement of Income. KeySpan Generation owns the land on which our generation facilities are located.

Asset Retirement Obligations:

On December 31, 2005, KeySpan Generation implemented FIN 47 “Accounting for Conditional Asset Retirement Obligations”. FIN 47 was issued to clarify that the term conditional asset obligation used in SFAS 143 “Accounting for Asset Retirement Obligations” refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. Previously, KeySpan Generation adopted SFAS 143 on January 1, 2003. SFAS 143 required us to record a liability and corresponding asset representing the present value of legal obligations associated with the retirement of tangible, long-lived assets that existed at the inception of the obligation.

At March 31, 2008 the following asset retirement obligations were recorded on the Consolidated Balance Sheet in Deferred Credits and Other Liabilities, at their estimated present values:

<i>(In Millions of Dollars)</i>			
March 31, 2008			
Asset Retirement Obligations			
Asbestos removal	(i)	\$	1.5
Tanks removal and cleaning	(ii)		4.7
Waste water treatment pond removal	(iii)		1.5
Total Asset Retirement Obligations		\$	7.7

- (i) Asbestos-containing materials was deemed to exist in roof flashing, floor tiles, pipe insulation and mechanical room insulation within our common facilities as well as in our older generation plants. KeySpan Generation has a legal obligation to remove asbestos upon either a major renovation or demolition.
- (ii) KeySpan Generation has numerous storage tanks that contain among other things waste oil, #2 and #6 fuel oil, diesel fuel, multi chemicals, lube oil, kerosene, ammonia, and other waste contaminants. All of these tanks are subject to cleaning and removal requirements prior to demolition and retirement if so specified by law or regulation.
- (iii) KeySpan Generation has several wastewater treatment ponds associated with certain of its power stations. There are closure requirements for wastewater treatment pond systems based on regulations promulgated by the State of New York which were effective May 11, 2003.

KeySpan Generation asset retirement obligation accretion expense was \$0.2 million and \$0.3 million for the period January 1, 2007 through August 24, 2007 and August 25, 2007 through March 31, 2008, respectively. In total accretion expense was \$0.5 million and \$0.4 million as of March 31, 2008 and December 31, 2006, respectively.

Power Supply Agreement (PSA):

The PSA provides for the sale to LIPA of all of the capacity and, to the extent LIPA requests, energy conversion from the oil and gas-fired generating facilities. (LIPA represents the only customer of capacity and energy.) Capacity refers to the ability to generate energy and, pursuant to New York Power Pool (“NYPP”) requirements, must be maintained at specified levels (including reserves) regardless of the source and amount of energy consumption. By contrast, energy refers to the electricity actually generated for consumption by customers. Such sales of capacity and energy conversion services to LIPA are made under rates approved by the FERC in accordance with the terms of the PSA entered into in 1998. KeySpan filed with the FERC an updated cost of service for the generating plants in October 2003. FERC approved implementation of new rates on October 1, 2004, retroactive back to January 1, 2004.

The PSA provides incentives or penalties for us to maintain the output capability of the generating facilities, as measured by annual industry-standard tests of operating capability, and plant availability and efficiency. These combined incentives and penalties may total as much as \$4.0 million annually. KeySpan Generation LLC earned incentives of \$3.0 million and \$1.0 million for the period January 1, 2007 through August 24, 2007 and August 25, 2007 through March 31, 2008, respectively. In total incentives earned were \$4 million as of March 31, 2008 and December 31, 2006. The PSA provides LIPA with all of the capacity from the generating facilities. However, LIPA has no obligation to purchase energy conversion services from the generating facilities and is able to purchase energy on a least-cost basis from all available sources consistent with existing transmission interconnection limitations of the transmission and distribution (“T&D”) system. We must, therefore, operate our generating facilities in a manner such that we can remain competitive with other producers of energy. To date, we have dispatched to LIPA and LIPA has accepted the level of energy conversion services generated at the agreed to price per megawatt hour. However, no assurances can be given as to the level and price of energy to be dispatched to LIPA in the future. Under the terms of the PSA, LIPA is obligated to pay for capacity at rates that reflect a large percentage of the overall fixed cost of maintaining and operating the generating facilities. A variable maintenance charge is imposed for each unit of energy conversion services actually acquired from the generating facilities. The variable maintenance charge is billed to LIPA on a monthly basis. The billings to LIPA under the PSA include no provision for fuel, as such fuel is owned by LIPA, and LIPA reimburses KeySpan Generation for the cost of all fuel deliveries.

The PSA runs for a term of fifteen years through May 2013, with LIPA having the option to renew the PSA for an additional fifteen-year term.

KeySpan Generation has an inventory of sulfur dioxide (“SO₂”) and nitrogen oxide (“NO_x”) emission allowances that may be sold to third party purchasers. There is no investment associated with these emission allowances. The number available for sale of emission allowances varies from year to year relative to the level of emissions from the generating facilities, which is greatly dependent on the mix of natural gas and fuel oil used for generation and the amount of purchased power that is imported onto Long Island. In accordance with the PSA, 33% of emission allowance sales revenue is retained by KeySpan Generation and the other 67% is credited to LIPA. LIPA also has a right of first refusal on any potential emission allowance sales. Additionally, we are bound by a memorandum of understanding with the New York State Department of Environmental Conservation which prohibits the sale of SO₂ allowances into certain states and requires the purchaser to be bound by the same restriction, which may affect the allowances’ market value.

Emission Credits

We are entitled to emission credits associated with its electric generating facilities on Long Island. These emission credits had a fair value of \$296.2 million on August 24, 2007 and have been recorded in [current assets](#). As agreed to in the PSA Agreement with LIPA, LIPA is entitled to \$251.5 million of this amount; the LIPA portion of the emission credits is reflected in deferred credits and other liabilities.

Generation Purchase Rights Agreement and 2006 Option Agreement.

On February 1, 2006, KeySpan and LIPA entered into an a new Option and Purchase and Sale Agreement (the “2006 Option Agreement”), to replace the Generation Purchase Rights Agreement (as amended, the “GPRA”), pursuant to which LIPA had the option, through December 15, 2005, to effectively acquire substantially all of the electric generating facilities owned by KeySpan on Long Island.

Under an amended GPRA, LIPA had the right to acquire certain of KeySpan’s Long Island-based generating assets formerly owned by LILCO, at fair market value at the time of the exercise of such right. LIPA was initially required to make a determination by May 2005, but KeySpan and LIPA agreed to extend the date by which LIPA was to make this determination to December 15, 2005. As part of the 2006 settlement between KeySpan and LIPA, the parties entered into the 2006 Option Agreement whereby LIPA had the option during the period January 1, 2006 to December 31, 2006 to purchase only the steam generating units at KeySpan’s Far Rockaway and/or E.F. Barrett Generating Stations (and certain related assets) at a price equal to the net book value of each facility. In December 2006, KeySpan and LIPA entered into an amendment to the 2006 Option Agreement whereby the parties agreed to extend the expiration of the option period to the later of (i) December 31, 2007 or (ii) 180 days following the effective date of the 2006 Option Agreement. Pursuant to the National Grid plc, KeySpan and LIPA negotiations, the parties further amended the 2006 Option Agreement to extend the expiration of the option period to May 31, 2008, [which was subsequently extended to December 31, 2008](#). The 2006 Option Agreement, as amended, replaces the GPRA. If LIPA were to exercise the option and purchase one or both of the generation facilities (i) LIPA and KeySpan will enter into an operation and maintenance agreement, pursuant to which KeySpan will continue to operate these facilities, through May 28, 2013, for a fixed management fee plus reimbursement for certain costs; and (ii) the 1998 PSA and 1998 EMA will be amended to reflect that the purchased generating facilities would no longer be covered by those agreements. It is anticipated that the fees received pursuant to the operation and maintenance agreement will offset the reduction in the operation and maintenance expense recovery component of the 1998 PSA and the reduction in fees under the 1998 EMA.

Following the announcement of the acquisition of KeySpan by National Grid plc (the “Merger”), LIPA, National Grid plc and KeySpan engaged in discussions concerning the impact of the transaction on LIPA’s operations. KeySpan, National Grid plc and LIPA reached an agreement pursuant to which LIPA agreed to waive its contractual right to terminate the 1998 LIPA Agreements and the 2006 LIPA Agreements upon consummation of the Merger between KeySpan and National Grid plc, in exchange for enhancements to certain of the 2006 LIPA Agreements and certain other considerations. The amended and enhanced agreements became effective upon the completion of the Merger between KeySpan and National Grid plc and the approval by the New York State Attorney General and the New York State Comptroller.

KeySpan Glenwood and Port Jefferson Centers

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC, our non cost-of-service rate regulated subsidiaries, have entered into 25 year Power Purchase Agreements (“PPAs”) with LIPA. Under the terms of the PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Both plants are designed to produce 79.9 megawatts. Under the PPAs, LIPA pays a monthly capacity fee, which provide for recovery of each plant’s construction costs, as well as an appropriate rate of return on investment. The PPAs also obligate LIPA to pay for each plant’s costs of operation and maintenance. These costs are billed on a monthly estimated basis and are subject to true-up for actual costs incurred.

Legal Matters: From time to time, we are subject to various legal proceedings arising out of the ordinary course of business. We do not consider any of such proceedings to be material to our business or likely to result in a material adverse effect on our results of operations or financial condition.

Environmental Matters

Ordinary business operations subject KeySpan Generation to various federal, state and local laws, rules and regulations dealing with the environment, including air, water, and hazardous waste. Our business operations are regulated by various federal, regional, state and local authorities, including the United States Environmental Protection Agency (the “EPA”), the New York State Department of Environmental Conservation (“DEC”), the New York City Department of Environmental Protection (NYC DEP) and the Nassau and Suffolk County Departments of Health.

Except as set forth below, no material proceedings relating to environmental matters have been commenced or, to our knowledge, are contemplated by any federal, state or local agency against us, and we are not a defendant in any material litigation with respect to any matter relating to the protection of the environment. We believe that KeySpan Generation’s operations are in substantial compliance with environmental laws and that requirements imposed by environmental laws are not likely to have a material adverse impact upon us.

Air. Our generating facilities are located within a Clean Air Act (“CAA”) ozone non-attainment and PM 2.5 (fine particulate matter) non-attainment area, and are subject to increasingly stringent NOx emission limitations to be implemented under forthcoming requirements of the United States Environmental Protection Agency (“EPA”) pursuant to the Clean Air Interstate Rule (“CAIR”) and potentially under the Ozone Transport Commission’s initiative to achieve additional NOx reductions. These efforts are designed to improve both ozone and particulate matter air quality. Our previous investments in low NOx boiler combustion modifications, the use of natural gas firing systems at our steam electric generating stations, and the compliance flexibility available under these cap and trade programs, have enabled KeySpan to achieve our prior emission reductions in a cost-effective manner. We are currently developing a compliance strategy to address these anticipated requirements. We plan to install enhanced NOx controls at certain of our Long Island based electric generating facilities as part of a prior commitment to LIPA. This will be conducted in conjunction with an efficiency improvement project at these facilities; a mechanism for recovery of these investments through fuel savings has been established. The cost of these improvements is estimated to be approximately \$100 million. Additional NOx controls are planned for other Long Island based electric generating facilities at an estimated cost of \$8 million. Such amounts are recoverable from LIPA.

Water. Additional capital expenditures associated with the renewal of the surface water discharge permits for our power plants will likely be required by the Department of Environmental Conservation (“DEC”). We are currently conducting studies as directed by the DEC to determine the impacts of our discharges on aquatic resources and are engaged in discussions with the DEC regarding the nature of capital upgrades or other mitigation measures necessary to reduce any impacts. These upgrades are expected to cost up to \$60 million for the Long Island units, however, such amounts are recoverable from LIPA. The actual expenditures will depend upon the outcome of the ongoing studies and the subsequent determination by the DEC of how to apply the standards set forth in recently promulgated federal regulations under Section 316 of the Clean Water Act designed to mitigate such impacts.

Note 6. Related Party Transactions

KeySpan Generation LLC is engaged in various transactions with KeySpan Corporation and its affiliates. For the most part, the various subsidiaries of KeySpan Corporation do not maintain separate cash balances. Financing for our working capital is obtained through the participation in a money pool. In addition, all cash generated from billings to LIPA is collected and held by the Parent's corporate and administrative subsidiary, KeySpan Corporate Services LLC (“KCS”). Further, all payments to third parties for our payables, including labor, are made by KCS on our behalf. We are also obligated to reimburse the Parent for our allocated share of interest on the promissory notes due LIPA and on the Authority Financing Notes.

*The money pool is funded by commercial paper issuance by KeySpan Corporation and operating funds of KeySpan Corporation affiliates. The various KeySpan Corporation subsidiaries can either borrow from or lend to the money pool. Interest expense is charged to “borrowers”, while “lenders” earn interest income. At March 31, 2008, we had an outstanding money pool receivable balance of **\$188.2** million. Interest rates associated with the money pool are generally the same as KeySpan’s short-term borrowing rate, plus a proportional share of the administrative costs incurred in obtaining the required funds.*

*KeySpan Corporation and its affiliates also provide us with various services, including executive and administrative, customer services, financial (including accounting, auditing, risk management, tax, treasury/finance), human resources, information technology, legal, and strategic planning. The costs of these services are charged to us via inter-company billings and generally settled through the money pool on a monthly basis. At March 31, 2008, we had a **\$43.1** million liability for these amounts. In addition, we had a **\$39.1** million liability to KeySpan Corporation for allocated pension and other postretirement benefit costs, as well as a **\$26.9** million liability for taxes paid on our behalf by the Parent.*

Note 7. Acquisition of KeySpan

On August 24, 2007 National Grid plc purchased all the outstanding stocks of Keyspan Corporation for \$42.00 per share in cash. The transaction has been accounted for using the purchase method of accounting for business combination in accordance with SFAS 141 “Business Combination”. As a result of the acquisition, Keyspan ceased to be public traded. The purchase price of \$7.6 billion is in the process of being allocated to KeySpan’s net assets based upon their fair value. The historical cost basis of KeySpan Generation assets and liabilities were determined to represent fair value due to the existence of regulatory-approved LIPA agreed to rate plans based upon the recovery of historic costs and a fair

return thereon. However land owned by KeySpan Generation was fair valued under the guidance of SFAS 141. As a result we increased the historical cost of the land by \$95.8 million at March 31, 2008. Additionally, upon the merger, we recorded the fair value of certain emission credits. See Note 5 for the fair valuation of emission credits.

As allowed for under SFAS 141, the fair value measurement of assets, liabilities and intangible assets, and the resulting impact on goodwill, can be adjusted during the allocation period.

Workforce Reduction Program

In connection with the acquisition of KeySpan, National Grid plc and KeySpan offered 673 non-union employees a voluntary early retirement offer (“VERO”) in an effort to reduce the workforce. Eligible employees must have been working in a targeted area as of April 13, 2007 and be at least 52 years of age with seven or more years of service as of September 30, 2007. For eligible employees who have elected to accept the VERO offer, National Grid plc and KeySpan have the right to retain that employee for up to three years before VERO payments are made. An employee who accepts the VERO offer but elects to terminate employment with National Grid plc or KeySpan prior to the three year period, without consent of National Grid plc or KeySpan, forfeits all rights to VERO payments. The cost of VERO offer to KeySpan Generation is estimated to be approximately \$8 million. This amount will be expensed over a three year period or over the remaining service period whichever is shorter. To date KeySpan Generation has expensed approximately \$2.7 million of VERO costs.

Note 8. Application of SFAS 101 “Regulated Enterprises - Accounting for the Discontinuation of Application of FASB Statement No. 71” for the LIPA Service Agreements.

As noted in Note 5 “Commitments and Contingencies”, under “Generation Purchase Rights Agreement and 2006 Option Agreement”, on May 28, 1998, KeySpan and LIPA entered into three major long-term service agreements. Negotiations between KeySpan and LIPA to amend certain aspects of these agreements were substantially concluded in 2006 and while KeySpan and LIPA performed in accordance with certain elements of these restated agreements beginning January 1, 2006, additional changes to these contract terms and the approvals needed to create binding agreements were not obtained until 2007. The changes in these service agreements impacted KeySpan’s accounting for certain transactions conducted between KeySpan and LIPA.

Under both the original and amended and restated service agreements, KeySpan is responsible for the management of employee benefit plans associated with employees providing service to LIPA and LIPA is responsible for the cost of funding and maintaining those plans. From May 28, 1998 through December 31, 2006, KeySpan followed SFAS 71, “Accounting for the Effects of Certain Types of Regulation”, in accounting for the agreements with LIPA and capitalized as a receivable the difference between the accrued liability associated with these plans and the funding based upon the recoveries agreed to in the rate plans with LIPA.

Certain events occurred over the course of 2006 and 2007 that constituted a change in facts and circumstances that made the continued application of SFAS 71 no longer appropriate and therefore KeySpan implemented Statement of Financial Accounting Standard 101 “Regulated Enterprises -

Accounting for the Discontinuation of Application of FASB Statement No. 71” (“SFAS 101”) effective January 1, 2007. Specifically, management’s determination to apply SFAS 101, was based upon its analyses of the continued applicability of paragraph 5 of SFAS 71, as well as its assessment of the increasing competitive environment in relation to renewal of the service agreements with LIPA.

Paragraph 5 of SFAS 71, requires that regulated rates be set to recover the enterprise's specific costs of providing the regulated services or products. However, in two material respects these amended and restated agreements did not maintain the direct link between the cost of providing LIPA with the agreed to services and the revenues recovered in providing those services. First, these amended and restated agreements contained a revised revenue formula that introduced a departure from cost of service recovery that had been in place since 1998. Second, although, KeySpan’s rights to be reimbursed for employee benefit plan costs in the future have been completely preserved in the amended and restated service agreements, these rights of recovery are not fully reflected in the revised service agreements’ current rates. Management has therefore concluded that the cause-and-effect relationship between costs and revenues no longer exists for its service agreements with LIPA.

Moreover, recent actions taken and comments made by New York State officials indicate renewal of the service agreements with LIPA will be based on competitive tendering using New York State procurement practices and standards as opposed to the practice to date where the utility franchise had effectively been awarded to KeySpan.

Based on facts and circumstances detailed above, management has concluded that the amended and restated service agreements no longer meet all of the relevant SFAS 71 criteria. As a result, KeySpan Generation implemented SFAS 101 effective January 1, 2007, the beginning of the period in which the changes that give rise to the need for the discontinuance of SFAS 101 became probable. Implementation of SFAS 101 resulted in KeySpan Generation’s de-recognition of a \$49.5 million receivable with LIPA, of which \$25.5 million (after tax) was recorded as an extraordinary charge for the period January 1, 2007 through August 24, 2007. The remaining amount was initially recorded through accumulated other comprehensive income and then ultimately charged to goodwill, net of tax, as a result of purchase accounting adjustments.