N.H.P.U.C.
F-8G Monthly Inc

State of New Hampshire
Public Utilities Commission
Concord

Monthly Income Statement
of EnergyNorth Natural Gas, Inc. for Month Ended July 2006

	Acct. No.		This Month	Cumulative This Year	Same Month Last Year	Cumulative Last Year
1	1501	Operating Revenues (See Reverse)	4,758,943	107,270,830	4,345,692	100,132,961
				-		
2	1502	Operating and Maintenance-Gas	3,915,674	92,488,899	3,725,627	82,870,161
3	1503	Depreciation-Gas	667,617	4,687,595	578,237	4,233,988
4	1504	Amortization-Gas	51,296	354,254	45,527	318,610
	NEW 1504	Amortization - Goodwill	-	-	-	-
5	1507	Taxes-Gas	366,656	5,095,537	365,370	6,184,755
6		Total Revenue Deductions	5,001,243	102,626,287	4,714,761	93,607,514
7	1508.1	Rent for Lease of Gas Plant	-	-	-	-
8	1508.2	Rent from Lease of Gas Plant	-	-	-	-
9	1508.3	Joint Facility Rents	-	-	-	-
10	1508.4	Rent from Gas Appliances	-	-	-	-
11	1508.5	Miscellaneous Rents	-	-	-	-
12	1508	Net Operating Rents	-	-	-	-
13		Net Gas Operating Income	(242,301)	4,644,537	(369,069)	6,525,447
15		Net Utility Operating Income	(242,301)	4,644,537	(369,069)	6,525,447
16		Other Income	28,146	195,847	-	65,177
17		Income Deductions	320,769	1,598,357	304,234	1,887,430
18		Net Income (Loss) Cont Oper	(534,924)	3,242,027	(673,303)	4,703,194
19		Earnings Available for Common Stock	(534,924)	3,242,027	(673,303)	4,703,194
		Gas Generating Report (Send Out) (Therms)				
20		Gas Generated-LNG	24,180	168,050	24,140	1,571,810
21		Gas Generated-Propane	750	881,460	-	646,290
22		Total Gas Generated	24,930	1,049,510	24,140	2,218,100
23		Total Gas Purchased	4,861,760	85,319,650	4,612,220	92,010,150
24		Total Generated and Purchased	4,886,690	86,369,160	4,636,360	94,228,250

EnergyNorth Natural Gas, Inc. — Month Ended June, 2007

	Acct. No.		Average No. Customers This Month	Average No. Customers Same Mo. Last Year	This Month	Cumulative This Year	Same Month Last Year	Cumulative Last Year
		Revenue Earned						
1	1600	Residential Sales	73,412	68,035	3,223,122	65,016,779	3,526,130	60,092,420
2	1602	Commercial & Industrial Sales	9,876	14,473	3,058,905	56,980,713	3,297,582	53,509,690
3		Unbilled Revenue	-	-	(1,105,753)	(9,337,641)	(957,020)	(14,648,293)
4		Emergency Sales	-	-	-	-	-	-
5	1608	Seasonal Sales	-	-	-	-	-	-
6		Interruptible	1	3	3,611	7,960	1,573	1,573
7		280 Day Service	1	3	29,012	39,406	14,804	33,607
8		Customer Charges Retained-Gas	-	-	-	-		-
9		FGSS and AAGS Revenue	-	-	-	-	-	-
10		Total Gas Revenue	83,290	82,514	5,208,897	112,707,217	5,883,069	98,988,997
11	1609	Customer Forfeited Disc & Penalty	-	-	101,389	709,826	86,793	706,415
12	1610	Miscellaneous Gas Revenue	-	-	22,420	132,940	26,880	135,000
13		Transportation Revenue	666	487	555,151	4,642,846	286,283	2,681,475
14		Total Revenue	83,956	83,001	5,887,857	118,192,829	6,283,025	102,511,887
		Gas Sold (Gas Sales Report)	(Therms)					
15	1600	Residential Sales			1,903,982	41,811,440	2,259,322	39,106,005
16	1602	Commercial & Industrial Sale			1,724,609	37,719,603	2,036,661	35,810,023
17		Emergency Sales				-	-	-
18	1608	Seasonal				-	-	-
19	1608	Interruptible			4,299	19,153	1,820	1,820
20		280 Day Service			27,968	36,918	16,203	35,623
		FGSS and AAGS				-	-	-
21		Total Gas Sold			3,660,858	79,587,114	4,314,006	74,953,471
22		Gas Used by Utility			11,155	203,752	6,337	132,189
23		Total Gas Used			3,672,013	79,790,866	4,320,343	75,085,660
24		Gas Generated and Purchased			5,086,520	92,881,660	5,532,080	81,482,470
25		Gas Unaccounted For			(836,173)	(4,943,810)	(1,151,763)	(9,176,513)
26		Transportation			2,250,680	18,034,604	2,363,500	15,573,323
27		Calendar Degree Days			82	4,490	67	4,031

Date: ______________________

Approved by: ______________________

Bill Donoghue
Senior Accountant - Keyspan New England

your concerns commitment

Trust

Strategy

Stability

Accountability

Responsibility

Vision

KEYSPAN

2002
Annual Report

A member of the S&P 500, KeySpan (www.keyspanenergy.com) is the largest distributor of natural gas in the Northeast with 2.5 million gas customers. KeySpan is also the largest investor-owned electric generator in New York State and operates Long Island's electric system serving 1.1 million customers. KeySpan is traded on the New York Stock Exchange under the symbol "KSE." With headquarters in Brooklyn, Boston and Long Island, KeySpan also manages a dynamic portfolio of service companies.

Major Brands

KEYSPAN Energy Delivery

KeySpan Energy Delivery New York is a regulated utility that sells and delivers natural gas to home and business customers in the New York City boroughs of Brooklyn, Queens and Staten Island.

KeySpan Energy Delivery Long Island is a regulated utility that sells and delivers natural gas to home and business customers in the Long Island counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County.

KeySpan Energy Delivery New England is comprised of four regulated gas utilities that sell and deliver natural gas to home and business customers in portions of New England.

KEYSPAN Home Energy Services

KeySpan Home Energy Services provides a full range of energy products and services for customers' homes including heating, air conditioning and water heating equipment installation, service and repair as well as heating and air conditioning service plans.

KEYSPAN Business Solutions

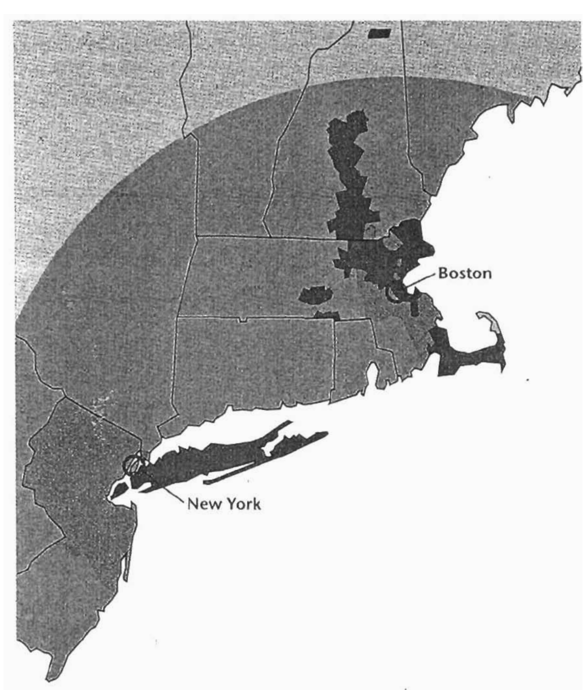
KeySpan Business Solutions provides a full range of energy products and services to business customers from the installation of heating, air conditioning and water heating systems for all businesses, to practical energy management solutions for large-scale commercial, industrial and institutional facilities.

Communications

KeySpan Communications owns and operates a high-speed fiber optic telecommunications network on Long Island and in New York City. The company has cooperative arrangements that extend the network throughout the New York City market, and has fiber access to Europe through cable landing sites on Long Island.

KeySpan Energy Development Corporation is responsible for the development of KeySpan's energy-related projects, both domestically and internationally. It's primary areas of interest include gas-fired power generation, natural gas pipelines, gas processing, storage and distribution.

Areas of Operation



- KeySpan Energy Delivery
- KeySpan Business Solutions
- KeySpan Home Energy Services
- Served By All Companies

Contents

1 Chairman's Letter to Shareholders
5 Review of Operations
16 Business Segment Highlights
17 Financial Review and Analysis

your trust top priority

Ensuring that shareholders, customers and employees trust and respect our leadership is an overriding priority and has been part of our culture for as long as I can remember. We strive to maintain the support of those we serve by having a sound business strategy, the resources and skills to meet their expectations, and by understanding and effectively managing our assets and all forms of business risk.

Robert B. Catell,
Chairman and
Chief Executive Officer

To Our Shareholders:

2002 proved to be a difficult year for American business. Growing geo-political tension and economic uncertainty contributed to nationwide uneasiness. Questionable business practices and ethical lapses on the part of a few in the private sector left many investors leery of management's accountability.

Viewed objectively, the events of 2002 forced both the public and private sectors to face the reality that rapid growth does not come that easily and cannot be achieved by risking corporate integrity. At KeySpan, we understand how important it is for our shareholders, our employees and our customers to be able to trust in our leadership. We place a premium on honesty and accountability, and strive every day to support these values at all levels throughout the organization. We also understand that we are ultimately responsible for developing and implementing a business strategy that delivers shareholder value. In 2002, the benefits of a sound, long-term strategy and a true understanding of the sectors in which we do business are what stood our investors in good stead.

At KeySpan, we understand how important it is for our shareholders, our employees and our customers to be able to trust in our leadership.

Our strength has always been in our core businesses – gas distribution, electric generation, transmission and distribution, and energy asset management and supply. Our strategy is based on growing these franchises, re-engineering our business practices and reducing expenses to maximize return, and enhancing our use of information-based management tools to accelerate earnings growth.

That strategy helped us make good on our promises in 2002, delivering record consolidated earnings of $2.77 per share, and core earnings — which exclude earnings from our oil and gas exploration and production subsidiaries — of $2.43 per share, also a record. Earnings from continuing operations increased approximately 13 percent in 2002 as compared to 2001 (excluding special items) driven largely by strong fourth quarter results reported by each of the Company's business units. And we continued our commitment to paying a stable dividend of $1.78 per share, which yields more than five percent at today's share price.

Over the last year, we demonstrated our customer-focused strategy for growth. The solid performance of our gas business and an aggressive approach to natural gas heat conversions were significant contributors to the year's success. We completed more than 57,000 gas installations and added approximately $64 million in new gross profit margin, for an annual total net profit margin of $1.5 billion. This would not have occurred without our strong focus on reliability and high service standards.

Financial results were further enhanced by an excellent performance from our electric business, which increased earnings before interest and taxes by $26.1 million over 2001 results. We also achieved profitability in the fourth quarter in our energy services business and benefited from the recent increase in gas commodity prices realized by the Company's gas exploration and production operations. In addition, KeySpan continued to benefit from lower interest costs and the elimination of the amortization of goodwill expense.

Relative to our peers, KeySpan's stock price performed well last year. In 2002, the S&P 500 and S&P Utility Indices were down 23 percent and 32 percent respectively, while KeySpan stock appreciated 1.7 percent.

For 2003, we will continue our focus on the Northeast, a region with customer demographics that provide for solid growth. But while we will aggressively pursue growth opportunities, our resources will once again be directed toward quality growth, not unrealistic financial targets. We expect to grow our core business by six percent in 2003 and deliver more than $1 billion in cash flow from operations, an improvement of $100 million over 2002.

Opportunities for natural gas expansion in the Northeast remain attractive, with saturation levels in our prime Long Island and New England markets at just 35 and 50 percent, respectively. Those levels offer the potential for achieving $900 million in additional gross profit margin over the longer term. For 2003, we anticipate adding $61 million in gross profit margin while we reduce capital expenditures by $35 million. This will further

demonstrate our focus on growth and our commitment to use capital efficiently.

The demand for natural gas is increasing in the Northeast and supply is expected to tighten, providing opportunities for pipeline and storage investments. Taking advantage of one such opportunity, in December 2002, KeySpan Energy Development Corporation acquired Algonquin LNG, a 600,000 barrel liquefied natural gas storage and receiving facility in Providence, Rhode Island, from Duke Energy. The purchase complements KeySpan's existing gas distribution business, playing a critical role in meeting peak-day gas supply needs in New England.

We have seen electric markets become more unstable over the last year, however KeySpan's generation investments remain particularly well positioned with long-term contracts and marketing in critical load pockets. Unlike many regions of the country, the New York City and Long Island electric markets are not suffering from a surplus of electric power, but rather continue to face increased demand with limited ability to import power. KeySpan's expertise in building, operating and maintaining generation facilities in urban and suburban markets puts our Company in a unique position for electric generation expansion.

Everything that is going on in the market today reinforces KeySpan's focus on our core competencies and will continue to shape the execution of our strategic blueprint.

Everything that is going on in the market today reinforces KeySpan's focus on our core competencies and will continue to shape the execution of our strategic blueprint. Along with re-engineering our business processes and reducing expenses, we have been actively positioning our Company for future growth. In May 2002, we issued $460 million in MEDS, a debt security that will effectively convert to equity in 2005, and in January 2003, we took a further proactive step to strengthen our balance sheet and improve our financial ratios by issuing 13.9 million shares of common stock, which generated net proceeds to the Company of $473 million. These two issuances had the combined effect of reducing our debt to capitalization ratio, as measured by credit rating agencies, by more than eight percent. In the coming year, as we continue to work at growing our core businesses, we will continue as well to explore opportunities to divest or monetize non-core assets that do not fit within our strategic focus. In February 2003, we reduced our ownership in The Houston Exploration Company from 66 percent to approximately 56 percent through Houston Exploration's stock repurchase of three million shares. The proceeds from the transaction will be used to pay down debt and further strengthen our balance sheet.

We also place a great deal of emphasis on managing risk for our shareholders, maintaining predictable revenues and a stable earnings stream. In fact, more than 80 percent of 2002 earnings before interest and taxes came from regulated or contractual businesses. In the last year, we have also standardized risk management practices across the entire KeySpan organization, establishing an enterprise-wide risk management framework as a top strategic initiative. This framework will continue to enable us to enhance shareholder value by achieving the optimal balance of risk and return. Finally, in order to better align our corporate structure with our strategy, we recently established two distinct business groups, one of which focuses on maximizing the customer relationship and the other on optimizing the assets of the corporation.

While it is traditional to thank the board of directors, KeySpan's management team and all our employees in these letters, I have always truly valued the opportunity to publicly show my appreciation for these critical players in our Company. They are the means by which any of our strategy gets accomplished. I would also like to thank you, our loyal shareholders, who kept your trust in KeySpan despite the market turmoil of the last year.

At KeySpan, we understand what it takes to deliver on our promises. With a commitment to responsibility and accountability, and a strategy that is solid yet can accommodate change, we are confident that we can deliver again in the coming year.

Robert B. Catell

Robert B. Catell
Chairman and Chief Executive Officer
March 12, 2003

strategy
clear, focused plan

KeySpan's strategy is consistent, viable and focused with a strong commitment to grow our core gas and electric generation businesses. Our portfolio of strategic businesses are in markets that we know better than anyone and we have confidence in our ability to deliver strong and reliable financial results for our shareholders.

Rudolph Wynter,
Director, Strategic Planning

REVIEW OF OPERATIONS

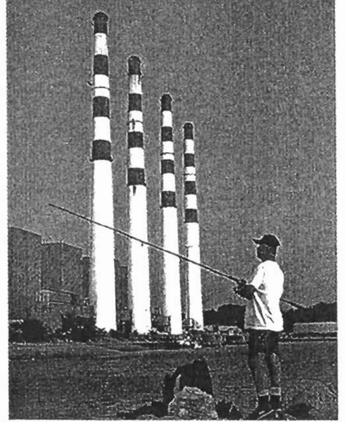
In a turbulent year for our industry, KeySpan delivered a solid performance with record earnings by following one of the most basic principles of good business — stick with what you know. That simple philosophy has been the foundation of KeySpan's success over the years, and 2002 was no exception. By focusing on our strengths, seeking realistic opportunities for growth, identifying creative business solutions and, above all, delivering on our promises, we were able to once again outperform our peers and provide clear shareholder value.

Effective Strategic Execution

The solid financial results delivered in 2002 are a reflection of our ability to effectively execute our strategy and grow the core businesses in which we have demonstrated our expertise. KeySpan's strategy remains consistent, viable and focused, but flexible enough to allow for refinements to respond to changing market conditions. Supporting our strategy is a commitment to maintain a strong financial profile and manage risk.

In 2002, we took a number of steps to further strengthen our balance sheet. Using the proceeds from a securities issuance and the sale of non-core assets such as Midland Enterprises and the gas portion of our THX Joint Venture, we were able to decrease our debt to capital ratio to less than 65 percent by year-end. An equity issuance in January 2003 allowed us to further reduce that ratio to less than 60 percent, which will reinforce our commitment to maintaining a solid "A" credit rating.

KeySpan's core gas distribution and electric generation, transmission and distribution businesses provide a solid foundation for growth.



Recognizing that a critical part of delivering shareholder value is limiting risk to the corporation, KeySpan focused even more closely on risk management in 2002, as investors, credit rating agencies and regulators responded to the financial market upheaval by demanding increased transparency in reporting and management of risk.

KeySpan has always maintained a low-risk profile, with predictable revenues and a stable earnings stream. More than 80 percent of our earnings come from regulated or contractual businesses and we work hard to foster strong, ongoing relationships with the customers to whom we sell our products and services.

Focusing on the Core

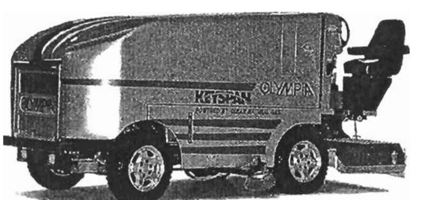
KeySpan's success in 2002 continued to be built on the strong foundation of our core regulated businesses, both gas and electric. As the largest gas distribution company in the Northeast and the largest investor-owned electric generator in New York State, achieving our growth target is dependent on increasing the size of our gas business, capitalizing on new generation opportunities, and maximizing the efficiency of existing assets.

Over the last five years, KeySpan has worked hard to grow our gas business by understanding the market we are in and the customers — and potential customers — we serve. Our regulated gas

business is uniquely positioned, possessing both the size and scale necessary for sustained growth, with more than 2.5 million gas customers over 4,300 square miles of service territory and more than a million remaining heating customer prospects. In 2002, we completed more than 57,000 gas installations and added approximately $64 million in new gross profit margin, for an annual total net profit margin of $1.5 billion. With results like these, we believe we are the fastest growing gas company in the nation.

Our Northeast market continues to present a huge potential for increased natural gas use. In our prime Long Island and New England markets, residential heating saturation levels are at just 35 percent and 50 percent, respectively, offering an outstanding opportunity. Even our more mature New York City market offers a significant opportunity for expansion. Considering that these market opportunities exist in areas with some of the highest median incomes in the nation, the prospect for additional gas sales is even more promising.

Our strategy for increasing our customer base is straightforward — add new gas customers through innovative marketing initiatives and attractive financing programs, and sell additional natural gas end uses to existing customers. By deepening the customer relationship and identifying product and service offerings that enhance customers' quality of life, we develop long-term revenue contribution.



Innovative end-uses, like this natural gas powered ice resurfacer, provide new opportunities for growth.

While targeting increased sales to existing customers, KeySpan is also expanding our distribution system, adding five million feet of gas mains over the last five years.

The "Science" of Marketing

To maximize the return to KeySpan and our shareholders in 2002, we combined the talent of our marketing team with the "science" of information technology. Our strategic marketing experts, working with our information technology group, developed a sales optimization model — an analytical tool that integrates sales, customer, and operational information in all markets and geographic areas. The model identifies strategic levers of profitable growth such as gross profit margin potential, capital expenditures, and operating and maintenance costs for existing and potential customers. Zip codes are analyzed by income, projected growth, pipe density and age of home. For KeySpan, the model identifies the customer opportunities that provide the best return on investment.

We also placed great emphasis on developing partnerships to promote gas sales in the commercial and residential markets. By working with plumbers, contractors, developers, manufacturers, homeowners associations and others, we were able to expand our promotional reach and increase incentive opportunities for customers.

Managing Supply

KeySpan has also taken a lead in ensuring that the natural gas we need to continue to grow will be available in the coming years. The increase in demand for natural gas in the Northeast will require new pipelines for strategic expansion. We continue to be involved in pipeline projects that will bring natural gas from newly developed areas like Nova Scotia. The Islander East pipeline project, which will bring natural gas from off-shore Nova Scotia to New York via a pipeline through Connecticut, continues to move forward with approval of the project secured from the

stability is part of our history

With the increased challenges of today's environment and KeySpan's considerable growth over the past few years, a disciplined, enterprise-wide risk management framework has been a top strategic initiative for KeySpan. We believe maintaining our low-risk profile and linking risk-taking activities with effective execution of our corporate strategy is what delivers shareholder value in the changing energy industry environment.

Cassandra Schultz,
Vice President and Chief Risk Officer

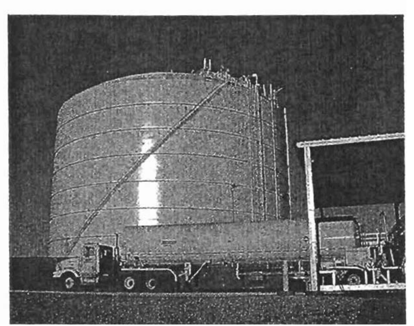
accountability on us

Working from facts, facing issues head-on and focusing on the right way to do business — that's what KeySpan is all about. Our Company's core values of honesty and integrity, along with open communication, underscore all of our internal and external business transactions. We set aggressive standards — and then work hard to exceed them.

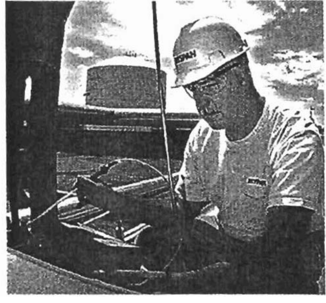
Kamal Dua,
Vice President,
Internal Audit

Federal Energy Regulatory Commission (FERC). We will continue to work with the state of Connecticut to obtain the required local permits to complete this project. Once completed, Islander East will bring an abundant new supply of natural gas not previously available to our region.

To strengthen supply in our Massachusetts market, KeySpan announced in December our acquisition of Algonquin LNG, LP, the owner and operator of a 600,000 barrel liquefied natural gas (LNG) storage and receiving facility in Providence, Rhode Island. The Providence facility plays a critical role in meeting peak-day gas supply needs in the Northeast since LNG is a key component to supply mix in the Northeast. The purchase of Algonquin LNG complements KeySpan's existing gas-distribution business and will make a solid contribution to earnings.



With natural gas supplies tightening, KeySpan's Algonquin and Greenpoint liquefied natural gas (LNG) facilities play a critical role in meeting peak-day demand.



Generating Electric Results

Strong energy sales, the stable performance of our long-term electric service contracts with the Long Island Power Authority (LIPA) and newly installed generation on Long Island all contributed to an outstanding year on the electric side of our business. Earnings before interest and taxes in 2002 increased nearly 10 percent, or $26.1 million, over 2001 results.

KeySpan's Electric Services encompasses two distinct businesses — electric generation and electric transmission and distribution (T&D) management operations. Both sides of the business were put to the test in 2002, as hot weather caused electric demand to soar. With more consecutive 90-plus degree days than seen in recent years and record peak demand, our generation and T&D personnel worked around the clock to keep the lights on and the air conditioners humming.

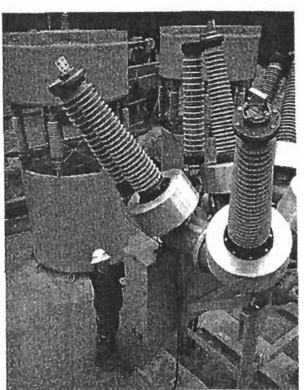
KeySpan's generating facilities provide approximately 6,400 megawatts of electric capacity to the Long Island and New York City regions, but the lesson we learned from summer 2002 is clear — electric demand continues to grow. Fortunately, KeySpan's capacity is growing along with it. Working in partnership with LIPA, we assisted in the installation of 400 additional megawatts of electric generation from 10 new gas turbines, including 160 megawatts from four turbines at KeySpan's new energy centers at Glenwood Landing and Port Jefferson. We also provided installation services for an additional 220 megawatts from 10 truck-mounted generators leased by LIPA at the beginning of the summer as a "last resort" alternative power source. Our existing facilities once again delivered top performances with the Long Island units operating at 98.3 percent availability during the critical summer months and at a higher efficiency than ever before.

In New York City, our Ravenswood generating station's steam units produced 5,021 gigawatt hours of electricity, the largest amount in ten years, helping us to meet metropolitan area customers' record demand. We are currently expanding the Ravenswood facility by 250 megawatts, which will increase its generating capacity by 10 percent. We expect the new unit to be operational by the end of 2003.

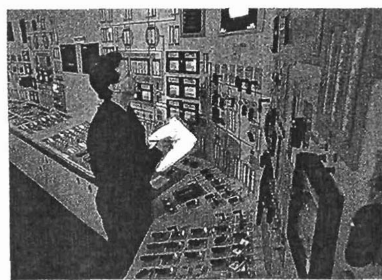
KeySpan is committed to generating electricity in the most environmentally sensitive way possible. Our investments in technology to facilitate greater natural gas use in our power plants have resulted in

a 15 percent reduction in CO_2 emissions over the last decade, while the electric generation industry as a whole increased CO_2 emissions by 26 percent. The new highly efficient combined cycle unit at Ravenswood will further reduce emission rates.

In addition, we continue to move forward with our proposed Spagnoli Road Energy Center in Melville, Long Island. In February, 2003, the New York State administrative law judges recommended that the State's Siting Board of Electric Generation and the Environment allow the construction of the plant. New York State's Department of Environmental Conservation (DEC) subsequently granted permission for the issuance of the appropriate air and water permits necessary for construction. Pending approval by the full Siting Board, and an agreement with LIPA, the new plant could be operational by 2005.



Electric demand hit all-time highs in 2002 both during the summer and as the winter season began. KeySpan's generating units were up to the task, operating at peak efficiency.



Meeting Electric Demand

Both as manager of LIPA's T&D system and owner and operator of Long Island's generation facilities, KeySpan undertook an unprecedented preparation program in order to be prepared for the anticipated demand in the summer of 2002. In order to make sure that the T&D system could manage the extra load, KeySpan workers replaced, reinforced and upgraded cables, transformers, wires, feeders, circuits and substations throughout the system. In May 2002, we completed one of the largest projects we had ever undertaken — replacing six and a half miles of Y-50, one of the major tie-lines that brings electricity to Long Island. At 20 miles long and 650 megawatts of capacity, Y-50 is one of Long Island's biggest and heaviest high voltage interconnections. We also engineered and completed 22 major transmission projects — three times the usual number — and 30 substations projects — twice the usual number — to upgrade the system so it could accommodate the load growth.

KeySpan has been repeatedly recognized for managing one of the most reliable T&D systems in New York State, as well as for delivering the fastest restoration time of any New York State overhead utility. In 2002, KeySpan's response to more than 20 significant storms was once again best in class.

Providing Energy Solutions

Operational efficiencies, aggressive marketing and effective positioning were the drivers of a successful year for KeySpan Services. With two major subsidiary units — KeySpan Business Solutions and KeySpan Home Energy Services — KeySpan Services focuses on providing energy solutions to the industrial, commercial, institutional and residential markets. Strategic planning and execution delivered profitability to KeySpan Business Solutions in 2002 and grew KeySpan Home Energy Services to anticipated profitability in 2003.

KeySpan Business Solutions (KBS), offering energy services to large commercial, industrial and institutional customers, delivered outstanding results at year's end by taking a page from the corporation's strategy — focusing on what it does best. By implementing a strategic realignment of operations into three regional hubs in New York, New Jersey and New England, enhancing financial controls and instituting operational refinements, KBS capitalized on its expertise in engineering, design, mechanical contracting, facilities

responsibility
our minds everyday

Caring about the places that we do business has long been part of the very fabric of KeySpan. We believe our community relationships are as essential to our growth and success as the "nuts and bolts" of our business. From environmental stewardship to economic development to supporting charitable organizations and causes, KeySpan is a true partner with the people we serve.

Pamela Adamo,
Vice President,
Community Development

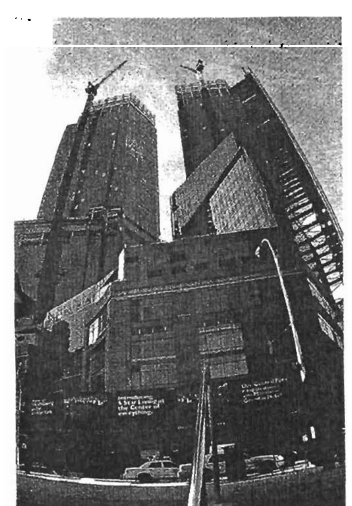
business vision on target

While the focus of regulatory agendas and public enthusiasm can shift from day to day, KeySpan remains focused on growing its core businesses. And its Northeast market presents unique opportunities with low market penetration levels, excellent customer demographics, and an increased understanding of the importance of clean, domestic fuel sources. Today, more than ever, we are achieving our vision of becoming the premier energy services company in the Northeast.

Taylor Caswell,
Director, Government Relations

management, and energy and environmental consulting.

Being able to "package" these services gives KBS a competitive advantage over other traditional energy services companies. Since KBS grew through acquisition of companies that had established reputations in a wide variety of services, we have also been able to build on their solid footings in the communities they originally served. In turn, the KBS operating companies are able to capitalize on the KeySpan brand and its reputation for quality service and financial strength. The combination is a powerful one. With big business names like Merck, Anheuser Busch, The Mills Corporation, Turner Construction and MGM/Mirage among the 2,000 customers it serves, KBS' targets include many Fortune 500 companies in select industries. Successful bids in 2002 include a $30 million contract for the $1.7 billion new AOL-Time Warner building in New York City and mechanical contracting services for the new Goldman Sachs office tower project in New Jersey, the tallest office building under construction in the United States. KBS also provided crucial energy consulting services to the effort to create a world-class oceanarium in New Bedford, Massachusetts. Once financing for this $120 million project is secured, KBS will be well-positioned to provide design and building services for its cogeneration, HVAC, plumbing and fire protection systems, as well as installing a fuel cell.



KeySpan Business Solutions' expertise in packaging energy services for the commercial market has landed impressive projects like the new AOL-Time Warner building (above) and the Goldman Sachs office tower (below).

Understanding Our Customers

In the residential and small commercial market, KeySpan Home Energy Services (KHES) has been growing steadily by focusing on providing services that anticipate customer needs, while enhancing the value of the customer to the overall corporation. In 2002, KHES implemented operational refinements to improve the efficiency of the business. During the year, we shifted the focus away from low-profit commodity sales (including exiting the electric retail market on Long Island), reduced overhead costs by consolidating call center facilities, and exited the Westchester market.

Since KHES grew out of the separation of appliance services from the utility function, its foundation was built on KeySpan's commitment to quality customer service. That continues to be its primary growth driver. From its start five years ago as a heating service contract business, KHES has grown into a full service HVAC business with anticipated revenues of $130 million for 2003. Service contracts still represent 30 percent of total revenue and, in 2002, KHES added 30,000 new service contracts for a total of approximately 200,000 contracts. But the larger focus for the company today is on the installation of residential and light commercial heating and cooling equipment, which comprises 70 percent of the revenue stream. KHES is a critical part of KeySpan's overall strategy to offer multiple energy products and services to enhance customer satisfaction while increasing the value of each customer to he corporation and its shareholders.

Preserving Our Communities

At KeySpan, we have always believed that delivering shareholder value goes beyond the "business" of business. No corporation operates in a vacuum and a firm connection to the communities that we serve has always been a fundamental value for our Company. Understanding what is important to our customers in their daily lives means more than just providing quality energy services, it means giving something back to the neighborhoods in which we operate.

In 2002, much of our community focus was on environmental issues — a natural connection for an energy company. We work hard to deliver energy responsibly and in an environmentally sensitive manner and we welcome the opportunity to support innovative ideas that broaden environmental awareness. Working with local and national organizations, KeySpan and the KeySpan Foundation continued to support a variety of programs from environmental education to beach clean-ups, and from energy conservation to preserving urban parks.

In November 2002, KeySpan was able to make an unprecedented contribution to environmental preservation through the sale of a 533-acre waterfront parcel of land to the State of New York as part of the State's Open Space Conservation Plan. The property, located on the North Fork of Long Island in Jamesport, is the largest remaining undeveloped parcel on the United States' East Coast.

KeySpan's community involvement includes support for breast cancer research, raising awareness through such events as the Faces of Breast Cancer Commemorative Tree Decorating Ceremony.

Education and environmental awareness came together in KeySpan's sponsorship of "Students on Ice," an opportunity for high school students to journey to the Arctic.

Under the sale agreement, 300 of the 533 acres will be preserved as prime farmland that can never be developed, and most of the remaining land — including bluffs, sand dunes, woodlands and a freshwater pond — will be turned into a state park. There will also be a 20-acre restoration farm on the property and a two-acre museum, commemorating the land's farming history.

Planning for Today and Tomorrow

From history to the future, KeySpan had the opportunity to participate in a unique program designed to educate high school students about the global environmental impact of human actions. In conjunction with a local daily newspaper, we sponsored "Students on Ice," an exploratory journey to the Canadian High Arctic and Greenland led by Geoff Green, a noted Arctic explorer. Participants from the New York metropolitan region were selected through an essay-writing contest focused on environmental challenges. In August 2002, three winning students became part of the expedition, learning about the world and its environmental concerns from a team of extraordinary educators. By studying the Earth's polar region's up close, Students on Ice hopes to foster a greater understanding of the fragility of life on our planet and raise young people's environmental consciousness. ●

your investment financial review

When all is said and done, we understand that the primary concern of our shareholders is how KeySpan performs as an investment. As always, we continue to remain committed to providing good shareholder value. The following section contains a financial review and analysis of KeySpan's operations as well as financial statements and selected financial data.

Financial Contents

17 Financial Review and Analysis
43 Financial Statements
83 Selected Financial Data
84 Directors and Officers
85 Shareholder Information

KeySpan, a member of the S&P 500, is a holding company providing a range of energy-related services through operations and investments in selected areas of the energy industry. We are engaged in natural gas distribution, electric services, energy services and other energy investments. In 2002, KeySpan had consolidated revenues of $6.0 billion and realized earnings of $391.6 million, or $2.77 per share from continuing operations. At December 31, 2002, KeySpan had consolidated assets of $12.6 billion.

gas distribution

KeySpan is the fifth largest gas distributor in the United States and the largest in the Northeast serving 2.5 million customers in New York City, Long Island and New England.

2002 Highlights:
- Net gas revenues increased by $19.6 million
- Added $64 million in new Gross Profit Margin (GPM)
- Completed more than 57,000 gas installations

electric services

KeySpan's electric services segment owns and operates gas and oil-fired electric generating plants on Long Island and New York City with total capacity of nearly 6,400 megawatts. It also serves approximately 1.1 million electric customers through management services agreements with the Long Island Power Authority.

2002 Highlights:
- Broke ground on a new 250 megawatt generation facility at our Ravenswood site
- Completed generation projects at Glenwood Landing and Port Jefferson adding almost 160 megawatts to our total capacity

energy services

The energy services segment markets services and products to customers in the New York metropolitan area as well as Rhode Island, Pennsylvania, Massachusetts and New Hampshire. It also provides fuel management services to the Ravenswood generating facility and owns a fiber optic network serving carriers on Long Island and New York.

2002 Highlights:
- Home Energy Services division added 30,000 new service contracts
- Business Solutions division won a $30 million contract for the new AOL-Time Warner building in New York City

energy investments

The energy investments segment consists of gas exploration and production operations, gas pipeline partnerships and other domestic and international energy-related investments. These investments consist of our 56% ownership in The Houston Exploration Company, KeySpan Exploration and Production, LLC, KeySpan Canada and our 20% interest in the Iroquois Gas Transmission System LP, our 50% interest in the Premier Transmission Pipeline and our 24.5% interest in Phoenix Natural Gas.

2002 Highlights:
- Increased production by 13% to 106 BCFe
- Completed sale of Midland Enterprises, a marine barge business, generating net proceeds of $175 million
- Acquired Algonquin LNG, a 600,000 barrel liquefied natural gas storage and receiving facility in Providence, Rhode Island from Duke Energy

KeySpan Corporation (referred to herein as "KeySpan", "we", "us" and "our") is a registered holding company under the Public Utility Holding Company Act of 1935, as amended ("PUHCA"). KeySpan operates six regulated utilities that distribute natural gas to approximately 2.5 million customers in New York City, Long Island, Massachusetts and New Hampshire, making us the fifth largest gas distribution company in the United States and the largest in the Northeast. We also own and operate electric generating plants in Nassau and Suffolk Counties on Long Island and in Queens County in New York City and are the largest investor owned generator in New York State. Under contractual arrangements, we provide power, electric transmission and distribution services, billing and other customer services for approximately one million electric customers of the Long Island Power Authority ("LIPA"). KeySpan's other subsidiaries are involved in gas and oil exploration and production; gas storage; wholesale and retail gas and electric marketing; appliance service; plumbing, heating, ventilation, air conditioning and other mechanical contracting services; large energy-system ownership, installation and management; engineering and consulting services; and fiber optic services. We also invest and participate in the development of natural gas pipelines, natural gas processing plants, electric generation, and other energy-related projects, domestically and internationally. (See Note 2 "Business Segments" for additional information on each operating segment.)

Consolidated Summary of Results

Consolidated earnings before interest and taxes ("EBIT") by segment, as well as consolidated earnings available for common stock is set forth in the following table for the periods indicated.

(In Thousands of Dollars, Except Per Share Amounts)			
	Year Ended December 31,		
	2002	2001	2000
Gas Distribution	$524,311	$492,362	$ 367,226
Electric Services	309,663	283,533	310,823
Energy Services	(10,377)	(143,492)	14,630
Energy Investments	128,265	141,477	131,686
Eliminations and other	(27,614)	33,975	(103,039)
Earnings Before Interest Charges and Taxes	924,248	807,855	721,326
Interest charges	301,504	353,470	201,314
Income taxes	225,394	210,693	217,262
Earnings from Continuing Operations	397,350	243,692	302,750
Discontinued operations	(19,662)	(19,438)	(1,943)
Net Income	377,688	224,254	300,807
Preferred stock dividends	5,753	5,904	18,113
Earnings for Common Stock	$371,935	$218,350	$ 282,694
Basic Earnings per Share:			
Continuing Operations	$ 2.77	$ 1.72	$ 2.12
Discontinued operations	(0.14)	(0.14)	(0.02)
	$ 2.63	$ 1.58	$ 2.10

As indicated in the above table, earnings from continuing operations less preferred stock dividends for the year ended December 31, 2002 increased by $153.8 million, or $1.05 per share compared to the same period in 2001. The increase in earnings from continuing operations reflects the following significant events which are discussed in more detail below: (i) the discontinuance of goodwill amortization in 2002; (ii) the recording of special items in 2001 which resulted in the recognition of certain gains and losses; and (iii) a significant decrease in interest expense in 2002. These benefits to comparative earnings were offset, in part, by a decrease in natural gas prices, particularly during the first quarter, which reduced 2002 earnings associated with gas exploration and production operations, as well as the impact of extremely warm weather during the first quarter which adversely affected natural gas consumption by gas distribution customers.

In January 2002, we adopted Statement of Financial Accounting Standard ("SFAS") 142 "Goodwill and Other Intangible Assets". The key requirements of this Statement include the discontinuance of goodwill amortization, a revised framework for testing goodwill impairment and new criteria for the identification of intangible assets. Consolidated goodwill amortization for 2001 was $49.6 million, or $0.36 per share, and $19.7 million, or $0.15 per share for 2000.

During 2001, we recorded the effects of a number of events that impacted results of operations for that year. These events are as follows: (1) we incurred losses attributed to the former Roy Kay companies of $95.0 million after-tax, or $0.69 per share, primarily reflecting costs related to the discontinuance of the general contracting activities of these companies, costs to complete work on certain loss construction projects, and operating losses incurred. (See Note 10 to the Consolidated Financial Statements, "Roy Kay Operations" and Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" - Legal Matters, for a further discussion of these issues); (2) our gas exploration and production subsidiaries recorded a non-cash impairment charge to recognize the effect of lower wellhead prices on their valuation of proved gas reserves. Our share of this charge was $26.2 million after-tax, or $0.19 per share. (See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies", Item F for further details); and (3) following a favorable appellate court ruling, we reversed a previously recorded loss provision regarding certain pending rate refund issues relating to the 1989 RICO class action settlement of $20.1 million after-tax, or $0.15 per share. This adjustment has been reflected as a $22.0 million reduction to Operations and Maintenance expense and a reduction of $11.5 million to Interest Charges on the Consolidated Statement of Income for the year ended December 31, 2001. (See Note 11 to the Consolidated Financial Statements "Class Action Settlement" for a further discussion of this issue.)

Interest expense decreased by $52.0 million ($33.8 million after-tax), or $0.24 per share in 2002 compared to 2001. The weighted average interest rate on outstanding commercial paper for 2002 was approximately 2.0% compared to approximately 4.5% for last year. Further, KeySpan had a number of interest rate swap agreements which effectively converted fixed rate debt to floating rate debt. The use of these derivative instruments reduced interest expense by $35.6 million in 2002. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments, and Fair Values" for a description of these instruments.) Interest expense in 2001 also reflects

the reversal of $11.5 million in accrued interest expense resulting from the RICO class action settlement.

Net income from gas exploration and production operations decreased by $13.4 million, or $0.11 per share, in 2002 compared to 2001. These operations were adversely impacted by significantly lower realized gas prices in 2002, particularly in the first quarter. As previously mentioned, these operations recorded a non-cash impairment charge in 2001; excluding this charge, the comparative decrease in earnings was $39.6 million, or $0.30 per share.

Income tax expense generally reflects the level of pre-tax income for all periods reported. Further, during the year we finalized the valuation study related to the assets transferred to KeySpan resulting from the KeySpan/Long Island Lighting Company ("LILCO") business combination completed in May 1998. As a result, an adjustment to deferred taxes of $177.7 million was recorded to reflect a decrease in the tax basis of the assets acquired. Concurrent with this adjustment, KeySpan reduced current income taxes payable by $183.2 million, resulting in a $5.5 million income tax benefit. Income tax expense also reflects additional tax benefits of approximately $15 million resulting from the finalization of amended tax returns and the reversal of certain tax reserves.

Average common shares outstanding in 2002 increased by 2% compared to 2001 reflecting the re-issuance of shares held in treasury pursuant to dividend reinvestment and employee benefit plans. This increase in average common shares outstanding reduced earnings per share in 2002 by $0.06 compared to 2001. In January 2003, we received net proceeds of approximately $473 million from the issuance of 13.9 million shares of common stock. See the discussion under the caption "Capital Expenditures and Financing" for further information on this equity offering.

Earnings before interest and taxes ("EBIT") increased by $116.4 million in 2002 compared to last year. Comparative EBIT results were impacted by the items mentioned above, namely; (i) the discontinuation of goodwill amortization in 2002 of $49.6 million; (ii) EBIT losses of $137.8 million incurred by the Roy Kay companies in 2001 compared to losses of $10.8 million incurred in 2002; (iii) the recording of a non-cash pre-tax impairment charge of $42.0 million in 2001 to recognize the effect of lower wellhead prices; and (iv) the reversal, in 2001, of a previously recorded loss provision relating to the RICO class action settlement of $22.0 million. Offsetting these benefits to comparative EBIT results was a decrease in EBIT in 2002 from gas exploration and production operations resulting from a significant decline in average realized gas prices. (See "Review of Operating Segments" and Note 2 to the Consolidated Financial Statements "Business Segments" for a detailed discussion of EBIT results for each of our lines of business.)

Earnings from continuing operations less preferred stock dividends for the year ended December 31, 2001 decreased by $46.9 million, or $0.40 per share, compared to the same period in 2000. These comparative results were primarily driven by the items recorded in 2001 that were previously discussed.

Further, on November 8, 2000 we acquired all of the common stock of Eastern Enterprises ("Eastern") and EnergyNorth Inc. ("ENI") in a transaction accounted for as a purchase. As a result, comparisons in consolidated earnings, revenues and expenses between fiscal years 2001 and 2000 have been significantly affected by the addition of these operations. (See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies".) As part of this transaction, in 2000 we recorded a $65.2 million pre-tax charge associated with early retirement and severance programs that were implemented upon the completion of the acquisitions. The after-tax effect of this charge on consolidated results was $41.1 million, or $0.31 per share.

Interest expense increased by $152.2 million, or 75% in 2001 compared to 2000, reflecting higher levels of debt outstanding, primarily related to: (i) $1.65 billion of long-term debt and $308.6 million of commercial paper issued to finance the acquisition of Eastern and ENI; (ii) debt assumed in the Eastern and ENI acquisition; (iii) $625 million of notes issued during the year, primarily used to repay short-term debt; (iv) debt incurred by KeySpan Canada, one of our Canadian subsidiaries; as well as (v) higher commercial paper borrowings during the year to satisfy seasonal working capital needs. As mentioned, we reversed $11.5 million of previously recorded interest expense relating to the RICO class action settlement during 2001, of which $9 million was recorded in 2000.

Income tax expense in 2001 generally reflects the lower level of pre-tax income compared to 2000. (See Note 3 to the Consolidated Financial Statements, "Income Taxes" for more information.) The decrease in preferred stock dividends in 2001 compared to 2000 resulted from the redemption, at maturity, of 14.5 million shares of preferred stock in the second quarter of 2000.

Average common shares outstanding in 2001 increased by 3% compared to 2000 reflecting the re-issuance of shares held in treasury pursuant to dividend reinvestment and employee benefit plans. This increase in average common shares outstanding reduced earnings per share in 2001 by $0.05 compared to 2000.

EBIT from continuing operations in 2001, after adjusting for the matters noted above, were substantially higher than such earnings for 2000. Our gas distribution operations benefited from the addition of the New England gas utilities for the entire year in 2001 compared to only two months in 2000, as well as from an increase in net margins due to continued gas sales growth, and cost saving synergies. Further, our gas exploration and production activities benefited from the combined effect of higher realized gas prices, primarily during the first quarter of 2001, and improved production volumes throughout the year. These benefits to EBIT from continuing operations were almost entirely offset by higher interest expense. In addition, during 2000 certain charges were incurred by our corporate and administrative areas that were not incurred in 2001, which resulted in a significant increase to comparative earnings. (See the discussion under the heading "Review of Operating Segments" for an analysis of comparative EBIT for each of our operating segments.)

On January 24, 2002, we announced that we had entered into an agreement to sell Midland Enterprises, LLC ("Midland"), KeySpan's inland marine barge business acquired in connection with the Eastern acquisition. In anticipation of this divestiture, which was completed on July 2, 2002, Midland's operations have been reported as discontinued for all periods. (See Note 9 to the Consolidated Financial Statements "Discontinued Operations" for further disclosure on the sale of Midland.) In the fourth quarter of 2001, an estimated loss on the sale of Midland, as well as an estimate for Midland's results of operations for the first six months of 2002 was recorded.

As a result of a change in the tax structure of this transaction, an additional after-tax loss of $19.7 million was recorded in 2002, primarily reflecting a provision for certain city and state taxes.

Financial Outlook for 2003

Consistent with our prior earnings guidance, and as reaffirmed in February 2003 following the announcement regarding the sale of a portion of our ownership in The Houston Exploration Company ("Houston Exploration"), our gas exploration and production subsidiary (as further discussed below), KeySpan's earnings for 2003 are forecasted to be approximately $2.45 to $2.60 per share, after giving effect to the sale of 13.9 million shares of common stock previously noted. Earnings from continuing core operations (defined for this purpose as all continuing operations other than gas exploration and production, less preferred stock dividends) are forecasted to be approximately $2.15 to $2.20 per share, while earnings from gas exploration and production operations are forecasted to be approximately $0.30 to $0.40 per share. The earnings forecast may vary significantly during the year due to, among other things, changing energy market and weather conditions. It should be noted that, starting in 2003, KeySpan will expense stock options granted to its employees in order to reflect all prospective compensation costs in earnings.

Consolidated earnings are seasonal in nature due to the significant contribution to earnings of our gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters of our fiscal year, and breakeven or marginally profitable earnings are anticipated to be achieved in the second and third quarters of our fiscal year.

Review of Operating Segments

The following discussion of financial results achieved by our operating segments is presented on an EBIT basis. We use EBIT measures in our financial and business planning process to provide a reasonable assurance that our financial forecasts will provide, among other things, (i) shareholders with a competitive return on their investment, (ii) adequate earnings and cash flow to service debt; and (iii) adequate interest coverage to maintain or improve our credit ratings. Information concerning EBIT is presented as a measure of those financial results. EBIT should not be construed as an alternative to net income or cash flow from operating activities as determined by Generally Accepted Accounting Principles.

Gas Distribution

KeySpan Energy Delivery New York ("KEDNY") provides gas distribution service to customers in the New York City Boroughs of Brooklyn, Staten Island and a portion of Queens. KeySpan Energy Delivery Long Island ("KEDLI") provides gas distribution service to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. Four natural gas distribution companies – Boston Gas Company, Essex Gas Company, Colonial Gas Company and EnergyNorth Natural Gas, Inc., each doing business under the name KeySpan Energy Delivery New England ("KEDNE"), provide gas distribution service to customers in Massachusetts and New Hampshire.

The table below highlights certain significant financial data and operating statistics for the Gas Distribution segment for the periods indicated.

	(In Thousands of Dollars)		
	Year Ended December 31,		
	2002	2001	2000
Revenues	$3,163,761	$3,613,551	$2,555,785
Cost of gas	1,569,325	2,017,782	1,303,515
Revenue taxes	98,151	119,084	117,811
Net Revenues	1,496,285	1,476,685	1,134,459
Operating Expenses			
Operations and maintenance	608,266	593,341	456,028
Early retirement and severance programs	—	—	41,790
Depreciation and amortization	237,186	253,523	143,335
Operating taxes	138,686	148,428	131,854
Total Operating Expenses	984,138	995,292	773,007
Operating Income	512,147	481,393	361,452
Other Income and (Deductions), net	12,164	10,969	5,774
Earnings Before Interest Charges and Taxes	$ 524,311	$ 492,362	$ 367,226
Firm gas sales and transportation (MDTH)	284,281	283,081	221,689
Transportation – Electric Generation (MDTH)	64,173	64,578	49,854
Other Sales (MDTH)	209,002	188,037	126,372
Warmer (Colder) than Normal – New York	7.0%	10.0%	(2.1%)
Warmer (Colder) than Normal – New England	4.0%	4.6%	(3.3%)

A MDTH is 10,000 therms and reflects the heating content of approximately one million cubic feet of gas. A therm reflects the heating content of approximately 100 cubic feet of gas. One billion cubic feet (BCF) of gas equals approximately 1,000 MDTH.

Net Revenues

Combined net gas revenues (revenues less the cost of gas sold and associated revenue taxes) from our gas distribution operations increased by $19.6 million, or 1.3%. Both the New York and New England based gas distribution operations were adversely impacted by the significantly warmer than normal weather experienced throughout the Northeastern United States during 2002, particularly during the first quarter. Based on heating degree days, weather for the twelve months ended December 31, 2002 was approximately 4%-7% warmer than normal and approximately 1%-3% colder than last year in the New York and New England service territories. However, weather during the heating season, January-March, was approximately 16%-19% warmer than normal, across our service territories. Our gas distribution operations historically earn approximately 60% of yearly EBIT during the January-March period.

During 2002, KEDNY and KEDLI, together, added approximately $40 million in gross gas load additions. The increased gas sales were generated from oil-to-gas space heating conversions, as well as from new construction. These load additions, however, were offset by declining usage per customer due to the extremely warm first quarter weather and the use of more efficient gas heating equipment. Additionally, the down-turn in the economy throughout the Northeastern United States had an adverse impact on gas consumption in 2002. As a result

of these factors, net revenues from firm gas customers (residential, commercial and industrial customers) in our New York service territory decreased by $1.5 million in 2002 compared to last year. Included in net revenues are regulatory incentives that contributed a favorable $6.7 million to comparative net revenues.

Net revenues from firm gas customers in the New England service territory increased by $20.5 million in 2002 compared to last year, primarily as a result of approximately $24 million in gross gas load additions. Also included in net revenues are base rate adjustments totaling $10.0 million associated with Boston Gas Company's Performance Based Rate Plan ("PBR"). The largest component of this adjustment reflects the beneficial effect of a favorable ruling of the Massachusetts Supreme Judicial Court relating to the "accumulated inefficiencies" component of the productivity factor in the PBR. This ruling resulted in a benefit to comparative net margins of $6.3 million. (See "Regulation and Rate Matters" for a further discussion of this matter.) Offsetting, to some extent, these benefits to revenues are the adverse effects of declining usage per customer due to the extremely warm first quarter weather and the use of more efficient gas heating equipment. Additionally, the down-turn in the economy throughout the Northeastern United States had an adverse impact on gas consumption in 2002.

KEDNY and KEDLI each operate under utility tariffs that contain a weather normalization adjustment that significantly offsets variations in firm net revenues due to fluctuations in weather. These weather normalization adjustments resulted in an increase to net gas revenues of $22.3 million in 2002, but this did not fully mitigate the impact of the loss in revenues due to the extremely warm weather experienced during the first quarter. The New England-based gas distribution subsidiaries do not have weather normalization adjustments. To lessen, to some extent, the effect of fluctuations in normal weather patterns on KEDNE's results of operations and cash flows, weather derivatives are in place for the 2002/2003 winter heating season. Since weather during the fourth quarter of 2002 was 7% colder than normal in the New :ngland service territory, we recorded a $3.3 million reduction to revnues to reflect the loss on these derivative transactions. (See Note 8 to ·e Consolidated Financial Statements "Hedging, Derivative Financial ;truments, and Fair Values" for further information).

Firm gas distribution rates in 2002, excluding gas cost recoveries, e remained substantially unchanged from last year in all of our ice territories.

Total net gas revenues increased by $342.2 million or 30% in compared to 2000. The gas distribution operations of KEDNE ı $296.8 million to this increase, while our New York based gas ution operations accounted for the remaining $45.4 million e. Net revenues from our firm gas customers increased by million in 2001 compared to 2000. This increase was largely ıy the addition of KEDNE's gas distribution operations which ːd for $296.8 million of the increase. Our New York based gas ɔn operations added $9.2 million to firm net revenues in 2001 he addition of new gas customers and through our continuto convert residential and commercial customers from oil-to-ıce heating purposes, primarily on Long Island. In addition, ·ative increase in firm net revenues in 2001 was favorably affected by the recovery of previously deferred property taxes, as well as regulatory incentives that added $13.3 million and $23.7 million, respectively, to the increase in firm net gas revenues in 2001. The related property tax expense is being amortized through operating taxes and therefore does not benefit EBIT.

In our large-volume heating and other interruptible (non-firm) markets, which include large apartment houses, government buildings and schools, gas service is provided under rates that are established to compete with prices of alternative fuel, including No. 2 and No. 6 grade heating oil. Net margins realized from these customers in 2002 are comparable to such margins realized last year. Net revenues in these markets in 2001 were slightly lower than sales to this market for 2000. The majority of these margins earned by KEDNE and KEDLI are returned to firm customers as an offset to gas costs.

We are committed to our expansion strategies initiated during the past few years. We believe that significant growth opportunities exist on Long Island and in the New England service territories. We estimate that on Long Island approximately 35% of the residential and multifamily markets, and approximately 55% of the commercial market currently use natural gas for space heating purposes. Further, we estimate that in the New England service territories approximately 50% of the residential and multi-family markets, and approximately 45% of the commercial market currently use natural gas for space heating purposes. We will continue to seek growth in all of our market segments through the expansion of the gas distribution system, as well as through the conversion of residential homes from oil-to-gas for space heating purposes and the pursuit of opportunities to grow multi-family, industrial and commercial markets.

Firm Sales, Transportation and Other Quantities

Total actual firm gas sales and transportation quantities remained consistent with last year. In the New York service territory, actual and weather normalized firm gas sales and transportation quantities decreased slightly in 2002 compared to 2001. In the New England services territories, firm gas sales and transportation quantities increased 4%, despite the warm first quarter weather, due to load additions.

Firm gas sales and transportation quantities increased by 27% during 2001, compared to 2000. The gas distribution operations of KEDNE, accounted for 73.9 MDTH, or 100% of the increase. Firm gas sales and transportation quantities from our New York based gas distribution operations decreased by 7% compared to 2000 as a result of warmer than normal weather. Weather was approximately 10% warmer than normal in 2001 and approximately 11% warmer than the prior year.

Weather normalized sales quantities in 2001 in our New York service territories were flat compared to 2000 due primarily to the adverse effect on consumption of extraordinarily high gas prices during the first quarter of 2001.

Net revenues are not affected by customers choosing to purchase their gas supply from other sources, since delivery rates charged to transportation customers generally are the same as the delivery component of rates charged to full sales service customers. Transportation quantities related to electric generation reflect the transportation of gas to KeySpan's electric generating facilities located on Long Island. Net

service territories) and related transportation. We have an agreement with Coral Resources, L.P. ("Coral"), a subsidiary of Shell Oil Company, under which Coral assists in the origination, structuring, valuation and execution of energy-related transactions on behalf of KEDNY and KEDLI. We also had a portfolio management contract with El Paso Energy Marketing, Inc. ("El Paso"), under which El Paso provided all of the city gate supply requirements at market prices and managed certain upstream capacity, underground storage and term supply contracts for KEDNE. Our agreement with El Paso expired on October 31, 2002 and our agreement with Coral expires on March 31, 2003. We have negotiated a new agreement with Entergy-Koch to replace the expired El Paso agreement. The new agreement with Entergy-Koch began on November 1, 2002 and extends through March 31, 2003. In anticipation of the expiration of the existing agreements, a request for proposal was sent to various portfolio managers. Upon evaluation of the bids, KeySpan will negotiate agreements for all of its gas distribution subsidiaries. It is anticipated that such agreements will become effective April 1, 2003.

Purchased Gas for Resale

The decrease in gas costs in 2002 compared to 2001 of $448.5 million, or 22%, reflects a decrease of 26% in the price per dekatherm of gas purchased, and a 1.0% increase in the quantity of gas purchased. The increase in gas costs in 2001 compared to 2000 of $714.3 million, or 55% primarily reflects the addition of KEDNE's operations for an entire year. KEDNE's operations accounted for $666.1 million of the increase. Fluctuations in utility gas costs associated with firm gas customers have no impact on operating results. The current gas rate structure of each of our gas distribution utilities includes a gas adjustment clause, pursuant to which variations between actual gas costs incurred and gas costs billed are deferred and refunded to or collected from customers in a subsequent period.

Operating Expenses

Operating expenses decreased by $11.2 million in 2002 compared to last year. Comparative operating expenses were significantly impacted by the discontinuation of goodwill amortization. As previously mentioned, in January 2002, we adopted Statement of Financial Accounting Standards ("SFAS") 142 "Goodwill and Other Intangible Assets," which required, among other things, the discontinuation of goodwill amortization. Goodwill amortization in the gas distribution segment for the twelve months ended December 31, 2001 was $35.6 million. Excluding the effects of this amortization, operating expenses increased by $24.4 million, or 3%, in 2002 compared to last year.

The increase in operating expense in 2002 is attributable, in part, to higher pension and other postretirement benefits which increased by approximately $25 million, net of amounts deferred and subject to regulatory true-ups, over the level incurred in 2001. The cost of these benefits has risen primarily as a result of lower actual returns on plan assets, as well as an increase in health care costs. Further, depreciation and amortization expense, excluding the 2001 goodwill amortization, has also increased as a result of the continued expansion of the gas distribution system.

Offsetting, to some extent, the increases in expenses noted above is a favorable $7.4 million adjustment to operating taxes recorded in 2002 related to the reversal of certain operating tax reserves established for the KeySpan/LILCO transaction and subsequent re-organization in May 1998. Further, we are realizing cost saving synergies as a result of early retirement and severance programs implemented in the fourth quarter of 2000. The early retirement portion of the program was completed in 2000, but the severance feature continued through 2002.

Operating expenses increased by $222.3 million, or 29%, in 2001 compared to 2000, due to the addition of the New England gas distribution operations, which added $289.1 million to operating expenses in 2001. This amount includes operations and maintenance costs of $170.6 million, depreciation and amortization charges of $91.0 million and general taxes of $27.5 million. Operating expenses related to our New York based gas distribution operations decreased in 2001 compared to 2000, as a result of cost savings synergies realized in 2001 and lower general and administrative costs being allocated to our New York operations as a result of a change in 2001 of the allocation methodology for these costs pursuant to the Securities and Exchange Commission's ("SEC") requirements under PUHCA. Further, in 2000 we recorded a charge of $41.8 million associated with early retirement and severance programs implemented upon the acquisition of Eastern and ENI.

Depreciation and amortization expense in 2001 reflects $35.6 million for the amortization of goodwill as previously noted, as well as continued property additions, and the amortization of certain costs that were previously deferred and were recovered through gas rates in 2001.

Other Matters

As previously mentioned, there remain significant growth opportunities in our Long Island and New England gas distribution service areas. The Northeast region represents a significant portion of the country's population and energy consumption. Gas sales growth and customer additions are critical to our earnings in the future. However, the beneficial effect of our growth initiatives may not be fully realized in the short-term since we will continue to make incremental investments in our gas distribution network and expand our promotional campaigns to optimize the long-term growth opportunities in our service territories.

To take advantage of the anticipated gas sales growth opportunities in our New York service territory, in 2000 we formed the Islander East Pipeline, LLC ("Islander East"), a limited liability company in which a KeySpan subsidiary and a subsidiary of Duke Energy Corporation each own a 50% equity interest. During 2002, Islander East received a certificate of public convenience and necessity from the Federal Energy Regulatory Commission ("FERC") to construct, own and operate a natural gas pipeline facility consisting of approximately 50 miles of interstate natural gas pipeline extending from Algonquin Gas Transmission Company's facilities in Connecticut, across the Long Island Sound and connecting with KEDLI's facilities on Long Island. Islander East has obtained all required permits in New York State for the construction of the facility. However, the State of Connecticut has issued a moratorium on the issuance of the permits relating to the construction of energy projects until June 2003. Islander East has therefore been unable to obtain the necessary permits from the State of Connecticut at this time. Islander East has also appealed a denial by the State of Connecticut of

the Coastal Zone Management permit to the U.S. Department of Commerce and such appeal is currently pending. Assuming the timely receipt of approvals from the State of Connecticut, the Islander East pipeline is expected to begin operating by year-end 2004 and will transport 260,000 DTH daily to the Long Island and New York City energy markets, enough fuel to heat 600,000 homes, as well as allow us to further diversify the geographic sources of our gas supply. We are currently evaluating various options for the financing of this pipeline. (See the discussion under "Capital Expenditures and Financing" for more information on our financing plans for 2003.)

On December 12, 2002, we acquired Algonquin LNG, LP, the owner and operator of a 600,000 barrel FERC-regulated liquefied natural gas ("LNG") storage and receiving facility in Providence, Rhode Island, from Duke Energy for approximately $28 million. Algonquin LNG was renamed KeySpan LNG, L.P. and its largest customer is Boston Gas Company, which contracts for more than half of the facility's storage capacity.

Electric Services

The Electric Services segment primarily consists of subsidiaries that own and operate oil and gas fired electric generating plants in the borough of Queens (the "Ravenswood facility") and the counties of Nassau and Suffolk on Long Island. In addition, through long-term contracts of varying lengths, we manage the electric transmission and distribution ("T&D") system, the fuel and electric purchases, and the off-system electric sales for LIPA.

Selected financial data for the Electric Services segment is set forth in the table below for the periods indicated.

		(In Thousands of Dollars)	
		Year Ended December 31,	
	2002	2001	2000
Revenues	$1,421,143	$1,421,179	$1,445,886
Purchased fuel	262,072	281,398	315,139
Net Revenues	1,159,071	1,139,781	1,130,747
Operating Expenses			
Operations and maintenance	659,882	662,083	617,399
Depreciation	61,377	52,284	49,278
Operating taxes	150,495	155,693	158,886
Total Operating Expenses	871,754	870,060	825,563
Operating Income	287,317	269,721	305,184
Other Income			
and (Deductions), net	22,346	13,812	5,639
Earnings Before Interest			
Charges and Taxes	$ 309,663	$ 283,533	$ 310,823
Electric sales (MWH)*	5,020,741	4,932,836	4,865,344
Capacity(MW)*	2,200	2,200	2,200
Cooling degree days	1,474	1,381	1,075

**Reflects the operations of the Ravenswood facility only.*

Net Revenues

Total electric net revenues increased by $19.3 million for the twelve months ended December 31, 2002, compared to the same period in 2001. Net revenues in 2002 reflect net revenues of $17.3 million from our new Glenwood Landing and Port Jefferson electric "peaking" facilities located on Long Island. The Glenwood facility was placed in service on June 1, 2002, while the Port Jefferson facility was placed in service on July 1, 2002. These facilities add a combined 160 megawatts of generating capacity to KeySpan's electric generation portfolio. The capacity of and energy produced by these facilities are dedicated to LIPA under 25 year contracts.

Net revenues from the LIPA Agreements increased by $47.2 million or 6% in 2002, compared to last year. Included in revenues for 2002, are billings to LIPA for certain third party costs that were significantly higher than such billings last year. These revenues have minimal impact on earnings since we record a similar amount of costs in operating expense and we share any cost under-runs with LIPA. Excluding these third party billings, revenues for 2002 associated with the LIPA Agreements were comparable to such revenues last year. In addition, in 2002 we earned $16.0 million associated with non-cost performance incentives provided for under these agreements, compared to $16.2 million earned last year. (For a description of the LIPA Agreements, see "LIPA Agreements".)

Net revenues from the Ravenswood facility were $45.2 million, or 13%, lower in 2002, compared to 2001. Net revenues from capacity sales decreased 19% compared to last year, while margins associated with the sale of electric energy were basically flat. Comparative energy sales benefited from a 2% increase in the megawatt hours sold as a result of the hot summer weather offset, in part, by a reduction in "spark-spread" (the selling price of electricity less cost of fuel). Measured in cooling degree days, weather during the 2002 cooling season was approximately 7% warmer than last year.

The decrease in net revenues from capacity sales in 2002, was due, in part, to more competitive pricing by the electric generators that bid into the New York Independent System Operator ("NYISO") energy market which lowered capacity clearing prices by approximately 8% compared to last year. Further, the NYISO revised its methodology employed to determine the available supply of and demand for installed capacity that also had an adverse impact on the capacity market by reducing the capacity required to be purchased by load serving entities such as electric utilities. However, in September 2002, the NYISO recognized a flaw in its revised methodology. Since this flaw resulted in insufficient capacity being procured by the market, it was identified as a reliability concern. The NYISO corrected its methodology prior to the recent 2002/2003 winter auction to ensure sufficient capacity is procured. Elimination of the flaw ensures compliance with New York State Reliability Rules. The Ravenswood facility and the NYISO energy market should benefit from this correction since, as a result, load serving entities should procure sufficient capacity to maintain reliability for customers.

The rules and regulations for capacity, energy sales and the sale of certain ancillary services to the NYISO energy markets continue to evolve and the FERC has adopted several price mitigation measures that have adversely impacted earnings from the Ravenswood facility. Certain

of these mitigation measures are still subject to rehearing and possible judicial review. The final resolution of these issues and their effect on our financial position, results of operations and cash flows cannot be fully determined at this time. (See discussion under Market and Credit Risk Management Activities for a further discussion of these matters.)

Total electric net revenues increased slightly in 2001 compared to 2000. Net revenues from the Ravenswood facility decreased by $12.6 million, or 3%, reflecting lower realized energy prices and lower ancillary service revenues offset, in part, by effective hedging strategies. (Ancillary services include primarily spinning reserves and non-spinning reserves available to replace energy that is unable to be delivered due to the unexpected loss of a major energy source.) Further, capacity and energy sales quantities, as well as realized energy prices were adversely impacted by an increase in available capacity in New York City during 2001.

Revenues from the service agreements with LIPA increased by $22.7 million, or 3% in 2001 compared to 2000. Included in revenues in 2001 were billings to LIPA for certain third party capital costs that were significantly higher than such billings in 2000 primarily due to the construction of an underground transmission line to reinforce the electric system capacity on the South Fork of Long Island. As noted previously, these revenues had a minimal impact on net income. Excluding the third party billings, revenues in 2001 associated with the LIPA Agreements were comparable to such revenues earned during the prior year. In addition, in 2001 we earned $16.2 million associated with non-cost performance incentives provided for under these agreements, compared to $15.4 million earned in 2000.

Operating Expenses

Operating expenses in 2002 were consistent with the prior year. However, included in comparative operating expenses is an increase in third party capital costs that are fully recoverable from LIPA, as noted previously. Excluding the increase in these costs, operating expenses have decreased by approximately $48 million in 2002 compared to 2001. In addition to third party capital costs, LIPA reimburses KeySpan for costs directly incurred by KeySpan in providing service to LIPA, subject to the sharing provisions in the LIPA Agreements. These reimbursements are based on predetermined estimates of operating costs. Variations between certain actual operating costs incurred (i.e. postretirement costs and property taxes) and the predetermined estimates are deferred and refunded to or collected from LIPA in subsequent periods. As a result of an adjustment related to this "true-up", certain pension and other postretirement costs were approximately $23 million lower in 2002 compared to 2001. Further, during 2002, we settled certain outstanding issues with LIPA and Consolidated Edison Company of New York, Inc. ("Consolidated Edison") that resulted in a $20.3 million decrease to comparative operating expenses. The increase in depreciation and amortization expense, as indicated in the above table, primarily reflects depreciation associated with the two new electric peaking facilities.

Operating expenses increased by $44.5 million, or 5% in 2001, compared to 2000, primarily as a result of the increase in third party costs previously noted and higher allocated charges for corporate and administrative costs due to changes in our allocation methodology as prescribed under PUHCA.

Other Income and Deductions

The increases in Other Income in 2002 and 2001 are due primarily to inter-company interest income earned by subsidiaries within the Electric Services segment. For the most part, the various subsidiaries of KeySpan do not maintain separate cash balances. Rather, liquid assets are maintained in a money pool, from and to which subsidiaries can either borrow or lend. Inter-company interest expense is charged to "borrowers", while inter-company interest income is earned by "lenders". In all years presented in the above table, the subsidiaries within the Electric Services segment have been net "lenders" to the money pool and, accordingly, have earned inter-company interest income. Interest rates associated with money pool borrowings are generally the same as KeySpan's short-term borrowing rate. All inter-company interest income and expense is eliminated for consolidated financial reporting purposes.

Other Matters

As previously mentioned, both the Glenwood Landing and Port Jefferson electric generating peaking facilities are fully operational. Short-term financing was used for the construction of these facilities, but various financing options to permanently finance these facilities are being explored. (See the discussion under "Capital Expenditures and Financing" for more information on our financing plans for 2003.) Further, construction has begun on a new 250 MW combined cycle generating facility at the Ravenswood facility site. The new facility is expected to commence operations in late 2003. The capacity and energy produced from this plant are anticipated to be sold into the NYISO energy markets. We are also progressing through the siting process before the New York State Board on Electric Generation Siting and the Environment with a proposal to build a similar 250 MW combined cycle electric generating facility on Long Island. On February 4, 2003, an Examiners' Recommended Decision was issued recommending the granting of a certificate of environmental capability and public need for this proposed facility. In addition, as part of our growth strategy, we continually evaluate the possible acquisition of additional generating facilities in the Northeast. However, we are unable to predict when or if any such facilities will be acquired and the effect any such acquired facilities will have on our financial condition, results of operations or cash flows.

Under the Generation Purchase Right Agreement ("GPRA"), LIPA had the right for a one-year period, beginning on May 28, 2001, to acquire all of our Long Island based generating assets formerly owned by LILCO at fair market value at the time of the exercise of such right. By agreement dated March 29, 2002, LIPA and KeySpan amended the GPRA to provide for a new six-month option period ending on May 28, 2005. The other terms of the option reflected in the GPRA remain unchanged. See the discussion under the heading "Electric Services – Revenue Mechanisms, Generation Purchase Right Agreement" for further details.

In late 2002, LIPA announced, and we acknowledged, that during 2001 and 2002 we had made errors in reporting LIPA's electric system requirements, resulting in an overestimation of LIPA's unbilled revenue. LIPA and KeySpan have continued to review and audit the reporting of electric system requirements for 2002 and earlier periods, and have

determined that, in addition to the 2002 and 2001 overestimation, unbilled revenues for prior periods back to May 1998 were slightly underestimated. Based upon the review the total overestimation in unbilled revenues amounted to approximately $65 million.

The LIPA revenue estimation error did not have an impact on LIPA's electric rates charged to its customers nor to its cash balances. We do not believe that the LIPA revenue estimation error will have any material adverse impact on the various agreements with LIPA or on our financial or operating performance.

Energy Services

The Energy Services segment primarily includes companies that provide services through three lines of business to clients located within the New York City metropolitan area, including New Jersey and Connecticut, as well as in Rhode Island, Pennsylvania, Massachusetts and New Hampshire. The lines of business are: Home Energy Services; Business Solutions; and Fiber Optic Services.

The table below highlights selected financial information for the Energy Services segment.

	(In Thousands of Dollars)		
	Year Ended December 31,		
	2002	2001	2000
Revenues	$938,761	$1,100,167	$770,110
Less: cost of gas and fuel	206,731	407,734	248,275
Net Revenues	732,030	692,433	521,835
Other operating expenses	743,965	839,918	503,512
Operating Income (Loss)	(11,935)	(147,485)	18,323
Other Income and (Deductions), net	1,558	3,993	(3,693)
Earnings (Loss) Before Interest Charges and Taxes	$ (10,377)	$ (143,492)	$ 14,630

Comparative EBIT results for 2002 compared to 2001 were significantly impacted by losses incurred by one of our subsidiaries. In 2001, we discontinued the general contracting activities related to the former Roy Kay companies, with the exception of completion of work on then existing contracts, based upon our view that the general contracting business is not a core competency of these companies. (See Note 10 to the Consolidated Financial Statements "Roy Kay Operations" for a more detailed discussion.) For the year-ended December 31, 2001, we incurred an EBIT loss of $137.8 million associated with the operations of the former Roy Kay companies. The Roy Kay EBIT results reflect costs related to the discontinuation of the general contracting activities of these companies, costs to complete work on certain loss construction projects, and operating losses. We are completing the contracts entered into by the former Roy Kay companies and, for the twelve months ended December 31, 2002, we incurred EBIT losses of $10.8 million reflecting increases in the estimates of and costs to complete these contracts, and general and administrative expenses.

Excluding the results of the former Roy Kay companies, the Energy Services segment reflected an increase in EBIT of $6.1 million in 2002 compared to last year. Revenues, excluding the Roy Kay companies, decreased by $180.4 million in 2002, while the cost of fuel decreased by $201.0 million. These declines, which for the most part offset each other, reflect the operations of our gas and electric marketing subsidiary. In 2002, this subsidiary began to focus its marketing efforts on higher net margin customers and as a result has substantially decreased its customer base. EBIT results for the Business Solutions group of companies, which provide mechanical contracting, plumbing, engineering and consulting services to commercial, institutional, and industrial customers, improved by $22.3 million in 2002 compared to 2001. This increase reflects additional work being performed on the backlog of projects existing at year-end last year and the absence of $6 million in losses incurred on four major projects in 2001. A backlog of approximately $514 million presently exists, which is 20% below the December 31, 2001 level.

Offsetting the positive contribution to EBIT by the Business Solutions group of companies, was a decrease of $15.4 million associated with the Home Energy Services group of companies. These companies provide residential and small commercial customers with service and maintenance of appliances, as well as the retail marketing of natural gas and electricity. Contributing to the decrease in EBIT from Home Energy Services were the following factors: (i) the continued adverse impact of the down-turn in the economy; (ii) the non-renewal of appliance service contracts due to the warm first quarter weather; (iii) costs associated with the closing of a service center; and (iv) an increase in the reserve for bad debts. Comparative EBIT results in 2002 benefited from the elimination of goodwill amortization, which for 2001 amounted to $8.2 million.

We continue to re-align and/or combine a number of our service centers in this segment in order to reduce operating and general and administrative costs, realize synergy savings and improve profitability.

Excluding the operations of the Roy Kay companies, EBIT for this segment was $19.0 million lower in 2001 compared to 2000, reflecting costs incurred to complete certain loss construction contracts and higher corporate allocated costs as a result of PUHCA requirements. (See "Securities and Exchange Commission Regulation" for further discussion.)

Energy Investments

The Energy Investment segment consists of our gas exploration and production operations, certain other domestic and international energy-related investments, as well as certain technology related investments. Our gas exploration and production subsidiaries are engaged in gas and oil exploration and production, and the development and acquisition of domestic natural gas and oil properties. At December 31, 2002, these investments consisted of our 66% ownership interest in Houston Exploration, as well as our wholly-owned subsidiary, KeySpan Exploration and Production, LLC. In line with our strategy of exploring the monetization or divesture of certain non-core assets, in October 2002 we monetized a portion of our assets in the joint venture drilling program with Houston Exploration that was initiated in 1999. We received $26.5 million in cash from Houston Exploration for 18.6 BCFe of estimated proved and probable reserves. The proceeds were used to pay down short-term debt; there was no earnings impact from this transaction. Further, in February 2003, we reduced our ownership interest in Houston Exploration to approximately 56% through the repurchase by Houston Exploration, of 3 million shares of stock

owned by KeySpan. The net proceeds of approximately $79 million received in connection with this repurchase were used to pay down short-term debt.

This segment also consists of KeySpan Canada; our 20% interest in Iroquois Gas Transmission System LP ("Iroquois"); and our 50% interest in the Premier Transmission Pipeline and 24.5% interest in Phoenix Natural Gas, both located in Northern Ireland.

Selected financial data and operating statistics for our gas exploration and production activities is set forth in the following table for the periods indicated.

		(In Thousands of Dollars)	
		Year Ended December 31,	
	2002	2001	2000
Revenues	$357,451	$400,031	$274,209
Depletion and amortization expense	176,925	142,728	95,364
Full cost ceiling test write-down	—	41,989	—
Other operating expenses	70,267	55,653	44,435
Operating Income	110,259	159,661	134,410
Other Income and (Deductions), net*	(14,765)	(39,728)	(22,738)
Earnings Before Interest Charges and Taxes	$ 95,494	$119,933	$111,672
Natural gas and oil production (Mmcf)	106,044	93,968	80,415
Natural gas (per Mcf) realized	$ 3.22	$ 4.24	$ 3.38
Natural gas (per Mcf) unhedged	$ 3.06	$ 4.09	$ 3.97

**Operating income above represents 100% of our gas exploration and production subsidiaries' results for the periods indicated. Earnings before interest and taxes, however, is adjusted to reflect minority interest.*

Earnings Before Interest and Taxes

The decrease in EBIT of $24.4 million in 2002 compared to last year, reflects a 24% reduction in average realized gas prices (average wellhead price received for production including hedging gains and losses), which lowered comparative revenues, as well as an increase in operating expenses associated with higher levels of production and a higher depletion rate. The adverse effect on revenues resulting from the decline in average realized gas prices was partially offset by an increase of 13% in production volumes.

The average realized gas price for 2002 was 105% of the average unhedged natural gas price, resulting in revenues that were $16.4 million higher than revenues that would have been achieved if derivative financial instruments had not been in place during 2002. Houston Exploration hedged approximately 64% of its 2002 production, principally through the use of costless collars. The average realized gas price for 2001 was 104% of the average unhedged natural gas price, resulting in revenues that were $12.9 million higher than revenues that would have been achieved if derivative financial instruments had not been employed during 2001. These derivative instruments are designed to provide Houston Exploration with a more predictable cash flow, as well as to reduce its exposure to fluctuations in natural gas prices. At December 31, 2002 Houston Exploration had derivative positions in place to hedge approximately 67% of its estimated 2003 production and approximately 20% of its estimated 2004 production, again principally through the use of costless collars. Depending upon market conditions, Houston Exploration may enter into additional derivative positions during 2003 to hedge a larger portion of its estimated 2004 production. (See Note 8 to the Consolidated Financial Statements, "Hedging, Derivative Financial Instruments, and Fair Value" for further information.)

The depreciation, depletion and amortization rate was $1.68 per Mcf for the twelve months ended December 31, 2002, compared to $1.49 per Mcf for the same period in 2001, reflecting higher finding and development costs together with the addition of fewer new reserves.

In 2001, our gas exploration and production subsidiaries recorded a non-cash impairment charge of $42.0 million to recognize the effect of lower wellhead prices on their valuation of proved gas reserves. Our share of this charge, which includes our joint venture ownership interest and minority interest, was $26.2 million after-tax. Excluding this charge, the comparative decrease in EBIT for 2002 compared to 2001 would have been greater. (See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies", Item F for more information on this charge.)

The increase in EBIT for 2001 compared to 2000 reflects a significant increase in gas exploration and production revenues, partially offset by an increase in operating expenses associated with higher production volumes. Revenues for 2001 benefited from the combined effect of a 17% increase in production volumes and a 25% increase in average realized gas prices. As noted above, 2001 EBIT results also reflect the recording of a non-cash impairment charge to recognize the effect of lower wellhead prices on the valuation of proved gas reserves.

As previously mentioned, the average realized gas price in 2001 was 104% of the average unhedged natural gas price, resulting in revenues that were $12.9 million higher than revenues that would have been achieved if derivative financial instruments had not been employed during 2001. The average realized gas price in 2000 was 85% of the average unhedged natural gas price, resulting in revenues that were $46.3 million lower than revenues that would have been achieved if derivative financial instruments had not been in place during 2000.

Natural gas prices continue to be volatile and the risk that we may be required to record an impairment charge on our full cost pool again in the future increases when natural gas prices are depressed or if we have significant downward revisions in our estimated proved reserves.

The table below indicates the net proved reserves of our gas exploration and production subsidiaries for the periods indicated.

	Year Ended December 31,					
	2002		2001		2000	
	BCFe	%	BCFe	%	BCFe	%
Houston Exploration	650	96.7%	608	94.0%	561	94.6%
KSE E&P	22	3.3%	39	6.0%	32	5.4%
Total	672	100.0%	647	100.0%	593	100.0%

Selected financial data for our other energy-related investments is set forth in the following table for the periods indicated.

	(In Thousands of Dollars)		
	Year Ended December 31,		
	2002	2001	2000
Revenues	$ 90,778	$ 98,287	$ 35,258
Operation and maintenance expense	57,161	71,411	31,551
Other operating expenses	17,623	20,883	9,988
Operating Income	15,994	5,993	(6,281)
Other Income and (Deductions), net	16,777	15,551	26,295
Earnings Before Interest Charges and Taxes	$ 32,771	$ 21,544	$ 20,014

The increase in EBIT in 2002 compared to last year primarily reflects lower comparative losses associated with certain technology-related investments. Further, higher EBIT from our Northern Ireland investments were, for the most part, offset by lower EBIT realized by KeySpan Canada. KeySpan Canada experienced lower per unit sales prices, as well as lower quantities of sales of natural gas liquids in 2002, as a result of generally lower oil prices. The pricing of natural gas liquids is directly related to oil prices.

Overall, EBIT from these operations and investments in 2001 remained relatively constant compared to 2000. EBIT growth from our investments in KeySpan Canada, Northern Ireland and certain operations purchased as part of our acquisition of Eastern were offset, in part, by losses incurred from certain technology-related investments. Further, in the fourth quarter of 2000, we acquired the remaining 50% interest in KeySpan Canada, making us the sole owner. Results of operations associated with KeySpan Canada have been fully consolidated since the additional investment, whereas prior to this transaction, KeySpan Canada's results were reported as equity income in Other Income and (Deductions).

We do not consider certain businesses contained in the Energy Investments segment to be part of our core asset group. We have stated in the past that we may sell or otherwise dispose of all or a portion of our non-core assets. Based on current market conditions, we cannot predict when, or if, any such sale or disposition may take place, or the effect that any such sale or disposition may have on our financial position, results of operations or cash flows.

Allocated Costs

As previously mentioned, we are subject to the jurisdiction of the SEC under PUHCA. As part of the regulatory provisions of PUHCA, the SEC regulates various transactions among affiliates within a holding company system. In accordance with the regulations of PUHCA and the New York State Public Service Commission requirements, we have service companies that provide: (i) traditional corporate and administrative services; (ii) gas and electric transmission and distribution systems planning, marketing, and gas supply planning and procurement; and (iii) engineering and surveying services to subsidiaries. Revised allocation methodologies, approved by the SEC, have been in use since 2001 to allocate certain service company costs to affiliates.

These non-operating subsidiaries incurred certain costs in 2002 primarily related to general corporate expenses that were not allocated to the various operating subsidiaries. These expenses combined with inter-company money pool eliminations (that were higher in 2002 compared to 2001) resulted in an EBIT loss of $27.6 million in 2002. In 2001, these non-operating subsidiaries realized EBIT of $34.0 million, primarily related to the $22.0 million benefit associated with the favorable appellate court decision regarding the RICO class action settlement, previously mentioned.

During 2000, certain costs were incurred by our corporate and administrative subsidiaries that were not allocated to other operating segments, and were not incurred in 2001. These unallocated costs had a significant effect on comparative EBIT results between the two years and are as follows: (i) a charge of $10.0 million for a contribution to the KeySpan Foundation (a not-for-profit philanthropic foundation that makes donations to local charitable community organizations); (ii) an impairment charge of $23.2 million associated with our equity investment in certain technology-related activities; (iii) branding expenses and other costs related to the integration of the Eastern and ENI companies of $24.6 million; and (iv) early retirement and severance charges of $23.1 million. Item (i) is reflected in "Other Income and Deductions" and all other items are reflected in "Operations and Maintenance expense" in the Consolidated Statement of Income for 2000. Further, during 2001 we: (i) recorded the benefit associated with the favorable appellate court decision regarding the RICO class action settlement at our corporate holding company level, as mentioned previously, which increased EBIT by $22.0 million; and (ii) settled certain outstanding issues associated with LIPA and reallocated certain administrative costs which combined added $15.8 million to EBIT. The net result of the preceding items contributed to the increase in EBIT of $137.0 million in 2001 associated with our non-operating subsidiaries.

Liquidity

Cash flow from operations decreased by $81.1 million, or 9%, in 2002 compared to 2001. Operating cash flow from gas exploration and production activities was adversely impacted by significantly lower realized gas prices in 2002. Further, cash flow from operations in 2002 reflects the funding of the minimum pension obligation related to our New England subsidiaries of $80 million. These adverse effects on cash flow were partially offset by the termination of two interest rate swap agreements that resulted in a favorable operating cash flow benefit of approximately $23.4 million, as well as lower income tax payments. State and federal tax payments were lower in 2002, compared to last year, as KeySpan is currently in a refund position with regard to such taxes. (See Note 8 to the Consolidated Financial Statements, "Hedging, Derivative Financial Instruments, and Fair Value" for an explanation of the interest rate hedges.)

Cash flow from operations for 2001 reflects strong results from gas distribution and electric operations, as well as significant contributions from gas exploration and production activities. Further, the decrease in natural gas prices in the second half of 2001 also had a positive impact on cash flow from operations. As a result of the seasonal nature of gas distribution operations, we incur significant cash expenditures during the summer and early fall to purchase and inject gas into our storage facilities. We recover these costs in subsequent periods as

ıne gas is removed from storage and delivered to our customers, primarily during the winter, for space heating purposes. Significant cash flows are generated during the first two quarters of the subsequent fiscal year as we receive payment from customers for such heating season use. Due to the significant increase in gas prices during the summer and early fall of 2000, gas cost recoveries for the first two quarters of 2001 were greater than such recoveries for the same period in 2000. Further, gas prices during the third and fourth quarters of 2001 were lower than the prior year, resulting in lower cash expenditures required to maintain natural gas inventory in storage. Also, as stated earlier, gas exploration and production activities benefited from higher gas prices during the first two quarters of 2001 compared to 2000. These enhancements to cash flow were partially offset by an increase in interest payments due to higher levels of outstanding debt.

A substantial portion of consolidated revenues are derived from the operations of businesses within the Electric Services segment, that are largely dependent upon two large customers – LIPA and the NYISO. Accordingly, our cash flows are dependent upon the timely payment of amounts owed to us by these customers.

In 2002, KeySpan renewed its existing 364-day revolving credit agreement with a commercial bank syndicate of 16 banks totaling $1.3 billion, a reduction from the previous $1.4 billion facility. The credit facility is used to back up the $1.3 billion commercial paper program. The fees for the facility are subject to a ratings-based grid, with an annual fee of .075% on the total amount of the revolving facility. The credit agreement allows for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, Adjustable Bank Rate ("ABR") loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin of 42.5 basis points for loans up to 33% of the facility, and an additional 12.5 basis points for loans over 33% of the total facility. ABR loans are based on the greater of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders. We do not anticipate borrowing against this facility; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The credit facility contains certain affirmative and negative operat-g covenants, including restrictions on KeySpan's ability to mortgage, ›dge, encumber or otherwise subject its property to any lien, as well ertain financial covenants that require us to, among other things, ntain a consolidated indebtedness to consolidated capitalization of no more than 66%, a decrease from the 68% ratio required r the previous credit facility.

Under the terms of the credit facility, KeySpan's debt-to-total cap-tion ratio reflects 80% equity treatment for the MEDS Equity Units in May 2002. In addition, the $425 million Ravenswood Master treated as debt. At December 31, 2002, consolidated indebted- calculated under the terms of the credit facility, was 64.6% of ated capitalization. This ratio was reduced to 59.8% by the sale nillion shares of common stock in January 2003 as discussed olation of this covenant could result in the termination of the lity and the required repayment of amounts borrowed there- vell as possible cross defaults under other debt agreements. sion under "Capital Expenditures and Financing"

The credit facility also requires that net cash proceeds from the sale of significant subsidiaries be applied to reduce consolidated inde edness. Further, an acceleration of indebtedness of KeySpan or one of its subsidiaries for borrowed money in excess of $25 million in the aggregate, if not annulled within 30 days after written notice, would create an event of default under the Indenture dated November 1, 2000, between KeySpan Corporation and the JPMorganChase Bank as Trustee. At December 31, 2002, KeySpan was in compliance with all covenants.

At December 31, 2002, we had cash and temporary cash investments of $170.6 million. During 2002, we repaid $132.8 million of commercial paper and, at December 31, 2002, $915.7 million of commercial paper was outstanding at a weighted average annualized interest rate of 1.52%. We had the ability to borrow up to an additional $384.3 million at December 31, 2002 under the commercial paper program.

During 2002, Houston Exploration entered into a new revolving credit facility with a commercial banking syndicate that replaced the previous $250 million revolving credit facility. The new facility provides Houston Exploration with an initial commitment of $300 million, which can be increased at its option to a maximum of $350 million with prior approval from the banking syndicate. The new credit facility is subject to borrowing base limitations, initially set at $300 million and will be re-determined semi-annually. Up to $25 million of the borrowing base is available for the issuance of letters of credit. The new credit facility matures on July 15, 2005, is unsecured and ranks senior to all existing debt of Houston Exploration.

Under the Houston Exploration credit facility, interest on base rate loans is payable at a fluctuating rate, or base rate, equal to the sum of (a) the greater of the federal funds rate plus 0.50% or the bank's prime rate plus (b) a variable margin between 0% and 0.50%, depending on the amount of borrowings outstanding under the credit facility. Interest on fixed loans is payable at a fixed rate equal to the sum of (a) a quoted reserve adjusted LIBOR rate, plus (b) a variable margin between 1.25% and 2.00%, depending on the amount of borrowings outstanding under the credit facility.

Financial covenants require Houston Exploration to, among other things, (i) maintain an interest coverage ratio of at least 3.00 to 1.00 of earnings before interest, taxes and depreciation ("EBITDA") to cash interest; (ii) maintain a total debt to EBITDA ratio of not more than 3.50 to 1.00; and (iii) hedge no more than 70% of natural gas production during any 12-month period. At December 31, 2002, Houston Exploration was in compliance with all financial covenants.

During 2002, Houston Exploration borrowed $79 million under its credit facility and repaid $71 million. At December 31, 2002, $152 million of borrowings remained outstanding at a weighted average annualized interest rate of 3.42%. Also, $0.4 million was committed under outstanding letters of credit obligations. At December 31, 2002, $147.6 million of borrowing capacity was available. KeySpan Canada has two revolving credit facilities with financial institutions in Canada. Repayments under these agreements totaled approximately US $26.1 million during 2002. At December 31, 2002, approximately US $150.9 million was outstanding at a weighted average annualized interest rate of 3.23%. KeySpan Canada currently has available borrowings of

approximately US $55.8 million. These revolving credit agreements have been extended through January 2004. An event of default would exist under these credit facilities if KeySpan, as guarantor on the facilities, falls below investment grade rating or falls below A3 or A- at a time when its consolidated indebtedness, as measured using the same criteria employed under KeySpan's credit facility, is greater than 66% of consolidated capitalization or its cash flow to interest expense is less than 2.25 to 1.00. At December 31, 2002, KeySpan and KeySpan Canada were in compliance with all covenants.

On January 17, 2003, KeySpan sold 13.9 million shares of common stock to the open market and realized net proceeds of approximately $473 million. All shares were offered by KeySpan pursuant to the effective shelf registration statement filed with the SEC. Net proceeds from the equity sale were used initially to pay down commercial paper and reduced our debt to capitalization ratio by approximately 480 basis points. Consolidated indebtedness at December 31, 2002, as calculated under the terms of KeySpan's credit facility and, adjusted for this equity offering was 59.8% of consolidated capitalization. In addition, as previously noted, we used the net proceeds of approximately $79 million received, in February 2003, in connection with the partial monetization of Houston Exploration to repay short-term debt. The anticipated impact of additional common shares outstanding due to the equity offering offset by the expected interest savings from the repayments of commercial paper is anticipated to result in dilution of approximately 7% per share in 2003.

In connection with the KeySpan/LILCO transaction, KeySpan and certain of its subsidiaries issued promissory notes to LIPA to support certain debt obligations assumed by LIPA. At December 31, 2002 the remaining principal amount of promissory notes issued to LIPA was approximately $600 million. In an effort to mitigate the dilutive effect of the equity issuance, in February 2003, KeySpan notified LIPA of its intention to redeem approximately $447 million aggregate principal amount of such promissory notes at the applicable redemption prices plus accrued and unpaid interest through the dates of redemption. It is anticipated that such redemption will take place before the end of the first quarter of 2003. Under these promissory notes, KeySpan is required to obtain letters of credit to secure its payment obligations if its long-term debt is not rated at least in the "A" range by at least two nationally recognized statistical rating agencies.

The ratings on our long-term debt have remained unchanged since December 31, 2001. The following table represents the ratings of our long-term debt at December 31, 2002. Currently, these ratings are all on stable outlook with the exception of Standard & Poor's rating on KeySpan, which is on negative outlook.

	Moody's Investor Services	Standard and Poor's	FitchRatings
KeySpan Corporation	A3	A	A–
KEDNY	A2	A+	A+
KEDLI	A2	A+	A
Boston Gas	A2	A2	NA
Colonial Gas	A	A	NA

We satisfy our seasonal working capital requirements primarily through internally generated funds and the issuance of commercial paper. We believe that these sources of funds are sufficient to meet our seasonal working capital needs. In addition, we currently use treasury stock to satisfy the requirements of our dividend reinvestment and employee benefit plans.

Capital Expenditures and Financing

Construction Expenditures

The table below sets forth our construction expenditures by operating segment for the periods indicated:

	(In Thousands of Dollars)	
	Year Ended December 31,	
	2002	2001
Gas Distribution	$ 407,679	$ 384,323
Electric Services	371,885	211,816
Energy Investments	324,486	437,976
Energy Services	14,316	17,134
Corporate Unallocated	15,511	8,510
	$1,133,877	$1,059,759

Construction expenditures related to the Gas Distribution segment are primarily for the renewal and replacement of mains and services and for the expansion of the gas distribution system. Construction expenditures for the Electric Services segment reflect costs to: (i) maintain our generating facilities; (ii) expand the Ravenswood facility; and (iii) construct the new Long Island generating facilities as previously noted. Construction expenditures related to the Energy Investments segment primarily reflect costs associated with gas exploration and production activities. These costs are related to the exploration and development of properties primarily in Southern Louisiana and in the Gulf of Mexico. Expenditures also include development costs associated with the joint venture with Houston Exploration, as well as costs related to KeySpan Canada's gas processing facilities.

At December 31, 2002, total expenditures associated with the siting, permitting and construction of the Ravenswood expansion project, the siting, permitting and procurement of equipment for the Long Island 250MW combined cycle generation plant, and the siting and permitting of the Islander East pipeline project were $234.6 million.

Construction expenditures for 2003 are estimated to be $1.1 billion, including estimated expenditures for the construction of the new electric generating facilities. The amount of future construction expenditures is reviewed on an ongoing basis and can be affected by timing, scope and changes in investment opportunities.

Financing

At December 31, 2001, KeySpan had authorization under PUHCA to issue up to $1 billion of securities and had an existing $1 billion shelf registration statement on file with the SEC, with $500 million available for issuance. In February 2002, we filed a new shelf registration statement for the issuance of an additional $1.2 billion of securities, thereby giving us the ability to issue up to $1.7 billion of debt, equity or various forms of preferred stock.

In May 2002, we issued $460 million of MEDS Equity Units at 8.75% consisting of a three-year forward purchase contract for our common stock and a six-year note. The purchase contract commits us three years from the date of issuance of the MEDS Equity Units to issue and the investors to purchase a number of shares of our common stock based on a formula tied to the market price of our common stock at that time. The 8.75% coupon is composed of interest payments on the six-year note of 4.9% and premium payments on the three-year equity forward contract of 3.85%. These instruments have been recorded as long-term debt on our Consolidated Balance Sheet, but rating agencies, as well as our credit facility, consider between 80% to 100% of the instruments as equity for purposes of calculating debt-to-total capitalization ratios. (See Note 6 to the Consolidated Financial Statements "Long-Term Debt" for further details on the MEDS Equity Units.)

The issuance of the MEDS equity units utilized $920 million of our financing authority under both the shelf registration and the PUHCA financing authority. Both the $460 million six-year note and the $460 million forward equity contract are considered current issuances for these purposes. On December 6, 2002 the SEC issued an order increasing the available financing authority under PUHCA to an aggregate $780 million. Following the recent common stock offering previously mentioned and shares expected to be issued for employee benefit and dividend reinvestment plans, we have approximately $40 million available for the issuance of new securities under our current PUHCA authorization. However, the issuance of securities in connection with the redemption of existing securities (including the promissory notes discussed previously) is permitted under our PUHCA authorization notwithstanding the foregoing limit. We intend to seek authorization to issue additional securities in the near term.

In May 2002, Colonial Gas Company repaid $15 million of its 6.81% Series A First Mortgage Medium -Term Notes. These Notes would have matured on May 19, 2027, but the holder of the Notes elected to exercise a put option to redeem the Notes early.

As previously noted, we issued commercial paper to finance the construction of our two Long Island peaking-power plants, and we will continue to finance the construction of the new 250MW combined cycle generating facility at the Ravenswood facility site, as well as the Islander East Pipeline, through the issuance of commercial paper.

During 2003, we intend to issue approximately $150 million of either taxable or tax-exempt long-term debt securities, the proceeds of which, it is anticipated, will be used to re-pay the outstanding commercial paper related to the construction of our two Long Island peaking-power plants. We also may issue an additional $200 to $300 million of medium-term or long-term debt in 2003 to refinance existing indebtedness. We will continue to evaluate our capital structure and financing strategy for 2003 and beyond. We believe that our current sources of funding (i.e., internally generated funds, the issuance of additional securities as noted above, and the availability of commercial paper), together with the cash proceeds from the recent equity offering, are sufficient to meet our anticipated working capital needs for the foreseeable future.

Off-Balance Sheet Arrangements

Guarantees

KeySpan has fully and unconditionally guaranteed $525 million of medium- term notes issued by KEDLI under KEDLI's current shelf registration, as well as a US $130 million revolving credit agreement associated with KeySpan Canada. Both the medium-term notes and outstanding borrowings under the credit agreement are reflected on the Consolidated Balance Sheet.

Further, at December 31, 2002 KeySpan has guaranteed: (i) $153.9 million of surety bonds associated with certain construction projects currently being performed by subsidiaries within the Energy Services segment; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in the aggregate amount of $65.7 million; (iii) the obligations of KeySpan Ravenswood LLC, the lessee under the $425 million Master Lease Agreement associated with the Ravenswood facility; and (iv) $64.4 million of subsidiary letters of credit. KeySpan has also guaranteed $25 million associated with a non-affiliated company's line of credit. These guarantees are not recorded on the Consolidated Balance Sheet. The guarantee of the KEDLI medium-term notes expires in 2010, while the other guarantees have terms that do not extend beyond 2005; however the Master Lease Agreement can be extended to 2009. At this time, we have no reason to believe that our subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact such defaults may have on our consolidated results of operations, financial condition or cash flows. (See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for a description of the leasing arrangement associated with the Ravenswood Master Lease Agreement and additional information regarding KeySpan's guarantees.)

Variable Interest Entity

We have an arrangement with a variable interest entity through which we lease a portion of the Ravenswood facility. We acquired the Ravenswood facility, in part, through the variable interest entity from Consolidated Edison on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into a lease agreement (the "Master Lease") with a variable interest, unaffiliated financing entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to a KeySpan subsidiary. The variable interest unaffiliated financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). Monthly lease payments equal the monthly interest expense on the debt securities. The Master Lease currently qualifies as an operating lease for financial reporting purposes while preserving our ownership of the facility for federal and state income tax purposes.

The initial term of the Master Lease expires on June 20, 2004 and may be extended until June 20, 2009. In June 2004, we have the right to either purchase the facility at the original acquisition cost of $425 million plus the present value of the lease payments that would otherwise have been paid through June 20, 2009, or terminate the Master Lease and dispose of the facility. If the Master Lease is terminated, KeySpan has guaranteed an amount equal to 83% of the original acqui-

sition cost plus the present value of the lease payments that would have otherwise been paid through June 20, 2009. In June 2009, when the Master Lease terminates, we may purchase the facility in an amount equal to the original acquisition cost, subject to adjustments, or surrender the facility to the lessor. If we elect not to purchase the facility, the lessor will sell the property; we have guaranteed the lessor 84% of the original acquisition cost.

In January 2003, The Financial Accounting Standards Board (the "Board") issued Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51". This Interpretation would require us to, among other things, consolidate this variable interest entity for the first interim period ending after June 15, 2003, so long as the current variable interest structure remains intact. This Interpretation will require us to classify the Master Lease as debt on the Consolidated Balance Sheet at an amount generally equal to fair market value. As previously mentioned, under the terms of our credit facility the Master Lease is considered debt in the ratio of debt-to-total capitalization and therefore, implementation of FIN 46 will have no impact on our credit facility. Further, we will be required to record an asset on the Consolidated Balance Sheet for an amount equal to the fair market value of the leased assets. However, such amount cannot exceed the amount of debt to be recorded for the variable interest entity. At this time, we believe that the fair market value of the leased assets is in excess of the original acquisition cost. The Interpretation contains certain other provisions that we will be required to implement in 2003 and such provisions may impact future earnings. (See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for additional information on the Master Lease and Interpretation No. 46 implementation issues.)

Contractual Obligations

KeySpan has certain contractual obligations related to its outstanding long-term debt, outstanding credit facility borrowings, outstanding commercial paper borrowings, operating and capital leases, and demand charges associated with certain commodity purchases. KeySpan's outstanding short-term and long-term debt issuances are explained in more detail in Note 6 to the Consolidated Financial Statements "Long-Term Debt". KeySpan's operating and capital leases, as well as its demand charges are more fully detailed in Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies". The table below reflects maturity schedules for KeySpan's contractual obligations at December 31, 2002:

			(In Thousands of Dollars)	
Contractual Obligations	Total	1–3 Years	4–5 Years	After 5 Years
Long-term Debt	$5,229,855	$1,337,999	$512,666	$3,379,190
Capital Leases	13,884	3,157	2,064	8,663
Operating Leases	604,782	244,306	159,508	200,968
Demand Charges	462,297	462,297	—	—
Total Contractual Cash Obligations	6,310,818	2,047,759	674,238	3,588,821
Commercial Paper	$ 915,697	Revolving		

Discussion of Critical Accounting Policies and Assumptions

In preparing our financial statements, the application of certain accounting policies requires difficult, subjective and/or complex judgments. The circumstances that make these judgments difficult, subjective and/or complex have to do with the need to make estimates about the impact of matters that are inherently uncertain. Actual effects on our financial position and results of operations may vary significantly from expected results if the judgments and assumptions underlying the estimates prove to be inaccurate. The critical accounting policies requiring such subjectivity are discussed below.

Percentage-of-Completion

Percentage-of-completion accounting is the prescribed method of accounting for long-term construction type contracts in accordance with Generally Accepted Accounting Principles and, accordingly, the method used for revenue recognition by the Energy Services segment. Percentage-of-completion is measured principally by comparing the percentage of costs incurred to date for each contract to the estimated total costs for each contract at completion. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. Application of percentage-of-completion accounting results in the recognition of costs and estimated earnings in excess of billings on uncompleted contracts (recorded within the Consolidated Balance Sheet) which arise when revenues have been recognized but the amounts cannot be billed under the terms of the contracts. Such amounts are recoverable from customers based on various measures of performance, including achievement of certain milestones, completion of specified units or completion of the contract. Due to uncertainties inherent within estimates employed to apply percentage-of-completion accounting, it is possible that estimates will be revised as project work progresses. Changes in estimates resulting in additional future costs to complete projects can result in reduced margins or loss contracts. Application of percentage-of-completion accounting requires that the impact of those revised estimates be reported in the consolidated financial statements prospectively.

Valuation of Goodwill

KeySpan records goodwill on purchase transactions, representing the excess of acquisition cost over the fair value of net assets acquired. In testing for goodwill impairment under SFAS 142, significant reliance is placed upon estimated future cash flows requiring broad assumptions and significant judgment by management. Cash flow estimates are determined based upon future commodity prices, customer rates, customer demand, operating costs, rate relief from regulators, customer growth and other items. A change in the fair value of our investments could cause a significant change in the carrying value of goodwill. While we believe that our assumptions are reasonable, actual results may differ from our projections. The assumptions used to measure the fair value of our investments are the same as those used by us to prepare yearly operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set yearly budgetary guidelines.

Under SFAS 142, goodwill is deemed impaired if the fair value of the reporting unit's assets is less than the carrying value of those assets

including goodwill. It was determined that KeySpan's financial reporting segments are virtually the same as the reporting unit levels as defined in SFAS 142.

For those segments with goodwill, the following amounts were evaluated using the standards set forth by SFAS 142 through December 31, 2002.

	(In Thousands of Dollars)
Reporting Unit	
Gas Distribution	$1,592,510
Energy Services	142,121
Energy Investments and other	55,120
Total Goodwill	$1,789,751

The majority of the goodwill associated with the Gas Distribution unit resulted from the November 2000 acquisition of Eastern and ENI. For purposes of determining goodwill impairment, the fair value of the entire Gas Distribution segment is evaluated against the carrying value of the entire unit. Some of the major factors that were considered in determining the fair value of the Gas Distribution unit included assumptions regarding the growth in revenues, earnings before interest, taxes, depreciation and amortization, and the weighted average cost of capital.

For the initial implementation of SFAS 142, the fair value of each of the reporting units exceeded the carrying value and no impairment charge was necessary. The fair value for the reporting units was evaluated based on the present value of anticipated cash flows.

As permitted under SFAS 142, we can rely on our previous valuations for the annual impairment testing provided that the following criteria for each reporting unit are met: (a) the assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination; and (b) the most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin.

In the case of the Gas Distribution and the Energy Investments segment, the above criteria have been met and no further evaluation was required. In regard to the Energy Services segment, criteria (b) was not met since the initial fair value valuation did not exceed the carrying value by an amount deemed by us to be substantial. However, our annual test was performed in the fourth quarter of 2002 which verified that no impairment charge was deemed necessary. KeySpan will continue to monitor the goodwill associated with this reporting unit.

Accounting for the Effects of Rate Regulation on Gas Distribution Operations

The financial statements of the Gas Distribution segment reflect the ratemaking policies and orders of the NYPSC, the New Hampshire Public Utilities Commission ("NHPUC"), and the Massachusetts Department of Telecommunications and Energy ("DTE").

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas Company and EnergyNorth Natural Gas, Inc.) are subject to the provisions of SFAS 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the actions of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies.

In separate merger-related orders issued by the DTE, the base rates charged by Colonial Gas Company and Essex Gas Company have been frozen at their current levels for a ten-year period ending 2009. Due to the length of these base rate freezes, the Colonial and Essex Gas Companies had previously discontinued the application of SFAS 71.

SFAS 71 allows for the deferral of expenses and income on the consolidated balance sheet as regulatory assets and liabilities when it is probable that those expenses and income will be allowed in the rate setting process in a period different from the period in which they would have been reflected in the consolidated statements of income of an unregulated company. These deferred regulatory assets and liabilities are then recognized in the consolidated statement of income in the period in which the amounts are reflected in rates.

Rate regulation is undergoing significant change as regulators and customers seek lower prices for utility service and greater competition among energy service providers. In the event that regulation significantly changes the opportunity for us to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101 "Regulated Enterprises – Accounting for the Discontinuation of Application of FASB Statement No. 71." We estimate that the write-off of all our net regulatory assets at December 31, 2002 could result in a charge to net income of $230.1 million or $1.63 per share, which would be classified as an extraordinary item. In management's opinion, our regulated subsidiaries that currently are subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

As is further discussed under the caption "Regulation and Rate Matters", the rate plans previously in effect for KEDNY, KEDLI and Boston Gas Company have all expired. The continued application of SFAS 71 to record the activities of these subsidiaries is contingent upon the actions of regulators with regard to future rate plans. We anticipate filing a base rate case and a performance based rate plan for Boston Gas Company in the second quarter of 2003. Further, we are currently evaluating various options that may be available to us including, but not limited to, proposing new plans for KEDNY and KEDLI. The ultimate resolution of any future rate plans could have a significant impact on the application of SFAS 71 to these entities and, accordingly, on our financial position, results of operations and cash flows. However, management believes that currently available facts support the continued application of SFAS 71 and that all regulatory assets and liabilities are recoverable or refundable through the regulatory environment.

Pension and Other Postretirement Benefits

As discussed in Note 4 of the Consolidated Financial Statements, "Postretirement Benefits", KeySpan participates in both non-contributory defined benefit pension plans, as well as other post-retirement benefit ("OPEB") plans (collectively "postretirement plans"). KeySpan's reported costs of providing pension and OPEB benefits are dependent upon numerous factors resulting from actual plan experience and assumptions of future experience. Pension and OPEB costs (collectively

postretirement costs") are impacted by actual employee demographics, the level of contributions made to the plans, earnings on plan assets, and health care cost trends. Changes made to the provisions of these plans may also impact current and future postretirement costs. Postretirement costs may also be significantly affected by changes in key actuarial assumptions, including, anticipated rates of return on plan assets and the discount rates used in determining the postretirement costs and benefit obligations.

The discount rate used for our postretirement benefits at December 31, 2002 was 6.75%. Our discount rate assumption is based upon the current investment yield associated with rating agency indices that have high quality long-term corporate bonds.

For 2002, the assumed long-term return on our postretirement plans' assets was 8.5%. In selecting an assumed rate of return, we consider past performance and economic forecasts for the types of investments held by the plans. The actual 10-year compound rate of return, net of all expenses, for the KeySpan postretirement plans are greater than 8.5%. In addition, in eight of the last 10 years, actual returns have been greater than 8.5%. Our postretirement plans' assets presently consist of approximately 65% equity, 33% fixed income/bonds and 2% cash. In an effort to maximize plan performance, actual asset allocation will fluctuate from year to year depending on the then current economic environment. Based upon the historical performance of equity investments over time, our asset allocation, and our investment strategy, the assumed long-term rate of return appears reasonable.

Our health care cost trend assumptions are developed based on historical cost data, the near-term outlook and an assessment of likely long-term trends. The salary growth assumptions reflect our long-term actual experience and future and near-term outlook.

Actual results that differ from our assumptions are accumulated and amortized over ten years.

Certain gas distribution subsidiaries are subject to SFAS 71, and, as a result, changes in postretirement expenses are deferred for future ecovery from or refund to gas sales customers. Further, changes in ostretirement expenses associated with subsidiaries that service the PA Agreements are also deferred for future recovery from or refund to 'A. As a result of these deferrals, we estimate that the actual impact of tretirement expense to KeySpan's Consolidated Statement of me is approximately 50% of the otherwise actuarially determined nse.

The year-end December 31, 2002 assumed discount rate used to nine postretirement obligations was 6.75%. A 25 basis point se or decrease in the assumed year-end discount rate would have impact on 2002 expense. However, a 25 basis point decrease in med year-end discount rate would result in the recording ditional minimum pension liability. Therefore, a year-end rate of 6.50% would have required an additional $76.4 million Other Comprehensive Income ("OCI"), net of tax and deferrals viously. A year-end discount rate of 7.00% would have e charge to OCI by a net $8.8 million.

uary 1, 2002, the assumed discount rate used to determine ent obligations was 7.0%. A 25 basis point increase or he assumed discount rate at the beginning of the year would have impacted 2002 expense by approximately $4.2 million, of tax and deferrals.

In 2002, the expected rate of return on plan assets was 8.50%. 25 basis point increase or decrease in the return on plan assets would have impacted 2002 expense by approximately $2.0 million, net of ta and deferrals.

Historically, we have funded our pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At December 31, 2002, we had a funding balance in excess of the ERISA minimum funding requirements and as a result KeySpan will not be required to make any contribution to its pension plans in 2003. However, although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Future funding requirements are heavily dependent on actual return on plan assets. Therefore, if the actual return on plan assets continues to be significantly below the expected returns, we may elect to fund the pension plans in 2003.

Full Cost Accounting

Our gas exploration and production subsidiaries use the full cost method to account for their natural gas and oil properties. Under full cost accounting, all costs incurred in the acquisition, exploration, and development of natural gas and oil reserves are capitalized into a "full cost pool". Capitalized costs include costs of all unproved properties, internal costs directly related to natural gas and oil activities, and capitalized interest.

Under full cost accounting rules, total capitalized costs are limited to a ceiling equal to the present value of future net revenues, discounted at 10%, plus the lower of cost or fair value of unproved properties less income tax effects (the "ceiling limitation"). A quarterly ceiling test is performed to evaluate whether the net book value of the full cost pool exceeds the ceiling limitation. If capitalized costs (net of accumulated depreciation, depletion and amortization) less deferred taxes are greater than the discounted future net revenues or ceiling limitation, a write-down or impairment of the full cost pool is required. A write-down of the carrying value of the full cost pool is a non-cash charge that reduces earnings and impacts stockholders' equity in the period of occurrence and typically results in lower depreciation, depletion and amortization expense in future periods. Once incurred, a write-down is not reversible at a later date.

The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, held constant over the life of the reserves. Our gas exploration and production subsidiaries use derivative financial instruments that qualify for hedge accounting under SFAS 133 to hedge against the volatility of natural gas prices. In accordance with current SEC guidelines, these derivatives are included in the estimated future cash flows in the ceiling test calculation. In calculating the ceiling test at December 31, 2002, our subsidiaries estimated that a full cost ceiling "cushion" existed, whereby the carrying value of the full cost pool was less that the ceiling limitation. No writedown is required when a cushion exists. Natural gas prices continue to be volatile and the risk that a write down to the full cost pool will be required increases when natural gas prices are depressed or if there are significant downward

Exploration estimates its proved reserves and future net revenues using sales prices estimated to be in effect as of the date it makes the reserve estimates. Natural gas prices, which have fluctuated widely in recent years, affect estimated quantities of proved reserves and future net revenues. Any estimates of natural gas and oil reserves and their values are inherently uncertain, including many factors beyond our control. The accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. In addition, estimates of reserves may be revised based upon actual production, results of future development and exploration activities, prevailing natural gas and oil prices, operating costs and other factors, which revision may be material. Reserve estimates are highly dependent upon the accuracy of the underlying assumptions. Actual future production may be materially different from estimated reserve quantities and the differences could materially affect future amortization of natural gas and oil properties.

Valuation of Derivative Instruments

We employ derivative instruments to hedge a portion of our exposure to commodity price risk and interest rate risk, to partially hedge the cash flow variability associated with our electric energy and capacity sales from the Ravenswood facility, as well as to economically hedge certain other commodity exposures. In addition, KeySpan Canada has used swap instruments to lock-in the purchase price on the purchase of electricity needed to operate its gas processing plants.

All of our derivative instruments, except for certain weather derivatives, meet the SFAS 133 definition of a derivative. For those derivative instruments designated as cash flow hedges, changes in the market value of substantially all of our derivatives are recorded in Other Comprehensive Income, (in line with effectiveness measurements) and are not recorded through earnings until the derivative positions are settled. Further, none of KeySpan's derivative instruments qualify as "energy trading contracts" as defined by current accounting literature.

When available, quoted market prices are used to record a contract's fair value. However, market values for certain derivative contracts may not be readily available or determinable. A number of our commodity related derivative instruments are exchange traded and, accordingly, fair value measurements are generally based on standard New York Mercantile Exchange ("NYMEX") quotes. We use industry-published indices, NYISO location zone indices, as well as other local published indices to value contracts for commodities that are not exchange traded, such as No. 6 grade fuel oil and electricity. The fair value of our electric capacity hedges is based on published NYISO capacity bidding prices. Further, if no active market exists for a commodity, fair values may be based on pricing models.

For collar transactions relating to natural gas sales associated with our gas exploration and production subsidiaries, we use standard NYMEX quotes, and published volatility with Black- Scholes valuations to calculate the fair value of these instruments.

All fair value measurements, whether calculated using standard NYMEX quotes or other valuation techniques, are subjective and subject to fluctuations in commodity prices, interest rates and overall economic market conditions and, as a result, our fair value measurements may not be precise and can fluctuate significantly from period to period.

The table below summarizes the sources of fair value for cash-flow derivative instruments that qualify for hedge accounting treatment at December 31, 2002.

			(In Thousands of Dollars)
	Fair Value of Contracts		
Source of Fair Value	Maturity 2003	Maturity 2004	Total Fair Value
Prices actively quoted	$(16,959)	$ (91)	$(17,050)
Prices provided by external sources	124	—	124
Prices based on models and other valuation methods	(10,743)	(3,675)	(14,418)
Local published indices	(467)	(817)	(1,284)
	$(28,045)	$(4,583)	$(32,628)

During 2002, we also had interest rate swap agreements in which approximately $1.3 billion of fixed rate debt was effectively converted to floating rate debt. The fair values of these derivative instruments were provided to us by our counter-parties and represent the present value of estimated future cash-flows based on a forward interest rate curve for the life of the derivative instrument.

Additionally, we use derivative financial instruments to reduce cash flow variability associated with the purchase price for a portion of future natural gas purchases for our regulated gas distribution activities. Since these derivative instruments are employed to reduce variability of the purchase price of natural gas to be sold to regulated firm gas sales customers, the accounting for these derivative instruments is subject to SFAS 71. At December 31, 2002, these instruments had a fair value of $4.8 million and were valued using, primarily, standard NYMEX quotes. These derivative instruments will be settled in 2003. Further, certain contracts for the physical purchase of natural gas for our regulated firm gas sales customers can no longer be exempted as normal purchases from the requirements of SFAS 133. At December 31, 2002, these contracts had a fair value of $1.2 million. The fair value for these contracts was determined using matrix-pricing models based on contracts with similar terms and risks.

KeySpan also has a small number of derivative financial instruments that meet the SFAS 133 definition of a derivative but do not qualify for hedge accounting treatment. Further, these instruments do not qualify as "energy trading contracts" as defined by current accounting literature. We use NYMEX futures to economically hedge the cash flow variability associated with the purchase of fuel for a portion of our fleet vehicles. KeySpan Canada has a portfolio of financially-settled natural gas collars and natural gas liquid swap transactions. Finally, our retail gas and electric marketing subsidiary has bought options to economically hedge the cash flow variability associated with a portion of expected future natural gas purchases. At December 31, 2002, these instruments, all of which expire in 2003, had an unfavorable net mark-to-market value of $0.4 million, which was recorded to earnings. We use standard NYMEX quotes, local published commodity indices, and prices provided by external sources to value these instruments.

See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" for a further description of all our derivative instruments.

Dividends

We are currently paying a dividend at an annual rate of $1.78 per common share. Our dividend policy is reviewed annually by the Board of Directors. The amount and timing of all dividend payments is subject to the discretion of the Board of Directors and will depend upon business conditions, results of operations, financial conditions and other factors. Based on currently foreseeable market conditions, we intend to maintain the dividend at the $1.78 level.

Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to KeySpan is conditioned upon maintenance of a utility capital structure with debt not exceeding 55% and 58%, respectively, of total utility capitalization. In addition, the level of dividends paid by both utilities may not be increased from current levels if a 40 basis point penalty is incurred under the customer service performance program. At the end of KEDNY's and KEDLI's rate years (September 30, 2002 and November 30, 2002, respectively), the ratio of debt to total utility capitalization was 42% and 52%, respectively. Additionally, we have met the requisite customer service performance standards. Our corporate and financial activities and those of each of our subsidiaries (including their ability to pay dividends to us) are also subject to regulation by the SEC. (For additional information, see the discussion under the heading "Securities and Exchange Commission Regulation").

Regulation and Rate Matters

Gas Distribution

By orders dated February 5, 1998 and April 14, 1998, the NYPSC approved the KeySpan/LILCO business combination and established gas rates for both KEDNY and KEDLI. Pursuant to the orders, $1 billion of efficiency savings, excluding gas costs, attributable to operating synergies that are expected to be realized over the ten-year period following the combination, were allocated to customers, net of transaction costs.

Effective May 29, 1998, KEDNY's base rates to core customers were reduced by $23.9 million annually. In addition, KEDNY is subject to an earnings sharing provision pursuant to which it was required to credit core customers with 60% of any utility earnings up to 100 basis points above certain threshold return on equity levels over the term of the rate plan (other than any earnings associated with discrete incentives) and 50% of any utility earnings in excess of 100 basis points above such threshold levels. The threshold level for the rate year ended September 30, 2002 was 13.25%. KEDNY slightly exceeded the threshold return on equity for the rate year ended September 30, 2002. On September 30, 2002, KEDNY's rate agreement with the NYPSC expired. Under the terms of the agreement, the then current gas distribution rates and all other provisions, including the earnings sharing provision (at the 13.25% threshold level), remain in effect until changed by the NYPSC. At this time, we are currently evaluating various options that may be available to us regarding KEDNY's rates, including but not limited to, proposing a new rate plan.

The 1998 orders also required KEDLI to reduce base rates to its customers by $12.2 million annually effective February 5, 1998 and by an additional $6.3 million annually effective May 29, 1998. KEDLI is subject to an earnings sharing provision pursuant to which it is required to credit to firm customers 60% of any utility earnings in any rate year up to 100 basis points above a return on equity of 11.10% and 50% of any utility earnings in excess of a return on equity of 12.10%. KEDLI did not earn above its threshold return level in its rate year ended November 30, 2002. On November 30, 2000, KEDLI's rate agreement with the NYPSC expired. Under the terms of the agreement, the gas distribution rates and all other provisions, including the earnings sharing provision, will remain in effect until changed by the NYPSC. At this time, we are currently evaluating various options that may be available to us regarding KEDLI's rate plan, including but not limited to, proposing a new rate plan.

We expect current gas distribution rates for KEDNY and KEDLI to remain in effect through 2003.

Boston Gas Company, Colonial Gas Company and Essex Gas Company operations are subject to Massachusetts' statutes applicable to gas utilities. Rates for gas sales and transportation service, distribution safety practices, issuance of securities and affiliate transactions are regulated by the DTE.

Boston Gas Company's gas rates for local distribution service are governed by a five-year performance-based rate plan approved by the DTE in 1996 (the "Plan"). Under the Plan, Boston Gas Company's rates for local distribution were recalculated annually to reflect inflation for the previous 12 months, and reduced by a productivity factor of 1%. The productivity factor has been the subject of a remand proceeding at the DTE. With respect to this appeal, on March 7, 2002, the Massachusetts Supreme Judicial Court ruled in favor of Boston Gas Company and reduced the productivity factor from 1.0% to .5%. Further, the plan contains a margin sharing mechanism, whereby 25% of earnings in excess of a 15% return on equity are passed back to customers. Similarly, ratepayers absorb 25% of any shortfall below a 7% return on equity. The Plan expired on October 31, 2002.

On March 27, 2002, we filed notice, as required, with the DTE that we may file a base rate case and a performance based rate plan for the Boston Gas Company to replace the plan that expired on October 31, 2002. On May 21, 2002, we filed with the DTE a request to extend the existing performance based rate plan for an additional term of one year. This request was denied by the DTE in early September 2002. As a result, we anticipate filing a base rate case and a performance based rate plan for the Boston Gas Company in the second quarter of 2003, to be effective in the fourth quarter of 2003.

In connection with the Eastern acquisition of Colonial Gas Company in 1999, the DTE approved a merger and rate plan that resulted in a ten year freeze of base rates to Colonial Gas Company's firm customers. The base rate freeze is subject only to certain exogenous factors, such as changes in tax laws, accounting changes, or regulatory, judicial, or legislative changes. The Office of the Attorney General appealed the DTE's order to the Supreme Judicial Court, which appeal is still pending. Due to the length of the base rate freeze, Colonial Gas Company discontinued its application of SFAS 71 "Accounting for the Effects of Certain Types of Regulation". Essex Gas Company is also under a ten-year base rate freeze and has also discontinued its application of SFAS 71.

EnergyNorth Natural Gas, Inc.'s base rates continue as set by the NHPUC in 1993.

Securities and Exchange Commission Regulation
KeySpan and its subsidiaries are subject to the jurisdiction of the SEC under PUHCA. The rules and regulations under PUHCA generally limit the operations of a registered holding company to a single integrated public utility system, plus additional energy-related businesses. In addition, the principal regulatory provisions of PUHCA: (i) regulate certain transactions among affiliates within a holding company system including the payment of dividends by such subsidiaries to a holding company; (ii) govern the issuance, acquisition and disposition of securities and assets by a holding company and its subsidiaries; (iii) limit the entry by registered holding companies and their subsidiaries into businesses other than electric and/or gas utility businesses; and (iv) require SEC approval for certain utility mergers and acquisitions.

The SEC's order issued on November 8, 2000, in connection with our acquisition of Eastern and ENI as amended on December 6, 2002 and February 14, 2003, provides us with, among other things, authorization to do the following through December 31, 2003 (the "Authorization Period"): (a) subject to an aggregate amount of $5.8 billion, (i) maintain existing financing agreements, (ii) issue and sell up to $2.2 billion of additional securities in compliance with certain defined parameters, (iii) issue additional guarantees and other forms of credit support in an aggregate amount of $2.0 billion at any time in addition to any such securities, guarantees and credit support outstanding or existing as of November 8, 2000, and (iv) amend, renew, extend, supplement or replace any of the foregoing; (b) issue shares of common stock or reissue shares of common stock held in treasury under dividend reinvestment and stock-based management incentive and employee benefit plans; (c) maintain existing and enter into additional hedging transactions with respect to outstanding indebtedness in order to manage and minimize interest rate costs; (d) invest up to $2.2 billion in exempt wholesale generators; and (e) pay dividends out of capital and unearned surplus as well as paid-in-capital with respect to certain subsidiaries, subject to certain limitations.

In addition, we have committed that during the Authorization Period, our common equity will be at least 30% of our consolidated capitalization and each of our utility subsidiaries' common equity will be at least 30% of such entity's capitalization. At December 31, 2002 our consolidated common equity was 33% of our consolidated capitalization, including commercial paper, and each of our utility subsidiaries common equity was at least 35% of its respective capitalization.

Electric Services – Revenue Mechanisms

LIPA Agreements
KeySpan, through certain of its subsidiaries, provides services to LIPA under the following agreements:

Management Services Agreement ("MSA")
A KeySpan subsidiary manages the day-to-day operations, maintenance and capital improvements of the T&D system. LIPA exercises control over the performance of the T&D system through specific standards for performance and incentives. In exchange for providing the services, we earn a $10 million annual management fee and are operating under a contract, which provides certain incentives and imposes certain penalties based upon performance. We have reached an agreement with LIPA to extend the MSA for 31 months through 2008, as discussed under the heading "Generation Purchase Right Agreement" below. Annual service incentives or penalties exist under the MSA if certain targets are achieved or not achieved. In addition, we can earn certain incentives for budget underruns associated with the day-to-day operations, maintenance and capital improvements of LIPA's T&D system. These incentives provide for us to (i) retain 100% on the first $5 million in annual budget underruns, and (ii) retain 50% of additional annual underruns up to 15% of the total cost budget, thereafter all savings accrue to LIPA. With respect to cost overruns, we will absorb the first $15 million of overruns, with a sharing of overruns above $15 million. There are certain limitations on the amount of cost sharing of overruns. To date, we have performed our obligations under the MSA within the agreed upon budget guidelines and we are committed to providing on-going services to LIPA within the established cost structure. However, no assurances can be given as to future operating results under this agreement.

Power Supply Agreement ("PSA")
A KeySpan subsidiary sells to LIPA all of the capacity and, to the extent requested, energy conversion services from our existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC. Under the terms of the PSA, rates will be reestablished for the contract year commencing January 1, 2004 by recalculating the revenue requirement underlying those rates. We anticipate submitting to the FERC a rate filing reflecting the recalculated revenue requirement in the Fall of 2003. We are unable to predict the outcome of that proceeding at this time. Rates charged to LIPA include a fixed and variable component. The variable component is billed to LIPA on a monthly basis and is dependent on the number of megawatt hours dispatched. LIPA has no obligation to purchase energy conversion services from us and is able to purchase energy conversion services on a least-cost basis from all available sources consistent with existing interconnection limitations of the T&D system. The PSA provides incentives and penalties that can total $4 million annually for the maintenance of the output capability and the efficiency of the generating facilities. The PSA runs for a term of fifteen years, with LIPA having the option to renew the PSA for an additional fifteen year term.

Energy Management Agreement ("EMA")
The EMA provides for a KeySpan subsidiary to procure and manage fuel supplies on behalf of LIPA to fuel the generating facilities under contract to it and perform off-system capacity and energy purchases on a least-cost basis to meet LIPA's needs. In exchange for these services we earn an annual fee of $1.5 million. In addition, we arrange for off-system sales on behalf of LIPA of excess output from the generating facilities and other power supplies either owned or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales. In addition, the EMA provides incentives and penalties that can total $7 million annually for performance related to fuel purchases and off-system power purchases. The EMA covers a period of fifteen years to 2013

for the procurement of fuel supplies and eight years to 2006 for off-system management services.

Under these agreements, we are required to obtain a letter of credit in the aggregate amount of $60 million supporting our obligations to provide the various services if our long-term debt is not rated in the "A" range by a nationally recognized rating agency.

Generation Purchase Right Agreement ("GPRA")

Under the GPRA, LIPA had the right for a one-year period beginning on May 28, 2001, to acquire all of our Long Island based generating assets formerly owned by LILCO at fair market value at the time of the exercise of such right.

By agreement dated March 29, 2002, LIPA and KeySpan amended the GPRA to provide for a new six month option period ending on May 28, 2005. The other terms of the option reflected in the GPRA remained unchanged. In return for providing LIPA an extension of the GPRA, KeySpan has been provided with a corresponding extension of 31 months for the MSA to the end of 2008.

The extension is the result of a new initiative established by LIPA to work with KeySpan and others to review Long Island's long-term energy needs. LIPA and KeySpan will jointly analyze new energy supply options including re-powering existing plants, renewable energy technologies, distributed generation, conservation initiatives and retail competition. The extension allows both LIPA and KeySpan to explore alternatives to the GPRA including re-powering existing facilities, the sale of some or all of KeySpan's plants to LIPA, or the sale of some or all of these plants to other investor-owned entities.

KeySpan Glenwood and Port Jefferson Energy Centers

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC have entered into 25 year Power Purchase Agreements with LIPA (the "PPAs"). 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 guarantees full 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.

Ravenswood Facility

We currently sell capacity, energy and ancillary services associated with the Ravenswood facility through a bidding process into the NYISO energy markets on both a day ahead and a real time basis. We also have the ability to enter into bilateral transactions to sell all or a portion of the energy produced by the Ravenswood facility to Load Serving Entities, i.e. entities that sell to end-users or to brokers and marketers.

Environmental Matters

KeySpan is subject to various federal, state and local laws and regulatory programs related to the environment. Ongoing environmental compliance activities, which have not been material, are charged to operation and maintenance activities. We estimate that the remaining cost of our manufactured gas plant ("MGP") related environmental cleanup activities, including costs associated with the Ravenswood facility, will be approximately $192.9 million and we have recorded a related liability for such amount. We have also recorded an additional $39.2 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of December 31, 2002, we have expended a total of $70.5 million on environmental investigation and remediation activities. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Guarantees and Contingencies" for a further explanation of these matters.)

Market and Credit Risk Management Activities

Market Risk: We are exposed to market risk arising from potential changes in one or more market variables, such as energy commodity price risk, interest rate risk, foreign currency exchange rate risk, volumetric risk due to weather or other variables. Such risk includes any or all changes in value whether caused by commodity positions, asset ownership, business or contractual obligations, debt covenants, exposure concentration, currency, weather, and other factors regardless of accounting method. We manage our exposure to changes in market prices using various risk management techniques for non-trading purposes, including hedging through the use of derivative instruments, both exchange-traded and over-the-counter contracts, purchase of insurance and execution of other contractual arrangements. (See Item 7A. Quantitative and Qualitative Disclosures About Market Risk and Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" for a further explanation of derivative financial instruments.)

Credit Risk: We are exposed to credit risk arising from the potential that our counter-parties fail to perform on their contractual obligations. Our credit exposures are created primarily through the sale of gas and transportation services to residential, commercial, electric generation, and industrial customers and the provision of retail access services to gas marketers, by our regulated gas businesses; the sale of commodities and services to LIPA and the NYISO; the sale of gas power and services to our retail customers by our unregulated energy service businesses; entering into financial and energy derivative contracts with energy marketing companies and financial institutions; and the sale of gas, natural gas liquids, oil and processing services to energy marketing and oil and gas production companies.

We have regional concentration of credit risk due to receivables from residential, commercial and industrial customers in New York, New Hampshire and Massachusetts, although this credit risk is spread over a diversified base of residential, commercial and industrial customers. Customers' payment records are monitored and action is taken, when appropriate. Companies within the Energy Services segment have a concentration of credit risk to large customers and to the governmental and healthcare industries.

We also have concentrations of credit risk from LIPA, our largest customer, and from other energy companies. Concentration of energy company counter-parties may impact overall exposure to credit risk in that our counter-parties may be similarly impacted by changes in economic, regulatory or other considerations. We actively monitor the credit profile of our wholesale counter-parties in derivative and other contractual arrangements, and manage our level of exposure accordingly. Over the past year, the credit quality of certain energy companies has declined. In instances where counter-parties' credit quality has declined, we limit our credit exposure by restricting new transactions with the counter-party, requiring additional collateral or credit support and negotiating the early termination of certain agreements.

Regulatory Issues and Competitive Environment

We are subject to various other risk exposures and uncertainties associated with our gas and electric operations. The most significant contingency involves the evolution of the gas distribution and electric industries towards more competitive and deregulated environments. Set forth below is a description of these exposures.

The Gas Industry

Long Island and New York

The NYPSC continues to conduct collaborative proceedings on ways to develop the competitive energy market in New York. On July 13, 2001, the presiding officers in the case issued their recommended decision ("RD"). The RD recommends that the NYPSC adopt an end state vision that includes removing the utilities from the provision of the energy (gas and electric) commodity. The RD also recommends that utilities exit the commodity function only where there is a workably competitive market. The RD states that the only market that is currently workably competitive is the commodity market for nonresidential large–use gas customers. Parties filed briefs on and opposing exceptions to the RD.

On May 23, 2002, the NYPSC issued an Order Adopting Terms of Gas Restructuring Joint Proposal Petition of KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island for a Multi-Year Restructuring Agreement ("Joint Proposal"). The Joint Proposal did not alter base rate levels, but established a merchant function backout credit of $.21/dth and $.19/dth for KEDNY and KEDLI, respectively. These credits are designed to lower transportation rates charged to transportation only customers. These credits were based on established levels of projected avoided costs and levels of customer migration to non-utility commodity service. Lost revenues resulting from application of these credits will be recovered from firm gas sales customers.

As a result of circumstances in 2001, including the California energy crisis and the bankruptcy of Enron Corp., state regulators around the country are reassessing the pace of movement toward deregulation. We are unable to predict the outcome or pace of this trend or its ultimate effect on our results of operation, financial condition or cash flows.

On December 20, 2002, New York State Governor George Pataki signed into law the "Energy Consumer Protection Act of 2002" ("Act"). The Act defines energy services companies that provide gas or electric commodity service to customers as utilities subject to the Home Energy Fair Practices Act provisions ("HEFPA") of the New York Public Service Law. Under the Act, in certain circumstances utilities such as KEDNY and KEDLI will be required to suspend distribution service to customers whose commodity service has been terminated by an energy services company. Generally, those energy services companies are required under the Act to provide these customers with the same consumer protections prescribed under HEFPA as are prescribed for full service sales customers of gas distribution companies. Those consumer protections include a series of notices warning of potential service termination, offering deferred payment agreements, and special protections for elderly, blind and disabled customers. The Act contemplates that the NYPSC will promulgate regulations implementing the Act, but such regulations have not yet been promulgated. The Act becomes effective on June 18, 2003. We cannot predict the impact of the Act on KeySpan's regulated or unregulated operations at this time.

New England

In July 1997, the DTE directed Massachusetts gas distribution companies to undertake a collaborative process with other stakeholders to develop common principles under which comprehensive gas service unbundling might proceed. A settlement agreement by the local distribution companies ("LDCs") and the marketer group regarding model terms and conditions for unbundled transportation service was approved by the DTE in November 1998. In February 1999, the DTE issued its order on how unbundling of natural gas service will proceed. For a five year transition period, the DTE determined that LDC contractual commitments to upstream capacity will be assigned on a mandatory, pro-rata basis to marketers selling gas supply to the LDC's customers. The approved mandatory assignment method eliminates the possibility that the costs of upstream capacity purchased by the LDCs to serve firm customers will be absorbed by the LDC or other customers through the transition period. The DTE also found that, through the transition period, LDCs will retain primary responsibility for upstream capacity planning and procurement to assure that adequate capacity is available to support customer requirements and growth. The DTE approved the LDCs Terms and Conditions of Distribution Service that conform to the settled upon model terms and conditions. Since November 1, 2000, all Massachusetts gas customers have the option to purchase their gas supplies from third party sources other than the LDCs. Further, the New Hampshire Public Utility Commission required gas utilities to offer transportation services to all commercial and residential customers starting November 1, 2001.

We believe that the actions described above strike a balance among competing stakeholder interests in order to most effectively make available the benefits of the unbundled gas supply market to all customers.

Electric Industry

The Ravenswood Facility and our New York City Operations

The NYISO's New York City local reliability rules currently require that 80% of the electric capacity needs of New York City be provided by "in-City" generators. As additional, more efficient electric power plants are built in New York City and the surrounding areas, the requirement that 80% of in-City load be served by in-City generators could be modified. Construction of new transmission facilities could also cause significant changes to the market. If generation and/or transmission facilities are constructed, and/or the availability of our Ravenswood facility deteriorates, then the capacity and energy sales volumes could be adversely affected. We cannot predict, however, when or if new power plants or transmission facilities will be built or the nature of future New York City energy requirements or market design.

Regional Transmission Organizations and Standard Market Design

During 2001, the FERC issued several orders and began several proceedings related to the development of Regional Transmission Organizations ("RTO") and the design of the wholesale energy markets. The details of how RTOs will be formed are currently evolving. On July 31, 2002, FERC issued a Notice of Proposed Rulemaking ("NOPR") intended to establish a standardized national market design and rules for competitive wholesale electric markets ("Standard Market Design" or "SMD"). These rules would apply to transmission owners ("TOs"), independent system operators ("ISOs"), and RTOs. The SMD is intended to create: (i) genuine wholesale competition; (ii) efficient transmission systems; (iii) the right pricing signals for investment in transmission and generation facilities; and (iv) more customer options. How the SMD will be implemented will be based on FERC's final rules in this regard, as well as the subject of various compliance filings by TOs, ISOs, and RTOs. We do not know how the markets will develop nor how these proposed changes will impact the operations of the NYISO or its market rules. Furthermore, we are unable to determine to what extent, if any, this process will impact the Ravenswood facility's financial condition, results of operations or cash flows.

New York Independent System Operator Matters

On May 31, 2002, FERC approved the NYISO's mitigation plan ("the Plan"). The Plan retains existing mitigation measures such as $1,000/MWhr energy price caps, non-spinning reserve bid caps, in-City capacity and energy mitigation measures, the day ahead Automated Mitigation Procedure ("AMP"), and the NYISO's general mitigation authority. In addition, the Plan implements a new in-City real time automated mitigation procedure. Although prices for various energy products in the NYISO markets have softened, it is not known to what extent each of these proceedings and revised rules may impact the Ravenswood facility's financial condition, results of operations or cash flows.

Quantitative and Qualitative Disclosures About Market Risk

The market risks discussed below relate to our derivative financial instruments. We have derivative financial instruments and derivative commodity contracts that are exposed to potential losses due to adverse changes in interest rates, commodity prices and weather. Interest rate risk generally is related to our outstanding debt and financing activities. The majority of our commodity price risk and volumetric risk due to weather relate to our Ravenswood merchant electric operations, exploration and production operations and our gas distribution operations. We use derivative contracts to manage price risk and volumetric risk exposure from these activities.

Financially-Settled Commodity Derivative Instruments: From time to time KeySpan has utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging exposure to commodity price risk and to hedge the cash flow variability associated with a portion of peak electric energy sales.

Houston Exploration has utilized collars, as well as over-the-counter ("OTC") swaps to hedge the cash flow variability associated with forecasted sales of a portion of its natural gas production. As of December 31, 2002, Houston Exploration has hedged approximately 67% and 20% of its estimated 2003 and 2004 production, respectively. Further, Houston Exploration may enter into additional derivative positions for 2003 and 2004. Houston Exploration used standard New York Mercantile Exchange ("NYMEX") futures prices and published volatility in its Black-Scholes calculation to value its outstanding derivatives. The maximum length of time over which Houston Exploration has hedged such cash flow variability is through December 2004.

The estimated amount of losses associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $34.9 million, or $22.7 million after-tax.

With respect to price exposure associated with fuel purchases for the Ravenswood facility, KeySpan employs standard NYMEX natural gas futures contracts and over-the-counter financially settled natural gas basis swaps to hedge the cash flow variability of a portion of forecasted purchases of natural gas. KeySpan also employs the use of financially-settled oil swap contracts to hedge the cash flow variability of a portion of forecasted purchases of fuel oil that will be consumed at the Ravenswood facility. The maximum length of time over which we have hedged cash flow variability associated with: (i) forecasted purchases of natural gas is through December 2003; and (ii) forecasted purchases of fuel oil is through April 2004. We used standard NYMEX futures prices to value the gas futures contracts and industry published oil indices for number 6 grade fuel oil to value the oil swap contracts. The estimated amount of gains associated with all such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $4.5 million, or $2.9 million after-tax.

Our retail gas and electric marketing subsidiary, our domestic gas distribution operations and KeySpan Canada employed NYMEX natural gas futures contracts and natural gas swaps to lock-in a price for expected future natural gas purchases. As applicable, we used standard NYMEX futures prices and relevant natural gas indices to value the out-

standing contracts. The maximum length of time over which we have hedged such cash flow variability is through December 2003. The estimated amount of gains associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $4.9 million, or $3.2 million after-tax.

We have also engaged in the use of cash-settled swap instruments to hedge the cash flow variability associated with (i) a portion of forecasted peak electric energy sales from the Ravenswood facility and (ii) forecasted sales of Unforced Capacity ("UCAP") to the NYISO. The maximum length of time over which we have hedged cash flow variability is through March 2004. We used NYISO-location zone published indices as well as published NYISO bidding prices to value these outstanding derivatives. The estimated amount of losses associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $1.1 million, or $0.7 million after-tax.

KeySpan Canada also has employed electricity swap contracts to lock-in the purchase price of electricity needed to operate its gas processing plants. These contracts are not exchange-traded and local published indices were used to value these outstanding swap agreements. The maximum length of time over which we have hedged such cash flow variability is through December 2003. The estimated amount of losses associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $1.5 million, or $1.0 million after-tax.

The following tables set forth selected financial data associated with these derivative financial instruments noted above that were outstanding at December 31, 2002.

Type of Contract Gas	Year of Maturity	Volumes mmcf	Floor $	Ceiling $	Fixed Price $	Current Price $	Fair Value ($000)
Collars	2003	54,300	3.48	4.92	—	4.43 – 4.99	(14,681)
	2004	18,300	3.50	4.75	—	4.03 – 4.81	(3,767)
Swaps/Futures – Short Natural Gas	2003	14,751	—	—	2.91– 3.52	3.87 – 4.99	(20,694)
Swaps/Futures – Long Natural Gas	2003	10,580	—	—	3.10 – 5.38	4.43 – 5.02	7,428
		97,931					(31,714)

Type of Contract Oil	Year of Maturity	Volume Barrels	Fixed Price $	Current Price $	Fair Value ($000)
Swaps – Short Fuel Oil	2003	90,000	28.50	28.14 - 31.00	(145)
Swaps – Long Fuel Oil	2003	320,815	20.05 – 27.20	23.72 - 33.81	2,633
	2004	5,548	20.50 – 23.70	22.66 - 23.19	6
		416,363			2,494

Type of Contract Electricity	Year of Maturity	Capacity	MWh	Fixed Margin/ Price $	Current Price $	Fair Value ($000)
Swaps – Energy	2003		119,680	12.70 – 57.80	14.15 – 48.09	(1,889)
	2004		68,800	14.00	22.25 - 22.34	(823)
Swaps – Capacity	2003	1,000		7.75	7.00 - 9.41	(696)
		1,000	188,480			(3,408)

Change in Fair Value of Derivative Instruments	2002 ($000)
Fair value of contracts at January 1,	$ 55,097
(Gain) on contracts realized	(26,204)
Fair value of new contracts when entered into during period	—
(Decrease) in fair value of all open contracts	(61,521)
Fair value of contracts outstanding at December 31,	$(32,628)

NYMEX futures are also used to economically hedge the cash flow variability associated with the purchase of fuel for a portion of our fleet vehicles. Further, KeySpan Canada has a portfolio of financially-settled natural gas collars and natural gas liquid swap transactions. Such contracts are executed by KeySpan Canada to: (i) synthetically fix the price that is paid or received by KeySpan Canada for certain physical transactions involving natural gas and natural gas liquids and (ii) transfer the price exposure of such instruments to other trading partners. In addition, our retail gas and electric marketing subsidiary has bought options to economically hedge the cash flow variability associated with a portion of expected future natural gas purchases. These derivative financial instruments do not qualify for hedge accounting under SFAS 133. At December 31, 2002, these instruments had a net fair market value of ($0.4) million, that was recorded on the Consolidated Balance Sheet. Based on the non-hedge designation of these instruments, the loss was recognized in the Consolidated Statement of Income.

Firm Gas Sales Derivative Instruments – Regulated Utilities: We also use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New Hampshire service territories. Since these derivative instruments are employed to reduce the variability of the purchase price of natural gas to be sold to regulated firm gas sales customers, the accounting for these derivative instruments is subject to SFAS 71. Therefore, changes in the market value of these derivatives have been recorded as a Regulatory Asset or Regulatory Liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers during the appropriate winter heating season consistent with regulatory requirements.

The following table sets forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2002.

Type of Contract	Year of Maturity	Volumes mmcf	Fixed Price $	Current Price $	Fair Value ($000)
Options	2003	5,560	3.90 – 4.50	4.27	3,250
Swaps	2003	2,080	3.85 – 4.50	4.79 – 4.95	1,586
		7,640			4,836

Physically-Settled Commodity Derivative Instruments: On April 1, 2002 we implemented Derivative Implementation Group ("DIG") Issue C15 and C16 of SFAS 133, "Accounting for Derivative Instruments and Hedging Activities", as amended and interpreted, incorporating SFAS 137 and SFAS 138 and certain implementation issues (collectively "SFAS 133"). Issue C15 establishes new criteria that must be satisfied in order for option-type and forward contracts in electricity to be exempted as normal purchases and sales, while Issue C16 relates to the exemption (as normal purchases and normal sales) of contracts that combine a forward contract and a purchased option contract. Based upon a review of our physical commodity contracts, we determined that certain contracts for the physical purchase of natural gas can no longer be exempted as normal purchases from the requirements of SFAS 133. At December 31, 2002, the fair value of these contracts was $1.2 million. Since these contracts are for the purchase of natural gas sold to regulated firm gas sales customers, the accounting for these contracts is subject to SFAS 71. Therefore, changes in the market value of these contracts have been recorded as a Regulatory Asset or Regulatory Liability on the Consolidated Balance Sheet.

Interest Rate Derivative Instruments: During most of 2002, we had interest rate swap agreements in which approximately $1.3 billion of fixed rate debt had been synthetically modified to floating rate debt. Under the terms of the agreements, we received the fixed coupon rate associated with these bonds and paid the counter-parties a variable interest rate that was reset on a quarterly basis. These swaps were designated as fair-value hedges and qualified for "short-cut" hedge accounting treatment under SFAS 133. Through the utilization of these agreements, we reduced recorded interest expense by $35.6 million for the twelve months ended December 31, 2002. In early November 2002, we terminated two interest rate swap agreements with an aggregate notional amount of $1.0 billion and received $80.9 million from our swap counter-parties, of which $23.4 million represented accrued swap interest. The difference between the termination settlement amount and the amount of accrued swap interest, $57.4 million, will be amortized to earnings (as an adjustment to interest expense) on a level yield basis over the remaining lives of the originally hedged debt obligations. The remaining swap, which had a notional amount of $270.0 million, and a fair market value of $15.6 million at December 31, 2002, was terminated on February 25, 2003. We received $18.4 million from our swap counter-parties, of which $8.1 million represents accrued swap interest. The difference between the termination settlement amount and the amount of accrued interest, $10.3 million, will be recorded to earnings in the first quarter of 2003. This swap was used to hedge a portion of our outstanding promissory notes to LIPA. As discussed in Note 6, to the Consolidated Financial Statements "Long-Term Debt", we intend to redeem a portion of these promissory notes before the end of the first quarter of 2003.

Additionally, we also have an interest rate swap agreement that hedges the cash flow variability associated with the forecasted issuance of a series of commercial paper offerings. The maximum length of time over which we have hedged such cash flow variability is through March 2003. The estimated amount of loss associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $0.6 million, or $0.4 million net of tax.

Weather Derivatives: The utility tariffs associated with KEDNE's operations do not contain weather normalization adjustments. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate a substantial portion of the effect of fluctuations from normal weather on our financial position and cash flows, we sold heating degree-day call options and purchased heating degree-day put options for the November 2002 – March 2003 winter season. With respect to sold call options, KeySpan is required to make a payment of $40,000 per heating degree day to its counter-parties when actual weather experienced during the November 2002 – March 2003 time frame is above 4,470 heating degree days, which equates to approximately 1% colder than normal weather. With respect to purchased put options, KeySpan will receive a $20,000 per heating degree day payment from its counter-parties when actual weather is below 4,150 heating degree days, or is approximately 7% warmer than normal. Based on the terms of such contracts, as discussed in Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies", we account for such instruments pursuant to the requirements of EITF 99-2, "Accounting for Weather Derivatives." In this regard, we account for such instruments using the "intrinsic value method" as set forth in such guidance. During the fourth quarter of 2002, weather was 7% colder than normal and, as a result, $3.3 million has been recorded as a reduction to revenues.

Derivative contracts are primarily used to manage exposure to market risk arising from changes in commodity prices and interest rates.

In the event of nonperformance by a counter-party to a derivative contract, the desired impact may not be achieved. The risk of a counter-party nonperformance is generally considered credit risk and is actively managed by assessing each counter-party credit profile and negotiating appropriate levels of collateral and credit support.

Foreign Currency Fluctuations

We follow the principles of SFAS 52, "Foreign Currency Translation" for recording our investments in foreign affiliates. Due to our continued activities in Canada and Northern Ireland, our investment in foreign affiliates has been growing. At December 31, 2002, the net assets of these affiliates was approximately $374 million and at December 31, 2002, the accumulated after-tax foreign currency translation included in Other Comprehensive Income was a debit of $2.2 million. (See Note 1 to the Consolidated Financial Statements, "Summary of Significant Accounting Policies.")

Statement of Management's Responsibility for Financial Statements

Management has prepared and is responsible for the consolidated financial statements and related information in the Annual Report. The financial statements, which include amounts based on judgments and estimates, have been prepared in conformity with generally accepted accounting principles consistently applied.

Management has developed and continues to maintain a system of internal accounting and other controls for KeySpan and its subsidiaries. Management believes these controls provide reasonable assurance that assets are safeguarded from loss or unauthorized use and that KeySpan's financial records are a reliable basis for preparing the financial statements. KeySpan's system of internal controls is supported by written policies, including a code of conduct, a program of internal audits, and by a program of selecting and training qualified staff. Underlying the concept of reasonable assurance is the premise that the cost of control should not exceed the benefit derived.

Management also has in place a system of disclosure controls and related procedures which provide reasonable assurance that KeySpan has complied with the required reporting and timely filings of all reports under the Securities Exchange Act of 1934.

Deloitte & Touche LLP, independent accountants, have audited the consolidated financial statements as described in their report. Their audit, which was conducted in accordance with auditing standards generally accepted in the United States of America, included consideration of the internal control structure. Their report expresses an independent opinion on the fairness of presentation of the financial statements.

The Board of Directors, through its audit committee consisting solely of outside directors, is responsible for reviewing and monitoring the company's financial reporting, accounting practices and the retention of the independent accountants. The audit committee meets regularly with management, internal auditors and independent accountants, both separately and together. The internal auditors and the independent accountants have free access to the audit committee to review the results of their audits, the adequacy of internal accounting controls and the quality of financial reporting.

Cautionary Statement Regarding Forward-Looking Statements

Certain statements contained herein are forward-looking statements, which reflect numerous assumptions and estimates and involve a number of risks and uncertainties. For these statements, we claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

There are possible developments that could cause our actual results to differ materially from those forecast or implied in the forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which are current only as of the date of this filing. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Among the factors that could cause actual results to differ materially are: volatility of energy prices of fuel used to generate electricity; fluctuations in weather and in gas and electric prices; general economic conditions, especially in the Northeast United States; our ability to successfully reduce our cost structure and operate efficiently; our ability to successfully contract for natural gas supplies required to meet the needs of our firm customers; implementation of new accounting standards; inflationary trends and interest rates; the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of recent and future acquisitions; available sources and cost of fuel; creditworthiness of counter-parties to derivative instruments and commodity contracts; retention of key personnel; federal and state regulatory initiatives that increase competition, threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses; the impact of federal and state utility regulatory policies and orders on our regulated and unregulated businesses; potential write-down of our investment in natural gas properties when natural gas prices are depressed or if we have significant downward revisions in our estimated proved gas reserves; competition in general facing our unregulated Energy Services businesses, including but not limited to competition from other mechanical, plumbing, heating, ventilation and air conditioning, and engineering companies, as well as, other utilities and utility holding companies that are permitted to engage in such activities; the degree to which we develop unregulated business ventures, as well as federal and state regulatory policies affecting our ability to retain and operate such business ventures profitably; and other risks detailed from time to time in other reports and other documents filed by KeySpan with the Securities and Exchange Commission.

Independent Auditors' Reports

To the Shareholders and Board of Directors of KeySpan Corporation:

We have audited the accompanying Consolidated Balance Sheet of KeySpan Corporation and subsidiaries (the Company) as of December 31, 2002, and the related Consolidated Statements of Income, Retained Earnings, Comprehensive Income, Capitalization, and Cash Flows for the year then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit. The consolidated financial statements of KeySpan Corporation for the years ended December 31, 2001 and 2000 were audited by other auditors who have ceased operations. Their report, dated February 4, 2002, expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the KeySpan Corporation and subsidiaries as of December 31, 2002, and the results of their operations and their cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, on January 1, 2002, the Company adopted Statement of Financial Accounting Standards No. 142 "Goodwill and Other Intangible Assets," (SFAS No. 142) to change its method of accounting for goodwill and other intangible assets.

As discussed above, the consolidated financial statements of the Company as of December 31, 2001, and for the two years in the period then ended were audited by other auditors who have ceased operations. The notes related to these consolidated financial statements have been revised to include the transitional disclosures required by SFAS No. 142, which was adopted by the Company as of January 1, 2002. Our audit procedures with respect to the disclosures in Note 1 G for 2001 and 2000 included (i) agreeing the previously reported earnings for common stockholders to the previously issued consolidated financial statements and the adjustments to earnings for common stockholders representing amortization expense recognized in those periods related to goodwill to the Company's underlying records obtained from management, and (ii) testing the mathematical accuracy of the reconciliation of adjusted net income to reported earnings for common shareholders, and the related earnings-per-share amounts. In addition, Note 12 has also been revised. Our auditing procedures with respect to the disclosures in Note 12 for 2001 and 2000 included (i) agreeing the amounts in the guarantor and other subsidiaries columns to underlying consolidating records obtained from management, (ii) comparing the sum of these columns to the previously issued consolidated financial statements, and (iii) testing the mathematical accuracy of the schedule. In our opinion, the adjustments in Notes 1G and 12 are appropriate and have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 2001 and 2000 financial statements of the Company other than with respect to such adjustments and, accordingly, we do not express an opinion or any other form of assurance on the 2001 and 2000 financial statements taken as a whole.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
February 10, 2003 (February 26, 2003 as to Note 16)
New York, New York

To the Shareholders and Board of Directors of KeySpan Corporation:

We have audited the accompanying Consolidated Balance Sheet and Consolidated Statement of Capitalization of KeySpan Corporation (a New York corporation) and subsidiaries as of December 31, 2001 and December 31, 2000 and the related Consolidated Statements of Income, Retained Earnings, Comprehensive Income and Cash Flows for the three years ended December 31, 2001. These financial statements are the responsibility of KeySpan Corporation's management.

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position and capitalization of KeySpan Corporation and subsidiaries as of December 31, 2001 and December 31, 2000 and the results of their operations and their cash flows for the three years ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP

ARTHUR ANDERSEN LLP

February 4, 2002
New York, New York

Readers of these consolidated financial statements should be aware that this report is a copy of a previously issued Arthur Andersen LLP report and that this report has not been reissued by Arthur Andersen LLP. Furthermore, this report has not been updated since February 4, 2002 and Arthur Andersen LLP completed its last post-audit review of the December 31, 2001 consolidated financial information on April 29, 2002.

Consolidated Statement of Income

(In Thousands of Dollars, Except Per Share Amounts)	Year Ended December 31, 2002	Year Ended December 31, 2001	Year Ended December 31, 2000
Revenues			
Gas Distribution	**$3,163,761**	$3,613,551	$2,555,785
Electric Services	**1,421,043**	1,421,079	1,444,711
Energy Services	**938,761**	1,100,167	770,110
Gas Exploration and Production	**357,451**	400,031	274,209
Energy Investments	**89,650**	98,287	35,887
Total Revenues	**5,970,666**	6,633,115	5,080,702
Operating Expenses			
Purchased gas for resale	**1,653,273**	2,171,113	1,408,680
Fuel and purchased power	**385,059**	538,532	460,841
Operations and maintenance	**2,101,897**	2,114,759	1,659,736
Early retirement and severance charges	—	—	65,175
Depreciation, depletion and amortization	**514,613**	559,138	330,922
Operating taxes	**410,651**	448,924	421,936
Total Operating Expenses	**5,065,493**	5,832,466	4,347,290
Operating Income	**905,173**	800,649	733,412
Other Income and (Deductions)			
Interest charges	**(301,504)**	(353,470)	(201,314)
Income from equity investments	**14,096**	13,129	20,010
Minority interest	**(24,918)**	(40,847)	(26,342)
Interest income	**1,572**	8,326	12,327
Other	**28,325**	26,598	(18,081)
Total Other Income and (Deductions)	**(282,429)**	(346,264)	(213,400)
Earnings Before Income Taxes	**622,744**	454,385	520,012
Income Taxes			
Current	**(48,487)**	101,738	170,809
Deferred	**273,881**	108,955	46,453
Total Income Taxes	**225,394**	210,693	217,262
Earnings from Continuing Operations	**397,350**	243,692	302,750
Discontinued Operations			
Income (loss) from operations, net of tax	**(3,356)**	10,918	(1,943)
Loss on disposal, net of tax	**(16,306)**	(30,356)	—
Loss from Discontinued Operations	**(19,662)**	(19,438)	(1,943)
Net Income	**377,688**	224,254	300,807
Preferred stock dividend requirements	**5,753**	5,904	18,113
Earnings for Common Stock	**$ 371,935**	$ 218,350	$ 282,694
Basic Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 2.77**	$ 1.72	$ 2.12
Discontinued Operations	**(0.14)**	(0.14)	(0.02)
Basic Earnings Per Share	**$ 2.63**	$ 1.58	$ 2.10
Diluted Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 2.75**	$ 1.70	$ 2.11
Discontinued Operations	**(0.14)**	(0.14)	(0.02)
Diluted Earnings Per Share	**$ 2.61**	$ 1.56	$ 2.09
Average Common Shares Outstanding (000)	**141,263**	138,214	134,357
Average Common Shares Outstanding – Diluted (000)	**142,300**	139,221	135,165

See accompanying Notes to the Consolidated Financial Statements.

Consolidated Balance Sheet

	December 31, 2002	(In Thousands of Dollars) December 31, 2001
ASSETS		
Current Assets		
Cash and temporary cash investments	**$ 170,617**	$ 159,252
Accounts receivable	**1,122,022**	1,009,166
Unbilled revenue	**473,060**	335,732
Allowance for uncollectible accounts	**(63,029)**	(72,299)
Gas in storage, at average cost	**273,036**	334,999
Material and supplies, at average cost	**113,519**	105,693
Other	**127,224**	125,944
	2,216,449	1,998,487
Assets Held for Disposal	**—**	191,055
Investments and Other	**259,188**	223,249
Property		
Gas	**6,124,281**	5,704,857
Electric	**1,974,352**	1,629,768
Other	**394,374**	400,643
Accumulated depreciation	**(2,740,516)**	(2,533,466)
Gas exploration and production, at cost	**2,438,998**	2,200,851
Accumulated depletion	**(973,889)**	(796,722)
	7,217,600	6,605,931
Deferred Charges		
Regulatory assets	**438,516**	458,191
Goodwill, net of amortization	**1,789,751**	1,782,826
Other	**692,802**	529,867
	2,921,069	2,770,884
Total Assets	**$12,614,306**	$11,789,606

See accompanying Notes to the Consolidated Financial Statements.

Consolidated Balance Sheet

	December 31, 2002	December 31, 2001
		(In Thousands of Dollars)
LIABILITIES AND CAPITALIZATION		
Current Liabilities		
Current redemption of long-term debt	**$ 11,413**	$ 993
Accounts payable and other liabilities	**1,061,649**	1,091,430
Commercial paper	**915,697**	1,048,450
Dividends payable	**64,714**	63,442
Taxes accrued	**51,276**	50,281
Customer deposits	**38,387**	36,151
Interest accrued	**77,092**	93,962
	2,220,228	2,384,709
Deferred Credits and Other Liabilities		
Regulatory liabilities	**84,479**	39,442
Deferred income tax	**877,013**	598,072
Postretirement benefits and other reserves	**759,731**	694,680
Other	**189,912**	207,992
	1,911,135	1,540,186
Commitments and Contingencies (See Note 7)	**—**	—
Capitalization		
Common stock	**3,005,354**	2,995,797
Retained earnings	**522,835**	452,206
Other comprehensive income	**(108,423)**	4,483
Treasury stock	**(475,174)**	(561,884)
Total common shareholders' equity	**2,944,592**	2,890,602
Preferred stock	**83,849**	84,077
Long-term debt	**5,224,081**	4,697,649
Total Capitalization	**8,252,522**	7,672,328
Minority Interest in Subsidiary Companies	**230,421**	192,383
Total Liabilities and Capitalization	**$12,614,306**	$11,789,606

See accompanying Notes to the Consolidated Financial Statements.

Consolidated Statement of Cash Flows

(In Thousands of Dollars)

	Year Ended December 31, 2002	Year Ended December 31, 2001	Year Ended December 31, 2000
Operating Activities			
Earnings from continuing operations	**$ 397,350**	$ 243,692	$ 302,750
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation, depletion and amortization	**514,613**	559,138	330,922
Early retirement and severance accruals	**—**	—	65,175
Deferred income tax	**90,724**	108,955	46,453
Income from equity investments	**(14,096)**	(13,129)	(20,010)
Dividends from equity investments	**3,905**	7,570	21,507
Gain from class action settlement	**—**	(33,510)	—
Provision for losses on contracting business	**—**	63,682	—
Changes in assets and liabilities			
Accounts receivable	**(259,454)**	401,976	(800,033)
Materials and supplies, fuel oil and gas in storage	**54,174**	(43,856)	(36,952)
Accounts payable and other liabilities	**(19,745)**	(425,196)	452,076
Interest accrued	**22,661**	24,560	32,659
Other	**18,945**	(3,701)	44,179
Net Cash Provided by Operating Activities	**809,077**	890,181	438,726
Investing Activities			
Construction expenditures	**(1,133,877)**	(1,059,759)	(633,035)
Other investments	**(27,579)**	—	(292,222)
Acquisition of Eastern Enterprises and EnergyNorth, Inc.	**—**	—	(1,762,007)
Investment held for disposal	**—**	—	(184,036)
Proceeds from sale of assets	**175,110**	18,458	—
Other	**—**	(6)	(510)
Net Cash (Used in) Investing Activities	**(986,346)**	(1,041,307)	(2,871,810)
Financing Activities			
Treasury stock issued	**86,710**	88,786	72,289
Issuance of long-term debt	**549,280**	812,116	2,166,955
Payment of long-term debt	**(124,991)**	(183,410)	(68,365)
Issuance (payment) of commercial paper	**(132,753)**	(251,787)	935,372
Payment of preferred stock	**—**	—	(363,000)
Preferred stock dividends paid	**(5,753)**	(5,904)	(20,261)
Common stock dividends paid	**(250,903)**	(245,598)	(239,740)
Termination of interest rate swaps	**57,415**	—	(59,490)
Other	**9,629**	12,846	(35,949)
Net Cash Provided by Financing Activities	**188,634**	227,049	2,387,811
Net (Decrease) or Increase in Cash and Cash Equivalents	**$ 11,365**	$ 75,923	$ (45,273)
Cash and Cash Equivalents at Beginning of Period	**159,252**	83,329	128,602
Cash and Cash Equivalents at End of Period	**$ 170,617**	$ 159,252	$ 83,329
Interest Paid	**$ 318,374**	$ 328,910	$ 165,020
Income Tax Paid	**$ 98,344**	$ 128,558	$ 187,219

See accompanying Notes to the Consolidated Financial Statements.

Consolidated Statement of Retained Earnings

			(In Thousands of Dollars)
	Year Ended December 31, 2002	Year Ended December 31, 2001	Year Ended December 31, 2000
Balance at Beginning of Period	**$ 452,206**	$ 480,639	$ 456,882
Net Income for Period	**377,688**	224,254	300,807
	829,894	704,893	757,689
Deductions:			
Cash dividends declared on common stock	**252,175**	246,783	239,740
Cash dividends declared on preferred stock	**5,753**	5,904	20,298
MEDS Equity Units	**49,131**	—	—
Other, primarily write-off of capital stock expense	**—**	—	17,012
Balance at End of Period	**$ 522,835**	$ 452,206	$ 480,639

Consolidated Statement of Comprehensive Income

			(In Thousands of Dollars)
	Year Ended December 31, 2002	Year Ended December 31, 2001	Year Ended December 31, 2000
Net Income	**$ 377,688**	$ 224,254	$ 300,807
Other comprehensive income (loss), net of tax			
Net gains on derivative instruments	**(17,033)**	(27,690)	—
Reclassification adjustment for other gains reclassified to net income	—	(3,242)	—
Foreign currency translation adjustments	**9,759**	(9,627)	(7,320)
Unrealized gains (losses) on marketable securities	**(10,019)**	(5,464)	3,131
Accrued unfunded pension obligation	**(55,768)**	(13,262)	—
Unrealized (losses) gains on derivative financial instruments	**(39,845)**	62,943	—
Other comprehensive income (loss), net of tax	**(112,906)**	3,658	(4,189)
Comprehensive Income	**$ 264,782**	$ 227,912	$ 296,618
Related tax (benefit) expense			
Net gains on derivative instruments	**$ (9,172)**	$ (14,910)	$ —
Reclassification adjustment for other gains reclassified to net income	**—**	(1,746)	—
Foreign currency translation adjustments	**5,255**	(5,184)	(3,941)
Unrealized gains (losses) on marketable securities	**(5,395)**	(2,942)	1,686
Accrued unfunded pension obligation	**(30,029)**	(7,140)	—
Unrealized (losses) gains on derivative financial instruments	**(21,454)**	33,892	—
Total Tax (Benefit) Expense	**$ (60,795)**	$ 1,970	$ (2,255)

See accompanying Notes to the Consolidated Financial Statements.

Consolidated Statement of Capitalization

	Shares Issued		*(In Thousands of Dollars)*	
	December 31, 2002	December 31, 2001	**December 31, 2002**	December 31, 2001
Common Shareholders' Equity				
Common stock, $0.01 par Value	**158,837,654**	158,837,654	**$ 1,588**	$ 1,588
Premium on capital stock			**3,003,766**	2,994,209
Retained earnings			**522,835**	452,206
Other comprehensive income			**(108,423)**	4,483
Treasury stock	**16,412,880**	19,407,905	**(475,174)**	(561,884)
Total Common Shareholders' Equity	**142,424,774**	139,429,749	**2,944,592**	2,890,602
Preferred Stock – No Redemption Required				
Par Value $100 per share				
7.07% Series B – private placement	**553,000**	553,000	**55,300**	55,300
7.17% Series C – private placement	**197,000**	197,000	**19,700**	19,700
6.00% Series A – private placement	**88,486**	90,770	**8,849**	9,077
Total Preferred Stock – No Redemption Required			**83,849**	84,077
Long-Term Debt	**Interest Rate**	**Maturity**		
Notes				
Medium term notes	6.15% – 9.75%	2005 – 2030	**2,885,000**	2,885,000
Senior subordinated notes	8.63%	2008	**100,000**	100,000
Total Notes			**2,985,000**	2,985,000
Gas Facilities Revenue Bonds	Variable	2020	**125,000**	125,000
	5.50% – 6.95%	2020 – 2026	**523,500**	523,500
Total Gas Facilities Revenue Bonds			**648,500**	648,500
Promissory Notes to LIPA				
Debentures	8.20%	2023	**270,000**	270,000
Pollution control revenue bonds	5.15%	2016	**108,022**	108,022
Electric facilities revenue bonds	5.30% – 7.15%	2019 – 2025	**224,405**	224,405
Total Promissory Notes to LIPA			**602,427**	602,427
MEDS Equity Units	8.75%	2005	**460,000**	—
First Mortgage Bonds	5.50% – 10.10%	2003 – 2028	**163,625**	179,122
Authority Financing Notes	Variable	2027 – 2028	**66,005**	66,005
Other Subsidiary Debt			**304,298**	330,293
Capital Leases		2005 – 2022	**13,884**	15,192
Subtotal			**5,243,739**	4,826,539
Unamortized interest rate hedge and debt discount			**(75,265)**	(80,173)
Derivative impact on debt			**67,020**	(47,724)
Less: current maturities			**11,413**	993
Total Long-Term Debt			**5,224,081**	4,697,649
Total Capitalization			**$8,252,522**	$7,672,328

See accompanying Notes to the Consolidated Financial Statements.

Note 1. Summary of Significant Accounting Policies

A. Organization of the Company

KeySpan Corporation, a New York corporation, was formed in May 1998, as a result of the business combination of KeySpan Energy Corporation, the parent of The Brooklyn Union Gas Company, and certain businesses of the Long Island Lighting Company ("LILCO"). On November 8, 2000, KeySpan acquired Eastern Enterprises ("Eastern"), a Massachusetts business trust, and the parent of several gas utilities operating in Massachusetts. Also on November 8, 2000, Eastern acquired EnergyNorth, Inc. ("ENI"), the parent of a gas utility operating in central New Hampshire. KeySpan Corporation will be referred to in these notes to the Consolidated Financial Statements as "KeySpan", "we", "us" and "our."

Our core business is gas distribution, conducted by our six regulated gas utility subsidiaries: The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York ("KEDNY") and KeySpan Gas East Corporation d/b/a KeySpan Energy Delivery Long Island ("KEDLI") distribute gas to customers in the boroughs of Brooklyn, Staten Island and a portion of the borough of Queens in New York City, and the counties of Nassau and Suffolk on Long Island and the Rockaway Peninsula in Queens, respectively; Boston Gas Company, Colonial Gas Company and Essex Gas Company, each doing business as KeySpan Energy Delivery New England ("KEDNE"), distribute gas to customers in southern, eastern and central Massachusetts; and EnergyNorth Natural Gas, Inc., d/b/a KeySpan Energy Delivery New England distributes gas to customers in central New Hampshire. Together, these companies distribute gas to approximately 2.5 million customers throughout the Northeast.

We also own, lease and operate electric generating plants on Long Island and in New York City. Under contractual arrangements, we provide power, electric transmission and distribution services, billing and other customer services for approximately 1.1 million electric customers of the Long Island Power Authority ("LIPA").

Our other subsidiaries are involved in gas and oil exploration and production; gas storage; wholesale and retail gas and electric marketing; appliance service; heating, ventilation and air conditioning installation and services; large energy-system ownership, installation and management; and fiber optic services. We also invest in, and participate in the development of, pipelines and other energy-related projects, domestically and internationally. (See Note 2, "Business Segments" for additional information on each operating segment.)

We are a registered holding company under the Public Utility Holding Company Act of 1935 ("PUHCA"), as amended. Therefore, our corporate and financial activities and those of our subsidiaries, including their ability to pay dividends to us, are subject to regulation by the Securities and Exchange Commission ("SEC"). Under our holding company structure, we have no independent operations or source of income of our own and conduct all of our operations through our subsidiaries and, as a result, we depend on the earnings and cash flow of, and dividends or distributions from, our subsidiaries to provide the funds necessary to meet our debt and contractual obligations. Furthermore, a substantial portion of our consolidated assets, earnings and cash flow is derived from the operations of our regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation by state regulatory authorities.

B. Basis of Presentation

The Consolidated Financial Statements presented herein reflect the accounts of KeySpan and its subsidiaries. Most of our subsidiaries are fully consolidated in the financial information presented, except for certain subsidiary investments in the Energy Investments segment which are accounted for on the equity method as we do not have a controlling voting interest or otherwise have control over the management of such companies. All significant intercompany transactions have been eliminated.

As noted, on November 8, 2000, we completed the acquisitions of Eastern and ENI. The transactions have been accounted for using the purchase method of accounting for business combinations and accordingly the accompanying consolidated financial statements include the results of Eastern and ENI since the acquisition date.

The preparation of financial statements in conformity with Generally Accepted Accounting Principles ("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.

C. Accounting for the Effects of Rate Regulation

The accounting records for our six regulated gas utilities are maintained in accordance with the Uniform System of Accounts prescribed by the Public Service Commission of the State of New York ("NYPSC"), the New Hampshire Public Utility Commission ("NHPUC"), and the Massachusetts Department of Telecommunications and Energy ("DTE"). Our electric generation subsidiaries are not subject to state rate regulation, but they are subject to Federal Energy Regulatory Commission ("FERC") regulation. Our financial statements reflect the ratemaking policies and actions of these regulators in conformity with GAAP for rate-regulated enterprises.

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas Company and EnergyNorth Natural Gas, Inc.) and our Long Island based electric generation subsidiaries are subject to the provisions of Statement of Financial Accounting Standards ("SFAS") 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the ability of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies. Accordingly, we record these future economic benefits and obligations as Regulatory Assets and Regulatory Liabilities on the Consolidated Balance Sheet, respectively.

In separate merger related orders issued by the DTE, the base rates charged by Colonial Gas Company and Essex Gas Company have been frozen at their current levels for a ten-year period. Due to the length of these base rate freezes, the Colonial and Essex Gas Companies had previously discontinued the application of SFAS 71.

The following table presents our net regulatory assets at December 31, 2002 and December 31, 2001.

	(In Thousands of Dollars)	
	December 31,	
	2002	2001
Regulatory Assets:		
Regulatory tax asset	$53,401	$64,536
Property taxes	58,400	54,617
Environmental costs	182,163	183,716
Postretirement benefits other than pensions	82,563	84,238
Costs associated with the KeySpan/LILCO transaction	61,989	55,204
Derivative assets	—	15,880
Total Regulatory Assets	$438,516	$458,191
Regulatory Liabilities	(84,479)	(39,442)
Net Regulatory Assets	$354,037	$418,749

The regulatory assets above are not included in rate base. However, we record carrying charges on the property tax and costs associated with the KeySpan/LILCO transaction cost deferrals. We also record carrying charges on our regulatory liabilities. The remaining regulatory assets represent, primarily, costs for which expenditures have not yet been made, and therefore, carrying charges are not recorded. We anticipate recovering these costs in our gas rates concurrently with future cash expenditures. If recovery is not concurrent with the cash expenditures, we will record the appropriate level of carrying charges. Deferred gas costs of $61.8 million and $5.6 million at December 31, 2002 and December 31, 2001, respectively are reflected in Accounts Receivable on the Consolidated Balance Sheet. Deferred gas costs are subject to current recovery from customers.

We estimate that full recovery of our regulatory assets will not exceed 15 years, except for the regulatory tax asset, which will be recovered over the estimated lives of certain utility property.

Rate regulation is undergoing significant change as regulators and customers seek lower prices for utility service and greater competition among energy service providers. In the event that regulation significantly changes the opportunity to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of all or a portion of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101 "Regulated Enterprises - Accounting for the Discontinuation of Application of FASB Statement 71." We estimate that the write-off of all regulatory assets at December 31, 2002 could result in a charge to net income of $230.1 million or $1.63 per share, which would be classified as an extraordinary item. In management's opinion, our regulated subsidiaries that are currently subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

D. Revenues

Gas Distribution: Utility gas customers are billed monthly or bi-monthly on a cycle basis. Revenues include unbilled amounts related to the estimated gas usage that occurred from the most recent meter reading to the end of each month.

The cost of gas used is recovered when billed to firm customers through the operation of gas adjustment clauses ("GAC") included in utility tariffs. The GAC provision requires periodic reconciliation of recoverable gas costs and GAC revenues. Any difference is deferred pending recovery from or refund to firm customers. Further, net revenues from tariff gas balancing services, off-system sales and certain on-system interruptible sales are refunded, for the most part, to firm customers subject to certain sharing provisions.

The New York and Long Island gas utility tariffs contain weather normalization adjustments that largely offset shortfalls or excesses of firm net revenues (revenues less gas costs and revenue taxes) during a heating season due to variations from normal weather. Revenues are adjusted each month the clause is in effect and are generally included in rates in the following month. The New England gas utility rate structures contain no weather normalization feature, therefore their net revenues are subject to weather related demand fluctuations.

Electric Services: Electric revenues are derived from billings to LIPA for management of LIPA's transmission and distribution ("T&D") system, electric generation, and procurement of fuel. The agreements with LIPA include provisions for us to earn, in the aggregate, approximately $11.5 million per year (plus up to an additional $5 million per year if certain cost savings are achieved) in annual management service fees from LIPA for the management of the T&D system and the management of all aspects of fuel and power supply. Under a Management Service Agreement ("MSA") costs in excess of budgeted levels are assumed by us up to $15 million, while cost reductions in excess of $5 million from budgeted levels are shared with LIPA. These agreements also contain certain non-cost incentive and penalty provisions which could impact earnings. Rates billed to LIPA on a monthly basis include fixed and variable components. Billings related to transmission, distribution and delivery services are based, in part, on negotiated estimated levels.

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC have entered into 25 year Power Purchase Agreements with LIPA (the "PPAs"). 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 ("MW"). Under the PPAs, LIPA pays a monthly capacity fee, which guarantees full 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.

In addition, electric revenues are derived from our investment in the 2,200 megawatt Ravenswood electric generation facility ("Ravenswood facility"), which we acquired in June 1999. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for a description of the Ravenswood transaction.) We realize revenues from our investment in the Ravenswood facility through the sale, at wholesale, of energy, capacity, and ancillary services to the New York Independent System Operator ("NYISO"). Energy and ancillary services are sold through a bidding process into the NYISO energy markets on a day ahead or real time basis.

Energy Services: Revenues earned by our Energy Services segment for mechanical and other contracting services are generally recognized by the percentage-of-completion method. This method measures the percentage of costs incurred and accrued to date for each contract to the estimated total costs for each contract at completion. Provisions for estimated losses on uncompleted contracts are made in the period such losses are determined. Changes in job performance, job conditions and estimated profitability may result in revisions to cost and income, which are recognized in the period in which the revisions are determined. The percentage of completion method of accounting may result in situations where billings to customers are in excess of costs incurred to date. These excess billings are not recognized in income until the related costs have been incurred and the earnings process is complete. At December 31, 2002 and December 31, 2001 we had billings in excess of costs of $27.2 million and $53.6 million, respectively. These balances are included in Accounts Payable and Other Liabilities on the Consolidated Balance Sheet and are expected to be included in income within one year.

Energy service and maintenance revenues are recognized as earned or over the life of the service contract, as appropriate. Energy sales made by our electric and gas marketing subsidiary are recorded upon delivery of the related commodity. Fiber optic service revenue is recognized upon delivery of service access. We have unearned revenue recorded in Deferred Credits and Other Liabilities - Other on the Consolidated Balance Sheet totaling $19.2 million and $18.0 million for the years ended December 31, 2002 and December 31, 2001, respectively. These balances represent unearned revenues for service contracts and leases on our fiber optic cables. The unearned revenues from the service contracts are generally amortized to income within one year, while the lease related unearned revenues are amortized over periods ranging from seven to 30 years.

Gas Exploration and Production: Natural gas and oil revenues earned by our gas exploration and production activities is recognized using the entitlements method of accounting. Under this method of accounting, income is recorded based on the net revenue interest in production or nominated deliveries. Production gas volume imbalances are incurred in the ordinary course of business. Net deliveries in excess of entitled amounts are recorded as liabilities, while net under deliveries are recorded as assets. Imbalances are reduced either by subsequent recoupment of over and under deliveries or by cash settlement, as required by applicable contracts. Production imbalances are mark-to-market at the end of each month using the market price at the end of each period.

E. Utility and Other Property — Depreciation and Maintenance

Property, principally utility gas property, is stated at original cost of construction, which includes allocations of overheads, including taxes, and an allowance for funds used during construction. The rates at which KeySpan subsidiaries capitalized interest for years ended December 31, 2000 through 2002 ranged from 3.44% to 10.67%. Capitalized interest for 2002, 2001 and 2000 was $19.7 million, $8.5 million and $2.7 million, respectively.

Depreciation is provided on a straight-line basis in amounts equivalent to composite rates on average depreciable property. 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. The composite rates on average depreciable property were as follows:

	Year Ended December 31,		
	2002	2001	2000
Electric	3.88%	3.78%	3.68%
Gas	3.44%	3.40%	3.51%

We also had $394.4 million of other property at December 31, 2002, which is not recovered under rate orders. This property consists of assets held primarily by our Corporate Services subsidiary of $312.6 million and $81.8 million in Energy Services assets. The Corporate Services assets consist largely of land, buildings, office equipment and furniture, vehicles, computer and telecommunications equipment and systems. These assets have depreciable lives ranging from three to 40 years. Energy Services assets consist largely of construction equipment and fiber optic cable and related electronics and have service lives ranging from seven to 40 years.

KeySpan's repair and maintenance costs, including planned major maintenance in the Electric Services segment for turbine and generator overhauls, are expensed as incurred. Planned major maintenance cycles primarily range from seven to eight years. Smaller periodic overhauls are performed approximately every 18 months.

F. Gas Exploration and Production Property — Depletion

At December 31, 2002, we had exploration and production property in the amount of $2.4 billion related to our investments in natural gas and oil properties. These assets are accounted for under the full cost method of accounting. Under the full cost method, costs of acquisition, exploration and development of natural gas and oil reserves are capitalized into a "full cost pool" as incurred. Unproved properties and related costs are excluded from the amortization base until a determination as to the existence of proved reserves. Properties are depleted and charged to operations using the unit of production method using proved reserve quantities.

These investments consist of our ownership interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company, as well as KeySpan Exploration and Production, LLC, our wholly-owned subsidiary engaged in a joint venture with Houston Exploration. On February 26, 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 56% following the repurchase, by Houston Exploration, of 3 million shares of stock owned by KeySpan. To the extent that such capitalized costs (net of accumulated depletion) less deferred taxes exceed the present value (using a 10% discount rate) of estimated future net cash flows from proved natural gas and oil reserves and the lower of cost or fair value of unproved properties, less deferred taxes, such excess costs are charged to operations. If an impairment is required, it would result in a charge to earnings but would not have an impact on cash flows. Once incurred, such impairment of gas properties is not reversible at a later date even if gas prices increase.

...e ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, held flat over the life of the reserves. We use derivative financial instruments that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities", to hedge the volatility of natural gas prices. In accordance with current SEC guidelines, we have included estimated future cash flows from our hedging program in the ceiling test calculation. As of December 31, 2002, we estimated, using a wellhead price of $4.99 per mcf, that our capitalized costs did not exceed the ceiling test limitation.

In calculating the ceiling test at December 31, 2001, we estimated, using a wellhead price of $2.38 per mcf, that our capitalized costs exceeded the ceiling limitation. As a result, in the fourth quarter of 2001, we recorded a $42.0 million impairment charge to write down our gas exploration and production assets, and recorded this charge in Depreciation, Depletion and Amortization on the Consolidated Statement of Income. Our share of the impairment charge was $26.2 million after-tax, or $0.19 per share.

Natural gas prices continue to be volatile and the risk that we will be required to write down our full cost pool increases when, among other things, natural gas prices are depressed, we have significant downward revisions in our estimated proved reserves or we have unsuccessful drilling results.

Houston Exploration capitalizes interest related to its unevaluated natural gas and oil properties, as well as some properties under development which are not currently being amortized. For years ended December 31, 2002, 2001 and 2000, capitalized interest was $8.0 million, $12.0 million and $13.7 million, respectively.

G. Goodwill

At December 31, 2002 and 2001, the balance of goodwill was $1.8 billion, representing the excess of acquisition cost over the fair value of net assets acquired. Our recorded goodwill, net of accumulated amortization, consists of $1.5 billion related to the Eastern and ENI acquisitions, $156 million related to the KeySpan/LILCO transaction, and 76 million related to the acquisitions of energy-related service companies and to certain ownership interests of 50% or less in energy-related investments in Northern Ireland which are accounted for under equity method.

On January 1, 2002, KeySpan adopted SFAS 142 "Goodwill and Intangible Assets". Under SFAS 142, among other things, good-... no longer required to be amortized and is to be tested for impair-... t least annually. The initial impairment test was to be performed ...ix months of adopting SFAS 142 using a discounted cash flow ... compared to an undiscounted cash flow method allowed ...revious standard. Any amounts impaired using data as of ... 2002, was to be recorded as a "Cumulative Effect of an ... Change". Any amounts impaired using data after the initial ...ate will be recorded as an operating expense. During the ...ter of 2002, we completed our initial impairment analysis ...porting units and determined that no consolidated impair-... Also, in the fourth quarter of 2002, KeySpan updated ...e carrying value of goodwill compared to the fair value ...

earnings available for common stockholders for the years ended December 31, 2002, 2001 and 2000 and pro-forma net income, fo... same periods, adjusted for the discontinuance of goodwill amortizati...

(In Thousands of Dollars, Except for Per Share Amou...			
	Year Ended December 31,		
	2002	2001	2000
Earnings for common stockholders	$371,935	$218,350	$282,694
Add back: goodwill amortization*	—	49,550	19,690
Adjusted net income	$371,935	$267,900	$302,384
Basic earnings per share	$ 2.63	$ 1.58	$ 2.10
Add back: goodwill amortization	—	0.36	0.15
Adjusted basic earnings per share	$ 2.63	$ 1.94	$ 2.25
Diluted earnings per share	$ 2.61	$ 1.56	$ 2.09
Add back: goodwill amortization	—	0.36	0.15
Adjusted diluted earnings per share	$ 2.61	$ 1.92	$ 2.24

* *Excludes the write-off of $12.4 million of goodwill in 2001 associated with the Roy Kay Operations.*

For the twelve months ended December 31, 2001 and 2000, respectively, goodwill amortization was recorded in each segment as follows: Gas Distribution $35.6 and $5.9 million; Energy Services $8.2 and $7.6 million; and Energy Investments and other $5.8 and $6.2 million. The increase in amortization expense in 2001 versus 2000 primarily reflects the acquisition of Eastern and ENI in November 2000.

Prior to implementation of SFAS 142, goodwill was reviewed for impairment under SFAS 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of". Under SFAS 121, the carrying value of goodwill is reviewed if the facts and circumstances, such as significant declines in sales, earnings or cash flows, or material adverse changes in the business climate, suggest it might be impaired. If this review indicates that goodwill is not recoverable, as determined based upon the estimated undiscounted cash flows of the entity acquired, impairment would be measured by comparing the carrying value of the investment in such entity to its fair value. Fair value would be determined based on quoted market values, appraisals, or discounted cash flows. For the year ended December 31, 2001, we reviewed the facts and circumstances for the entities carrying goodwill and as a result of the above procedures, wrote off $12.4 million associated with the Roy Kay Companies upon determination that the asset was not recoverable. (See Note 10, "Roy Kay Operations" for additional information.)

H. Hedging and Derivative Financial Instruments

From time to time, we employ derivative instruments to hedge a portion of our exposure to commodity price risk and interest rate risk, as well as to hedge cash flow variability associated with a portion of our peak electric energy sales. Whenever hedge positions are in effect, we are exposed to credit risk in the event of nonperformance by counter-parties to derivative contracts, as well as nonperformance by the counter-parties of the transactions against which they are hedged. We believe that the credit risk related to the futures, options and

do not qualify as energy trading contracts as defined by current accounting literature.

Financially-Settled Commodity Derivative Instruments: We employ derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with forecasted purchases and sales of various energy-forecasted commodities. All such derivative instruments are accounted for pursuant to the requirements of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS 138, "Accounting for Certain Derivative Instruments and Hedging Activities" (collectively, "SFAS 133"). With respect to those commodity derivative instruments that are designated and accounted for as cash flow hedges, the effective portion of periodic changes in the fair market value of cash flow hedges is recorded as Other Comprehensive Income on the Consolidated Balance Sheet, while the ineffective portion of such changes in fair value is recognized in earnings. Gains and losses (on such cash flow hedges) that are recorded as Other Comprehensive Income are subsequently reclassified into earnings concurrent with when hedged transactions impact earnings. With respect to those commodity derivative instruments that are not designated as hedging instruments, such derivatives are accounted for on the Consolidated Balance Sheet at fair value, with all changes in fair value reported in earnings.

Firm Gas Sales Derivatives Instruments — Regulated Utilities: We utilize derivative financial instruments to reduce cash flow variability associated with the purchase price for a portion of our future natural gas purchases. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New Hampshire service territories. Since these derivative instruments are being employed to support our gas sales prices to regulated firm gas sales customers, the accounting for these derivative instruments is subject to SFAS 71. Therefore, changes in the market value of these derivatives are recorded as a Regulatory Asset or Regulatory Liability on our Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers during the appropriate winter heating season consistent with regulatory requirements.

Physically-Settled Commodity Derivative Instruments: Upon our implementation of Derivative Implementation Group ("DIG") Issue C16 on April 1, 2002, certain of our contracts for the physical purchase of natural gas were assessed as no longer being exempt from the requirements of SFAS 133 as normal purchases. As such, these contracts are recorded on the Consolidated Balance Sheet at fair market value. However, since such contracts were executed for the purchases of natural gas that is sold to regulated firm gas sales customers, and pursuant to the requirements of SFAS 71, changes in the fair market value of these contracts are recorded as a Regulatory Asset or Regulatory Liability on the Consolidated Balance Sheet.

Weather Derivatives: The utility tariffs associated with our New England gas distribution operations do not contain a weather normalization adjustment. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate the effect of fluctuations from normal weather on our financial position and cash flows, we may enter into derivative instruments from time to time. Based on the terms of the contracts, we account for these instruments pursuant to the requirements of EITF 99-2 "Accounting for Weather Derivatives." In this regard, we account for weather derivatives using the "intrinsic value method" as set forth in such guidance.

Interest Rate Derivative Instruments: We continually assess the cost relationship between fixed and variable rate debt. Consistent with our objective to minimize capital costs, we periodically enter into hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable or variable to fixed. Payments made or received on these derivative contracts are recognized as an adjustment to interest expense as incurred. Hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable are designated and accounted for as fair-value hedges pursuant to the requirements of SFAS 133. Hedging transactions that effectively convert the terms of underlying debt obligations from variable to fixed are considered cash flow hedges.

I. Equity Investments

Certain subsidiaries own as their principal assets, investments (including goodwill) representing ownership interests of 50% or less in energy-related businesses that are accounted for under the equity method. None of these investments are publicly traded.

J. Income and Excise Tax

In accordance with SFAS 109, "Accounting for Income Taxes" and applicable rate regulation, certain of our regulated subsidiaries record a regulatory asset for the net cumulative effect of providing deferred income taxes on all differences between the financial statement carrying amounts of existing assets and liabilities, and their respective tax basis. Investment tax credits, which were available prior to the Tax Reform Act of 1986, were deferred and generally amortized as a reduction of income tax over the estimated lives of the related property.

We report our collections and payments of excise taxes on a gross basis. Gas distribution revenues include the collection of excise taxes, while operating taxes include the related expense. For the years ended December 31, 2002, 2001 and 2000, excise taxes collected and paid were $98.2 million, $119.1 million and $117.8 million, respectively.

K. Subsidiary Common Stock Issuances to Third Parties

We follow an accounting policy of income statement recognition for parent company gains or losses from issuances of common stock by subsidiaries to unaffiliated third parties.

L. Foreign Currency Translation

We follow the principles of SFAS 52, "Foreign Currency Translation," for recording our investments in foreign affiliates. Under this statement, all elements of the financial statements are translated by using a current exchange rate. Translation adjustments result from changes in exchange rates from one reporting period to another. At December 31, 2002, the foreign currency translation adjustment was included in Other Comprehensive Income on the Consolidated Balance Sheet. The functional currency for our foreign affiliates is their local currency.

M. Earnings Per Share

Basic earnings per share ("EPS") is calculated by dividing earnings for common stock by the weighted average number of shares of common stock outstanding during the period. No dilution for any potentially dilutive securities is included. Diluted EPS assumes the conversion of all potentially dilutive securities and is calculated by dividing earnings for common stock, as adjusted, by the sum of the weighted average number of shares of common stock outstanding plus all potentially dilutive securities.

At December 31, 2002 we have approximately 2.1 million options outstanding to purchase KeySpan common stock that were not used in the calculation of diluted EPS since the exercise price associated with these options was greater than the average per share market price of KeySpan's common stock. Further, we have 88,486 shares of convertible preferred stock outstanding that can be converted into 228,406 shares of common stock. These shares were not included in the calculation of diluted EPS for the years ending December 31, 2001 and 2000, since to do so would have been anti-dilutive.

Under the requirements of SFAS 128, "Earnings Per Share" our basic and diluted EPS are as follows:

	(In Thousands of Dollars, Except Per Share Amounts)		
	Year Ended December 31,		
	2002	2001	2000
Earnings for common stock	$371,935	$218,350	$282,694
Houston Exploration dilution	(471)	(1,116)	(725)
Preferred stock dividend	531	—	—
Earnings for common stock – adjusted	$371,995	$217,234	$281,969
Weighted average shares outstanding (000)	141,263	138,214	134,357
Add dilutive securities:			
Options	809	1,007	808
Convertible preferred stock	228	—	—
Total weighted average shares outstanding - assuming dilution	142,300	139,221	135,165
Basic earnings per share	$ 2.63	$ 1.58	$ 2.10
Diluted earnings per share	$ 2.61	$ 1.56	$ 2.09

N. Stock Options

We issue stock options to all KeySpan officers and certain other management employees as approved by the Board of Directors. These options generally vest over a three-to-five year period and have a ten-year exercise period. Up to approximately 19.3 million shares have been authorized for the issuance of options and approximately 6.7 million of these shares were remaining at December 31, 2002. Moreover, under a separate plan, Houston Exploration has issued approximately 2.4 million stock options to key Houston Exploration employees. During 2002, we announced our intention to record stock options as a compensation expense beginning with those options granted in 2003. KeySpan and Houston Exploration have adopted the prospective method of transition in accordance with SFAS 148 "Accounting for Stock-Based Compensation - Transition and Disclosure". Accordingly, compensation expense will be recognized by employing the fair value recognition provisions of SFAS 123, "Accounting for Stock-Based Compensation" for grants awarded after January 1, 2003.

KeySpan and Houston Exploration will continue to apply APB Opinion 25, "Accounting for Stock Issued to Employees," and related Interpretations in accounting for grants awarded prior to January 1, 2003. Accordingly, no compensation cost has been recognized for these fixed stock option plans in the Consolidated Financial Statements since the exercise prices and market values were equal on the grant dates. Had compensation cost for these plans been determined based on the fair value at the grant dates for awards under the plans consistent with SFAS 123, our net income and earnings per share would have decreased to the pro-forma amounts indicated below:

	(In Thousands of Dollars, Except Per Share Amounts)		
	Year Ended December 31,		
	2002	2001	2000
Earnings available for common stock:			
As reported	$371,935	$218,350	$282,694
Add: recorded stock-based compensation expense, net of tax	221	261	195
Deduct: total stock-based compensation expense, net of tax	(7,547)	(8,459)	(6,835)
Pro-forma earnings	$364,609	$210,152	$276,054
Earnings per share:			
Basic – as reported	$ 2.63	$ 1.58	$ 2.10
Basic – pro-forma	$ 2.58	$ 1.52	$ 2.05
Diluted – as reported	$ 2.61	$ 1.56	$ 2.09
Diluted – pro-forma	$ 2.56	$ 1.50	$ 2.04

All grants are estimated on the date of the grant using the Black-Scholes option-pricing model. The following table presents the weighted average fair value, exercise price and assumptions used for the periods indicated:

	Year Ended December 31,		
	2002	2001	2000
Fair value of grants issued	$3.42	$5.29	$2.87
Dividend yield	5.36%	4.91%	8.22%
Expected volatility	22.47%	29.04%	24.00%
Risk free rate	4.94%	5.13%	6.54%
Expected lives	10 years	10 years	6 years
Exercise price	$32.66	$39.50	$22.69

A summary of the status of our fixed stock option plans and changes is presented below for the periods indicated:

	Year Ended December 31,					
	2002		2001		2000	
Fixed Options	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of period	7,796,162	$29.67	6,456,627	$25.61	4,968,398	$28.81
Granted during the year	2,796,310	$32.66	2,285,350	$39.50	3,165,822	$22.69
Exercised	(506,794)	$24.42	(809,983)	$25.15	(1,577,259)	$27.82
Forfeited	(560,778)	$30.99	(135,832)	$29.19	(100,334)	$26.04
Outstanding at end of period	9,524,900	$30.74	7,796,162	$29.67	6,456,627	$25.61
Exercisable at end of period	4,105,999	$27.69	2,996,771	$24.86	2,759,599	$29.57

Remaining Contractual Life	Options Outstanding at December 31, 2002	Weighted Average Exercise Price	Range of Exercise price	Options Exercisable at December 31, 2002	Weighted Average Exercise Price	Range of Exercise Price
2 years	2,644	$13.76	$13.76	2,644	$13.76	$13.76
3 years	30,138	$25.98	$14.86 - 27.00	30,138	$25.98	$14.86 - 27.00
4 years	226,086	$30.43	$20.57 - 32.63	226,086	$30.43	$20.57 - 32.63
5 years	304,410	$32.56	$19.15 - 32.63	304,410	$32.56	$19.15 - 32.63
6 years	1,457,104	$27.78	$24.73 - 29.38	1,457,104	$27.78	$24.73 - 29.38
7 years	717,314	$26.82	$21.99 - 27.06	717,314	$26.82	$21.99 - 27.06
8 years	2,048,335	$22.71	$22.50 - 32.76	1,019,117	$22.71	$22.50 - 32.76
9 years	2,068,928	$39.50	$39.50	349,186	$39.50	$39.50
10 years	2,669,941	$32.66	$32.66	—	$32.66	$32.66
	9,524,900			4,105,999		

In early 2003, KeySpan's Board of Directors approved a modification to the Long-Term Incentive Compensation Plan and its application to officers of KeySpan. During 2003, long-term incentive compensation for officers will consist of 50% stock options and 50% performance shares. Performance shares will be awarded based upon the attainment of overall corporate performance goals and will better align incentive compensation with overall corporate performance. During 2002, and in prior years, the majority of long-term incentive compensation awards were stock option grants with a limited amount of restricted stock award grants.

O. Recent Accounting Pronouncements

On January 1, 2002, we adopted SFAS 141, "Business Combinations", and SFAS 142 "Goodwill and Other Intangible Assets". The key concepts from the two interrelated Statements include mandatory use of the purchase method when accounting for business combinations, discontinuance of goodwill amortization, a revised framework for testing goodwill impairment at a "reporting unit" level and new criteria for the identification and potential amortization of other intangible assets. Other changes to existing accounting standards involve the amount of goodwill to be used in determining the gain or loss on the disposal of assets and a requirement to test goodwill for impairment at least annually. See Item G "Goodwill" for a discussion of goodwill impairment testing.

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS 143, "Accounting for Asset Retirement Obligations." SFAS 143 requires an entity to record a liability and corresponding asset representing the present value of legal obligations associated with the retirement of tangible, long-lived assets. SFAS 143 was effective for fiscal years beginning after June 2002.

KeySpan has completed its assessment of SFAS 143. At December 31, 2002, we estimate that the present value of our future Asset Retirement Obligation ("ARO") is approximately $57 million, primarily related to our investment in Houston Exploration. We estimate that the cumulative effect of SFAS 143 and the change in accounting principle will be a benefit to net income of $49.5 million, or $32.2 million after-tax. KeySpan's largest asset base is its gas transmission and distribution system. A legal obligation may be construed to exist due to certain safety requirements at final abandonment. In addition, a legal obligation may be construed to exist with respect to KeySpan's liquefied natural gas ("LNG") storage tanks due to clean up responsibilities upon cessation of use. However, mass assets such as storage, transmission and distribution assets are believed to operate in perpetuity and, therefore, have indeterminate cash flow estimates. Since that exposure is in perpetuity and cannot be measured, no liability will be recorded. KeySpan's ARO will be re-evaluated in future periods until sufficient information exists to determine a reasonable estimate of fair value.

SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", was effective January 1, 2002, and addresses accounting and reporting for the impairment or disposal of long-lived assets. SFAS 144 supersedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" and APB Opinion No. 30, "Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business". SFAS 144 retains the fundamental provisions of SFAS 121 and expands the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. For 2002, implementation of this Statement did not have a significant effect on our results of operations and financial position.

In June of 2002, the FASB issued SFAS 146, "Accounting for Costs Associated with Exit or Disposal Activities". This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity". This Statement is effective for exit or disposal activities initiated after December 31, 2002, with early application encouraged.

In December of 2002, the FASB issued SFAS 148, "Accounting for Stock-Based Compensation-Transition and Disclosure", which amends SFAS 123, "Accounting for Stock-Based Compensation". This Statement provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. See Item N "Stock Options" for these disclosures. The transition guidance and annual disclosure provisions of SFAS 148 are effective for fiscal years ending after December 15, 2002, with earlier application permitted in certain circumstances. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002.

The recognition provisions of this Statement allow for three alternative methods of recognizing stock-based employee compensation expense. KeySpan has elected to follow the prospective method of recognizing an expense for all employee awards granted or modified after January 1, 2003. The expense associated with implementation of this method is not expected to be material in 2003.

In November 2002, the FASB issued FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 requires the guarantor to recognize a liability for the non-contingent component of a guarantee; that is, the obligation to stand ready to perform in the event that specified triggering events or conditions occur. The initial measurement of this liability is the fair value of the guarantee at inception. The recognition of the liability is required even if it is not probable that payments will be required under the guarantee or if the guarantee was issued with a premium payment or as part of a transaction with multiple elements. FIN 45 also requires additional disclosures related to guarantees (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for a description of KeySpan's outstanding guarantees). The disclosure requirements are effective for interim and annual financial statements for periods ending after December 15, 2002. The recognition and measurement provisions of FIN 45 are effective for all guarantees entered into or modified after December 31, 2002. We currently do not anticipate that implementation of this Statement will have a significant effect on our results of operations and financial condition.

In January 2003, the FASB issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. We currently have an arrangement with a variable interest entity through which we lease a portion of the Ravenswood facility (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for a description of the Ravenswood transaction).

Note 2. Business Segments

We have four reportable segments: Gas Distribution, Electric Services, Energy Services and Energy Investments.

The Gas Distribution segment consists of our six gas distribution subsidiaries. KEDNY provides gas distribution services to customers in the New York City boroughs of Brooklyn, Staten Island and a portion of the borough of Queens. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. The remaining gas distribution subsidiaries, collectively doing business as KEDNE, provide gas distribution service to customers in Massachusetts and New Hampshire.

The Electric Services segment consists of subsidiaries that: operate the electric transmission and distribution system owned by LIPA; own and provide capacity to and produce energy for LIPA from our generating facilities located on Long Island; and manage fuel supplies for LIPA to fuel our Long Island generating facilities. These services are provided in accordance with long-term service contracts having remaining terms that range from four to twelve years. The Electric Services segment also includes subsidiaries that own, lease and operate the 2,200 megawatt Ravenswood electric generation facility located in Queens, New York. All of the energy, capacity and ancillary services related to the Ravenswood facility is sold to the NYISO energy markets. Further, two 79.9 megawatt generating facilities located on Long Island were placed into service in June and July 2002. The capacity of and energy from these facilities are dedicated to LIPA under 25 year contracts.

The Energy Services segment includes companies that provide energy-related services to customers primarily located within the New York City metropolitan area including New Jersey and Connecticut, as well as Rhode Island, Pennsylvania, Massachusetts and New Hampshire, through the following three lines of business: (i) Home Energy Services, which provides residential customers with service and maintenance of energy systems and appliances, as well as the retail marketing of natural gas and electricity to residential and small commercial customers; (ii) Business Solutions, which provides plumbing, heating, ventilation, air conditioning and mechanical contracting services, as well as operation and maintenance, design, engineering and consulting services to commercial, institutional and industrial customers; and (iii) Fiber Optic Services, which provides various services to carriers of voice and data transmission on Long Island and in New York City.

The Energy Investments segment consists of our gas exploration and production investments, as well as certain other domestic and international energy-related investments. Our gas exploration and production subsidiaries are engaged in gas and oil exploration and production, and the development and acquisition of domestic natural gas and oil properties. These investments consist of our ownership interest in Houston Exploration, an independent natural gas and oil exploration company, as well as KeySpan Exploration and Production, LLC, our wholly-owned subsidiary engaged in a joint venture with Houston Exploration. As previously mentioned, on February 26, 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 56% following the repurchase, by Houston Exploration, of 3 million shares of stock owned by KeySpan. We realized $79 million in connection with this repurchase. Additionally there is an over-allotment option for 300,000 shares, which if exercised, would further reduce our ownership in Houston Exploration to 55%. Subsidiaries in this segment also hold a 20% equity interest in the Iroquois Gas Transmission System LP, a pipeline that transports Canadian gas supply to markets in the Northeastern United States; a 50% interest in the Premier Transmission Pipeline and a 24.5% interest in Phoenix Natural Gas, both in Northern Ireland; and investments in certain midstream natural gas assets in Western Canada through KeySpan Canada. With the exception of our gas exploration and production subsidiaries and KeySpan Canada, which are consolidated in our financial statements, these subsidiaries are accounted for under the equity method. Accordingly, equity income from these investments is reflected in Other Income and (Deductions) in the Consolidated Statement of Income.

The accounting policies of the segments are the same as those used for the preparation of the Consolidated Financial Statements. Our segments are strategic business units that are managed separately because of their different operating and regulatory environments. Operating results of our segments are evaluated by management on an earnings before interest and taxes ("EBIT") basis. To reflect a complete picture of the electric operations, we reclassified, for all periods presented, KeySpan Energy Supply from the Energy Services segment to the Electric Services segment. This subsidiary provides commodity management and procurement services for fuel supply and management of energy sales, primarily for and from the Ravenswood facility. Due to the July 2002 sale of Midland Enterprises LLC, an inland marine barge business, this subsidiary is reported as discontinued operations for all periods presented. See Note 9 "Discontinued Operations" for information on the sale of Midland.

The reportable segment information below is shown excluding the operations of Midland:

(In Thousands of Dollars)

	Year Ended December 31, 2002						
	Gas Distribution	Electric Services	Energy Services	Gas Exploration and Production	Other Investments	Eliminations	Consolidated
Unaffiliated revenue	3,163,761	1,421,043	938,761	357,451	89,650	—	5,970,666
Intersegment revenue	—	100	—	—	1,128	(1,228)	—
Depreciation, depletion and amortization	237,186	61,377	9,522	176,925	14,573	15,030	514,613
Income from equity investments	—	—	—	—	13,992	104	14,096
Interest income	2,020	1,834	1,248	—	238	(3,768)	1,572
Earnings before interest and income taxes	524,311	309,663	(10,377)	95,494	32,771	(27,614)	924,248
Interest charges	215,140	57,589	19,386	7,303	6,858	(4,772)	301,504
Total assets	7,452,583	1,739,928	497,269	1,187,425	974,409	762,692	12,614,306
Equity method investments	—	—	—	—	130,815	—	130,815
Construction expenditures	407,679	371,885	14,316	275,524	48,962	15,511	1,133,877

Eliminating items include intercompany interest income and expense, the elimination of certain intercompany accounts, as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.4 billion for the year ended December 31, 2002, represents approximately 24% of our consolidated revenues during that period.

(In Thousands of Dollars)

	Year Ended December 31, 2001						
	Gas Distribution	Electric Services	Energy Services	Gas Exploration and Production	Other Investments	Eliminations	Consolidated
Unaffiliated revenue	3,613,551	1,421,079	1,100,167	400,031	98,287	—	6,633,115
Intersegment revenue	—	100	—	—	—	(100)	—
Depreciation, depletion and amortization	253,523	52,284	33,636	184,717	15,737	19,241	559,138
Income from equity investments	—	—	—	—	13,129	—	13,129
Interest income	3,879	433	3,185		334	495	8,326
Earnings before interest and income taxes	492,362	283,533	(143,492)	119,933	21,544	33,975	807,855
Interest charges	219,307	46,842	21,106	2,993	9,772	53,450	353,470
Total assets	6,994,140	1,677,710	550,891	951,135	797,294	818,436	11,789,606
Equity method investments	—	—	—	—	107,069	—	107,069
Construction expenditures	384,323	211,816	17,134	385,463	52,513	8,510	1,059,759

Eliminating items include intercompany interest income and, expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.4 billion for the year ended December 31, 2001 represents approximately 21% of our consolidated revenues during that period.

							(In Thousands of Dollars)
	Year Ended December 31, 2000						
	Gas Distribution	Electric Services	Energy Services	Gas Exploration and Production	Other Investments	Eliminations	Consolidated
Unaffiliated revenue	2,555,785	1,444,711	770,110	274,209	35,258	629	5,080,702
Intersegment revenue	—	1,175	—	—	—	(1,175)	—
Depreciation, depletion and amortization	143,335	49,278	10,347	95,364	6,586	26,012	330,922
Income from equity investments	—	—	—	—	20,010	—	20,010
Interest income	3,951	2,180	—	—	6,134	62	12,327
Earnings before interest and income taxes	367,226	310,823	14,630	111,672	20,014	(103,039)	721,326
Interest charges	111,176	24,254	125	11,360	7,636	46,763	201,314
Total assets	7,286,138	1,871,323	755,506	830,170	683,399	(119,071)	11,307,465
Equity method investments	—	—	—	—	109,751	3,387	113,138
Construction expenditures	274,941	69,921	17,362	243,799	26,388	624	633,035

Eliminating items include intercompany interest income and, expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA, Consolidated Edison and the NYISO of $1.4 billion for the year ended December 31, 2000 represents approximately 28% of our consolidated revenues during that period.

Note 3. Income Tax

We file a consolidated federal income tax return. A tax sharing agreement between our holding company and its subsidiaries provides for the allocation of a realized tax liability or benefit based upon separate return contributions of each subsidiary to the consolidated taxable income or loss in the consolidated income tax returns. The subsidiaries record income tax payable or receivable from KeySpan resulting from the inclusion of their taxable income or loss in the consolidated return.

Income tax expense is reflected as follows in the Consolidated Statement of Income:

			(In Thousands of Dollars)
	Year Ended December 31,		
	2002	2001	2000
Current income tax	$(48,487)	$101,738	$170,809
Deferred income tax	273,881	108,955	46,453
Total income tax	$225,394	$210,693	$217,262

The components of deferred tax assets and (liabilities) reflected in the Consolidated Balance Sheet are as follows:

		(In Thousands of Dollars)
	December 31,	
	2002	2001
Reserves not currently deductible	$ 38,275	$ 55,372
Benefits of tax loss carry forwards	(13,997)	6,346
Property related differences	(818,116)	(498,726)
Regulatory tax asset	(18,690)	(22,588)
Property taxes	(52,339)	(61,126)
Discontinued operations	—	(74,936)
Other items - net	(12,146)	(2,414)
Net deferred tax liability	$ (877,013)	$ (598,072)

During the year ended December 31, 2002, an adjustment to deferred income taxes of $177.7 million was recorded to reflect a decrease in the tax basis of the assets acquired at the time of the KeySpan/LILCO combination. This adjustment resulted from a revised valuation study and the preparation of amended tax returns. Concurrent with this deferred tax adjustment, KeySpan reduced current income taxes payable by $183.2 million, resulting in a net $5.5 million income tax benefit. Currently, the Internal Revenue Service is auditing KeySpan's tax returns pertaining to the KeySpan/LILCO combination, as well as other return years. At this time, we cannot predict the outcome of the ongoing audit.

The following is a reconciliation between the effective tax rate and the federal income tax rate of 35%:

			(In Thousands of Dollars)
	Year Ended December 31,		
	2002	2001	2000
Computed at the statutory rate	$217,960	$159,035	$182,004
Adjustments related to:			
Tax credits	(1,026)	(1,100)	(1,181)
Removal costs	(4,787)	(1,470)	(2,788)
Accrual to return adjustment	(9,539)	2,354	(508)
Goodwill amortization	—	21,126	4,123
Minority interest in Houston Exploration	9,490	13,862	8,768
State income tax	30,370	26,418	30,384
Other items - net	(17,074)	(9,532)	(3,540)
Total income tax	$225,394	$210,693	$217,262
Effective income tax (1)	36%	46%	42%

(1) Reflects both federal as well as state income taxes.

Note 4. Postretirement Benefits

Pension Plans: The following information represents the consolidated results for our noncontributory defined benefit pension plans which cover substantially all employees. Benefits are based on years of service and compensation. Funding for pensions is in accordance with requirements of federal law and regulations. KEDLI is subject to certain deferral accounting requirements mandated by the NYPSC for pension costs and other postretirement benefit costs.

Boston Gas Company is also subject to deferral accounting requirements, as previously ordered by the DTE, for other postretirement benefit costs. In addition, by DTE approval dated January 28, 2003, Boston Gas Company will defer for the year 2003, and record as either a regulatory asset or regulatory liability, the difference between the level of pension expense that is included in rates charged to gas customers and the actuarial determined amounts. Information pertaining to discontinued operations has been excluded from this presentation.

The calculation of net periodic pension cost is as follows:

	(In Thousands of Dollars)		
	Year Ended December 31,		
	2002	2001	2000
Service cost, benefits earned during the period	$ 42,423	$ 41,162	$ 35,541
Interest cost on projected benefit obligation	132,424	128,481	109,231
Expected return on plan assets	(157,958)	(180,757)	(166,744)
Special termination charge (1)	—	—	45,838
Settlement gain (2)	—	—	(20,196)
Net amortization and deferral	(4,247)	(39,772)	(54,881)
Total pension (benefit) cost	$ 12,642	$ (50,886)	$ (51,211)

(1) See discussion of early retirement program at end of note.
(2) See discussion of pension plan settlement.
Pension cost includes expense and income for KEDNE since November 8, 2000.

The following table sets forth pension plans' funded status at December 31, 2002 and December 31, 2001. Plan assets are principally common stock and fixed income securities.

	(In Thousands of Dollars)	
	Year Ended December 31,	
	2002	2001
Change in benefit obligation:		
Benefit obligation at beginning of period	$(1,915,154)	$(1,914,885)
Service cost	(42,423)	(41,162)
Interest cost	(132,424)	(128,481)
Amendments	(2,932)	(8,679)
Actuarial gain (loss)	(103,988)	61,718
Benefits paid	116,728	116,335
Benefit obligation at end of period	(2,080,193)	(1,915,154)
Change in plan assets:		
Fair value of plan assets at beginning of period	1,899,256	2,170,093
Actual return on plan assets	(347,270)	(197,632)
Employer contribution	109,260	43,130
Benefits paid	(116,728)	(116,335)
Fair value of plan assets at end of period	1,544,518	1,899,256
Funded status	(535,675)	(15,898)
Unrecognized net loss from past experience different from that assumed and from changes in assumptions	627,199	8,207
Unrecognized prior service cost	71,126	84,036
Unrecognized transition obligation	237	1,212
Net prepaid pension cost reflected on consolidated balance sheet	$ 162,887	$ 77,557

	Year Ended December 31,		
	2002	2001	2000
Assumptions:			
Obligation discount	6.75%	7.00%	7.00%
Asset return	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	5.00%

Pension Plan Settlement: In 2000, we settled certain participating contracts covering retiree pension plans with MetLife. As required under SFAS 88 "Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits", a gain of $20.2 million was recognized as part of our pension cost for the year ended December 31, 2000.

Unfunded Pension Obligation: At December 31, 2001, accumulated benefit obligations were in excess of pension assets. As prescribed by SFAS 87 "Employers' Accounting for Pensions", we were required to record an additional $68.9 million minimum liability for this unfunded pension obligation. At December 31, 2002, the accumulated benefit obligations were re-measured which resulted in a revised minimum liability of $286.3 million. As permitted under current accounting guidelines, this accrual can be offset by a corresponding debit to a long-term asset up to the amount of accumulated unrecognized prior service costs. Any remaining amount is to be recorded in Other Comprehensive Income.

Therefore, at year-end, we have recorded a long-term asset in Deferred Charges Other of $61.5 million. We also recorded a $118.6 million contractual receivable in Deferred Charges Other, representing the amount that would be recovered from LIPA in accordance with our service agreements if the underlying assumptions giving rise to this minimum liability were realized and recorded as pension expense. The remaining charge to equity of $106.2 million, or $69.0 million after-tax, has been recorded as a debit to Other Comprehensive Income. At December 31, 2002 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in excess of plan assets were $1.1 billion, $948.0 million and $621.0 million, respectively. At the end of each year, we will re-measure the accumulated benefit obligations and pension assets, and adjust the accrual and deferrals as appropriate.

Other Postretirement Benefits: The following information represents the consolidated results for our noncontributory defined benefit plans covering certain health care and life insurance benefits for retired employees. We have 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.

Net periodic other postretirement benefit cost included the following components:

	(In Thousands of Dollars)		
	Year Ended December 31,		
	2002	2001	2000
Service cost, benefits earned during the period	$16,566	$20,339	$14,771
Interest cost on accumulated postretirement benefit obligation	65,486	64,649	47,412
Expected return on plan assets	(36,839)	(42,822)	(42,890)
Special termination charge (1)	—	—	5,590
Net amortization and deferral	17,527	11,664	(9,290)
Other postretirement benefit cost	$62,740	$53,830	$15,593

(1) See discussion of early retirement program at end of note.
Other postretirement benefit costs include expense and income for KEDNE since November 8, 2000.

The following table sets forth the plans' funded status at December 31, 2002 and December 31, 2001. Plan assets are principally common stock and fixed income securities.

	(In Thousands of Dollars)	
	Year Ended December 31,	
	2002	2001
Change in benefit obligation:		
Benefit obligation at beginning of period	$(969,692)	$(873,421)
Service cost	(16,566)	(20,339)
Interest cost	(65,486)	(64,649)
Plan participants' contributions	(1,587)	(1,439)
Amendments	57,984	52
Actuarial (loss)	(115,563)	(57,670)
Benefits paid	53,966	47,774
Benefit obligation at end of period	(1,056,944)	(969,692)
Change in plan assets:		
Fair value of plan assets at beginning of period	476,146	554,866
Actual return on plan assets	(82,950)	(39,703)
Employer contribution	20,349	7,318
Plan participants' contributions	1,587	1,439
Benefits paid	(53,966)	(47,774)
Fair value of plan assets at end of period	361,166	476,146
Funded status	(695,778)	(493,546)
Unrecognized net loss from past experience different from that assumed and from changes in assumptions	464,269	251,198
Unrecognized prior service cost	(60,104)	(8,392)
Accrued benefit cost reflected on consolidated balance sheet	$(291,613)	$(250,740)

	Year Ended December 31,		
	2002	2001	2000
Assumptions:			
Obligation discount	6.75%	7.00%	7.00%
Asset return	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	5.00%

The measurement of plan liabilities also assumes a health care cost trend rate of 9% grading down to 5% in 2009 and thereafter. A 1% increase in the health care cost trend rate would have the effect of increasing the accumulated postretirement benefit obligation as of December 31, 2002 by $118.4 million and the net periodic health care expense by $11.0 million. A 1% decrease in the health care cost trend rate would have the effect of decreasing the accumulated postretirement benefit obligation as of December 31, 2002 by $104.6 million and the net periodic health care expense by $9.4 million.

At December 31, 2002, KeySpan had a contractual receivable from LIPA of $238 million representing the postretirement benefits associated with the electric business unit employees recorded in Deferred Charges Other in the Consolidated Balance Sheet. LIPA has been reimbursing us for costs related to the postretirement benefits of the electric business unit employees in accordance with the LIPA Agreements.

Early Retirement Program: In December 2000, we completed an early retirement program for certain management and union employees. Included in the pension and other postretirement benefits expense for the year ended December 31, 2000 are charges of $45.8 million and $5.6 million, respectively related to the early retirement program.

Defined Contribution Plan: KeySpan also offers both its union and management employees a defined contribution plan. Both the KeySpan Energy 401(k) Plan for Management Employees and the KeySpan Energy 401(k) Plan for Union Employees are available to all eligible employees. These Plans are defined contribution plans subject to Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"). All eligible employees contributing to the Plan receive a certain employer matching contribution based on a percentage of the employee contribution, as well as a 10% discount on the KeySpan Common Stock Fund anywhere from three to twelve months after their date of hire depending upon the Plan. The matching contributions are in KeySpan's common stock. The match and discount amounts may be transferred out of common stock immediately. For the years ended December 31, 2002, 2001 and 2000, we recorded an expense equal to $11.2 million, $11.0 million and $6.7 million, respectively.

Note 5. Capital Stock

Common Stock: Currently we have 450,000,000 shares of authorized common stock. In 1998, we initiated a program to repurchase a portion of our outstanding common stock on the open market. At December 31, 2002, we had 16.4 million shares, or approximately $475 million of Treasury Stock outstanding. We completed this repurchase plan in 1999 and now utilize Treasury Stock to satisfy our common stock plans. During 2002, we issued 3 million shares out of treasury for the dividend reinvestment feature of our Investor Program, the Employee Stock Discount Purchase Plan and the 401(k) Plan.

On January 17, 2003, KeySpan sold 13.9 million shares of common stock in a public offering that generated net proceeds of approximately $473 million. All shares were offered by KeySpan pursuant to the effective shelf registration statement filed with the SEC. Net proceeds from the equity sale were used initially to pay down commercial paper.

Preferred Stock: We have the authority to issue 100,000,000 shares of preferred stock with the following classifications: 16,000,000 shares of preferred stock, par value $25 per share; 1,000,000 shares of preferred stock, par value $100 per share; and 83,000,000 shares of preferred stock, par value $.01 per share.

At December 31, 2002 we had 553,000 shares outstanding of 7.07% Preferred Stock Series B par value $100; 197,000 shares outstanding of 7.17% Preferred Stock Series C par value $100; and 88,486 shares outstanding of 6% Preferred Stock Series A par value $100, in the aggregate totaling $83.8 million.

Boston Gas Company has 562,700 shares of 6.421% non-voting preferred stock par value $25 per share outstanding at December 31, 2002. This issue of preferred stock has a 5% annual sinking fund requirement and $1.5 million was paid on September 1, 2002 to satisfy this requirement. We have the option of increasing the sinking fund payment up to 10% per year. This issue is callable beginning in 2003 and is reflected in Minority Interest on the Consolidated Balance Sheet.

Note 6. Long-Term Debt

Gas Facilities Revenue Bonds: KEDNY can issue tax-exempt bonds through the New York State Energy Research and Development Authority. Whenever bonds are issued for new gas facilities projects, proceeds are deposited in trust and subsequently withdrawn to finance qualified expenditures. There are no sinking fund requirements on any of our Gas Facilities Revenue Bonds. At December 31, 2002, KEDNY had $648.5 million of Gas Facilities Revenue Bonds outstanding. The interest rate on the variable rate series due December 1, 2020 is reset weekly and ranged from 1.00% to 1.68% through December 31, 2002, at which time the rate was 1.28%.

Authority Financing Notes: One of our electric generation subsidiaries can issue tax-exempt bonds through the New York State Energy Research and Development Authority. At December 31, 2002, $41.1 million of Authority Financing Notes 1999 Series A Pollution Control Revenue Bonds due October 1, 2028 were outstanding. The interest rate on these notes is reset based on an auction procedure. The interest rate during the year ranged from 1.00% to 1.68%, through December 31, 2002, at which time the rate was 1.20%.

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 ranged from .95% to 1.90% through December 31, 2002 at which time the rate was 1.60%.

Promissory Notes: In connection with the KeySpan/LILCO transaction, KeySpan and certain of its subsidiaries issued promissory notes to LIPA to support certain debt obligations assumed by LIPA. The remaining principal amount of promissory notes issued to LIPA was approximately $600 million at December 31, 2002. In February 2003, KeySpan notified LIPA of its intention to redeem approximately $447 million aggregate principal amount of such promissory notes at the applicable redemption prices plus accrued and unpaid interest through the dates of redemption. It is anticipated that such redemption will take place before the end of the first quarter of 2003. Under these promissory notes, KeySpan is required to obtain letters of credit to secure its payment obligations if its long-term debt is not rated at least in the "A" range by at least two nationally recognized statistical rating agencies.

Notes Payable: KEDLI had $125 million of Medium-Term Notes at 6.90% due January 15, 2008, and $400 million of 7.875% Medium-Term Notes due February 1, 2010, outstanding at December 31, 2002 each of which is guaranteed by KeySpan.

Further, KeySpan had $2.36 billion of Medium-Term Notes outstanding at December 31, 2002 of which $1.65 billion of these notes are associated with the acquisition of Eastern and ENI. These notes were issued in three series as follows: $700 million, 7.25% Notes due 2005; $700 million, 7.625% Notes due 2010 and $250 million, 8.00% Notes due 2030. The remaining Medium-Term Notes of $710 million have interest rates ranging from 6.15% to 9.75% and mature in 2005-2025.

In May 2002, we issued $460 million of MEDS Equity Units at 8.75% consisting of a three-year forward purchase contract for our common stock and a six-year note. The purchase contract commits us, three years from the date of issuance of the MEDS Equity Units, to issue and the investors to purchase, a number of shares of our common stock based on a formula tied to the market price of our common stock at that time. The 8.75% coupon is composed of interest payments on the six-year note of 4.9% and premium payments on the three-year equity forward contract of 3.85%. These instruments have been recorded as long-term debt on the Consolidated Balance Sheet. Further, upon issuance of the MEDS Equity Units, we recorded a direct charge to Retained Earnings of $49.1 million, which represents the present value of the forward contract's premium payments.

These securities are currently not considered convertible instruments for purposes of applying SFAS 128 "Earnings Per Share" calculations, unless or until such time as the market value of our common stock reaches a threshold appreciation price ($42.36 per share) that is higher than the current per share market value. Interest payments do, however, reduce net income and earnings per share.

The Emerging Issues Task Force of the FASB is considering proposals related to accounting for certain securities and financial instruments, including securities such as the Equity Units. The current proposals being considered include the method of accounting discussed above. Alternatively, other proposals being considered could result in the common shares issuable pursuant to the purchase contract to be deemed outstanding and included in the calculation of diluted earnings per share, and could result in periodic "mark to market" of the purchase contracts, causing periodic charges or credits to income. If this latter approach were adopted, our basic and diluted earnings per share could increase and decrease from quarter to quarter to reflect the lesser and greater number of shares issuable upon satisfaction of the contract, as well as charges or credits to income.

At December 31, 2001, KeySpan had authorization under PUHCA to issue up to $1 billion of securities and had an effective $1 billion shelf registration statement on file with the SEC, with $500 million available for issuance. In February 2002, we updated the shelf registration for the issuance of an additional $1.2 billion of securities, thereby giving KeySpan the ability to issue up to $1.7 billion of debt, equity or various forms of preferred stock. The issuance of the MEDS Equity Units utilized $920 million of KeySpan's financing authority under both the shelf registration and the PUHCA financing authority. Both the $460 million six-year note and the $460 million forward equity contract are considered current issuances under these arrangements. On December 6, 2002, the SEC issued an order increasing the available authorization amount of financing under PUHCA to an aggregate of $780 million. Following the recent common stock offering mentioned in Note 5 "Capital Stock" and shares expected to be issued for employee benefit and dividend reinvestment plans, we have approximately $40 million available for the issuance of new securities under our current PUHCA authorization. However, the issuance of securities in connection with the redemption of existing securities (including the promissory notes discussed previously) is permitted under our PUHCA authorization notwithstanding the foregoing limit. We intend to seek authorization to issue additional securities in the near term.

At December 31, 2002, Houston Exploration had outstanding $100 million of 8.625% Senior Subordinated Notes due 2008. These notes were issued in a private placement in March 1998 and are subordinate to borrowings under Houston Exploration's line of credit. These notes are redeemable at the option of Houston Exploration after January 1, 2003.

First Mortgage Bonds: Colonial Gas Company, Essex Gas Company, ENI and their respective subsidiaries, have issued and outstanding approximately $163.6 million of first mortgage bonds. These bonds are secured by KEDNE gas utility property. The first mortgage bond indentures include, among other provisions, limitations on: (i) the issuance of long- term debt; (ii) engaging in additional lease obligations; and (iii) the payment of dividends from retained earnings.

In May 2002, Colonial Gas Company repaid $15 million of its 6.81% Series A First Mortgage Medium-Term Notes. These Notes would have matured on May 19, 2027, but the holder of the Notes elected to exercise a put option to redeem the Notes early.

Commercial Paper and Revolving Credit Agreements: In 2002, KeySpan renewed its existing 364-day revolving credit agreement with a commercial bank syndicate of 16 banks totaling $1.3 billion, a reduction from the previous $1.4 billion facility. The credit facility is used to back up the $1.3 billion commercial paper program. The fees for the facility are subject to a ratings-based grid, with an annual fee of .075% on the total amount of the revolving facility. The credit agreement allows for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, Adjustable Bank Rate ("ABR") loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin of 42.5 basis points for loans up to 33% of the facility, and an additional 12.5 basis points for loans over 33% of the total facility. ABR loans are based on the greater of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders. We do not anticipate borrowing against this facility; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to borrow on the credit facility.

The credit facility contains certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its property to any lien and certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 66%, a decrease from the 68% ratio required under the previous credit facility.

Under the terms of the credit facility, the calculation of KeySpan's debt-to-total capitalization ratio reflects 80% equity treatment for the MEDS Equity Units issued in May 2002. Further the $425 million Ravenswood master lease (the "Master Lease") is treated as debt. (See Note 7 "Contractual Obligations Financial Guarantees and

Further, KeySpan had $2.36 billion of Medium-Term Notes outstanding at December 31, 2002 of which $1.65 billion of these notes are associated with the acquisition of Eastern and ENI. These notes were issued in three series as follows: $700 million, 7.25% Notes due 2005; $700 million, 7.625% Notes due 2010 and $250 million, 8.00% Notes due 2030. The remaining Medium-Term Notes of $710 million have interest rates ranging from 6.15% to 9.75% and mature in 2005-2025.

In May 2002, we issued $460 million of MEDS Equity Units at 8.75% consisting of a three-year forward purchase contract for our common stock and a six-year note. The purchase contract commits us, three years from the date of issuance of the MEDS Equity Units, to issue and the investors to purchase, a number of shares of our common stock based on a formula tied to the market price of our common stock at that time. The 8.75% coupon is composed of interest payments on the six-year note of 4.9% and premium payments on the three-year equity forward contract of 3.85%. These instruments have been recorded as long-term debt on the Consolidated Balance Sheet. Further, upon issuance of the MEDS Equity Units, we recorded a direct charge to Retained Earnings of $49.1 million, which represents the present value of the forward contract's premium payments.

These securities are currently not considered convertible instruments for purposes of applying SFAS 128 "Earnings Per Share" calculations, unless or until such time as the market value of our common stock reaches a threshold appreciation price ($42.36 per share) that is higher than the current per share market value. Interest payments do, however, reduce net income and earnings per share.

The Emerging Issues Task Force of the FASB is considering proposals related to accounting for certain securities and financial instruments, including securities such as the Equity Units. The current proposals being considered include the method of accounting discussed above. Alternatively, other proposals being considered could result in the common shares issuable pursuant to the purchase contract to be deemed outstanding and included in the calculation of diluted earnings per share, and could result in periodic "mark to market" of the purchase contracts, causing periodic charges or credits to income. If this latter approach were adopted, our basic and diluted earnings per share could increase and decrease from quarter to quarter to reflect the lesser and greater number of shares issuable upon satisfaction of the contract, as well as charges or credits to income.

At December 31, 2001, KeySpan had authorization under PUHCA to issue up to $1 billion of securities and had an effective $1 billion shelf registration statement on file with the SEC, with $500 million available for issuance. In February 2002, we updated the shelf registration for the issuance of an additional $1.2 billion of securities, thereby giving KeySpan the ability to issue up to $1.7 billion of debt, equity or various forms of preferred stock. The issuance of the MEDS Equity Units utilized $920 million of KeySpan's financing authority under both the shelf registration and the PUHCA financing authority. Both the $460 million six-year note and the $460 million forward equity contract are considered current issuances under these arrangements. On December 6, 2002, the SEC issued an order increasing the available authorization amount of financing under PUHCA to an aggregate of $780 million. Following the recent common stock offering mentioned in Note 5 "Capital Stock" and shares expected to be issued for employee benefit and dividend reinvestment plans, we have approximately $40 million available for the issuance of new securities under our current PUHCA authorization. However, the issuance of securities in connection with the redemption of existing securities (including the promissory notes discussed previously) is permitted under our PUHCA authorization notwithstanding the foregoing limit. We intend to seek authorization to issue additional securities in the near term.

At December 31, 2002, Houston Exploration had outstanding $100 million of 8.625% Senior Subordinated Notes due 2008. These notes were issued in a private placement in March 1998 and are subordinate to borrowings under Houston Exploration's line of credit. These notes are redeemable at the option of Houston Exploration after January 1, 2003.

First Mortgage Bonds: Colonial Gas Company, Essex Gas Company, ENI and their respective subsidiaries, have issued and outstanding approximately $163.6 million of first mortgage bonds. These bonds are secured by KEDNE gas utility property. The first mortgage bond indentures include, among other provisions, limitations on: (i) the issuance of long- term debt; (ii) engaging in additional lease obligations; and (iii) the payment of dividends from retained earnings.

In May 2002, Colonial Gas Company repaid $15 million of its 6.81% Series A First Mortgage Medium-Term Notes. These Notes would have matured on May 19, 2027, but the holder of the Notes elected to exercise a put option to redeem the Notes early.

Commercial Paper and Revolving Credit Agreements: In 2002, KeySpan renewed its existing 364-day revolving credit agreement with a commercial bank syndicate of 16 banks totaling $1.3 billion, a reduction from the previous $1.4 billion facility. The credit facility is used to back up the $1.3 billion commercial paper program. The fees for the facility are subject to a ratings-based grid, with an annual fee of .075% on the total amount of the revolving facility. The credit agreement allows for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, Adjustable Bank Rate ("ABR") loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin of 42.5 basis points for loans up to 33% of the facility, and an additional 12.5 basis points for loans over 33% of the total facility. ABR loans are based on the greater of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders. We do not anticipate borrowing against this facility; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to borrow on the credit facility.

The credit facility contains certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its property to any lien and certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 66%, a decrease from the 68% ratio required under the previous credit facility.

Under the terms of the credit facility, the calculation of KeySpan's debt-to-total capitalization ratio reflects 80% equity treatment for the MEDS Equity Units issued in May 2002. Further the $425 million Ravenswood master lease (the "Master Lease") is treated as debt. (See Note 7 "Contractual Obligations Financial Guarantees and

Contingencies" for a discussion of the Ravenswood Master Lease.) At December 31, 2002, consolidated indebtedness, as calculated under the terms of the credit facility, was 64.6% of consolidated capitalization. As a result of the common stock offering previously mentioned, this ratio has been reduced to 59.8%. Violation of this covenant could result in the termination of the credit facility and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements.

The credit facility also requires that net cash proceeds from the sale of subsidiaries be applied to reduce consolidated indebtedness. Further, an acceleration of indebtedness of KeySpan or one of its subsidiaries for borrowed money in excess of $25 million in the aggregate, if not annulled within 30 days after written notice, would create an event of default under the Indenture, dated as of November 1, 2000, between KeySpan Corporation and the Chase Manhattan Bank, as Trustee. At December 31, 2002, KeySpan was in compliance with all covenants.

At December 31, 2002, we had cash and temporary cash investments of $170.6 million. During, 2002, we repaid $132.8 million of commercial paper and, at December 31, 2002, $915.7 million of commercial paper was outstanding at a weighted average annualized interest rate of 1.52%. We had the ability to borrow up to an additional $384.3 million at December 31, 2002 under the commercial paper program.

During 2002, Houston Exploration entered into a new revolving credit facility with a commercial banking syndicate that replaced the existing $250 million revolving credit facility. The new facility provides Houston Exploration with an initial commitment of $300 million, which can be increased, at its option to a maximum of $350 million with prior approval from the banking syndicate. The new credit facility is subject to borrowing base limitations, initially set at $300 million and will be re-determined semi-annually. Up to $25 million of the borrowing base is available for the issuance of letters of credit. The new credit facility matures July 15, 2005, is unsecured and ranks senior to all existing debt.

Under the Houston Exploration credit facility, interest on base rate loans is payable at a fluctuating rate, or base rate, equal to the sum of (a) the greater of the federal funds rate plus 0.50% or the bank's prime rate plus (b) a variable margin between 0% and 0.50%, depending on the amount of borrowings outstanding under the credit facility. Interest on fixed loans is payable at a fixed rate equal to the sum of (a) a quoted reserve adjusted LIBOR rate plus (b) a variable margin between 1.25% and 2.00%, depending on the amount of borrowings outstanding under the credit facility.

Financial covenants require Houston Exploration to, among other things, (i) maintain an interest coverage ratio of at least 3.00 to 1.00 of earnings before interest, taxes and depreciation ("EBITDA") to cash interest; (ii) maintain a total debt to EBITDA of not more than 3.50 to 1.00; and (iii) hedge no more than 70% of natural gas production during any 12-month period. At December 31, 2002, Houston Exploration was in compliance with all financial covenants.

During 2002, Houston Exploration borrowed $79.0 million under its credit facility and repaid $71.0 million. At December 31, 2002, $152 million of borrowings remained outstanding at a weighted average annualized interest rate of 3.42%. Also, $0.4 million was committed under outstanding letters of credit obligations. At December 31, 2002, $147.6 million of borrowing capacity was available.

KeySpan Canada has two revolving credit facilities with financial institutions in Canada. Repayments under these agreements totaled approximately US $26.1 million during 2002. At December 31, 2002, approximately US $150.9 million was outstanding at a weighted average annualized interest rate of 3.23%. KeySpan Canada currently has available borrowings of approximately US $55.8 million. These revolving credit agreements have been extended through January 2004. An event of default would exist under these credit facilities if KeySpan, as guarantor on the facilities, falls below investment grade rating or falls below A3 or A- at a time when its consolidated indebtedness is greater than 66% of consolidated capitalization or its cash flow to interest expense is less than 2.25 to 1.00. At December 31, 2002, KeySpan and KeySpan Canada were in compliance with all covenants.

Capital Leases: Our subsidiaries lease certain facilities and equipment under long-term leases, which expire on various dates through 2022. The weighted average interest rate on these obligations was 6.25%.

Debt Maturity: The following table reflects the maturity schedule for our debt repayment requirements, including capitalized leases and related maturities, at December 31, 2002:

			(In Thousands of Dollars)
	Long-Term Debt	Capital Leases	Total
Repayments:			
Year 1	$ 10,333	$ 1,080	$ 11,413
Year 2	333	1,033	1,366
Year 3	1,327,333	1,044	1,328,377
Year 4	512,333	1,003	513,336
Year 5	333	1,061	1,394
Thereafter	3,379,190	8,663	3,387,853
	$5,229,855	$13,884	$5,243,739

Note 7. Contractual Obligations, Financial Guarantees and Contingencies

Lease Obligations: Lease costs included in operation expense were $71.1 million in 2002 reflecting, primarily, the Master Lease and the lease of our Brooklyn headquarters of $29.1 million and $14.3 million, respectively. Lease costs also include leases for other buildings, office equipment, vehicles and power operated equipment. Lease costs for the year ended December 31, 2001 and 2000 were $75.8 million and $69.3 million, respectively. The future minimum lease payments under various leases, all of which are operating leases, are $80.8 million per year over the next five years and $200.9 million, in the aggregate, for all years thereafter, including future minimum lease payments for the Master Lease of $30.8 million per year over the next five years and $61.7 million for all years thereafter (See discussion below for further information regarding the Master Lease.)

Variable Interest Entity: KeySpan has an arrangement with a variable interest entity through which we lease a portion of the Ravenswood facility. We acquired the Ravenswood facility, in part, through the

variable interest entity from Consolidated Edison on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into the Master Lease with a variable interest, unaffiliated financing entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to our subsidiary. The variable interest unaffiliated financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity.

KeySpan has guaranteed all payment and performance obligations of our subsidiary under the Master Lease. The Master Lease represents approximately $425 million of the acquisition cost of the facility, which is the amount of debt that would have been recorded on our Consolidated Balance Sheet had the variable interest entity not been utilized and conventional debt financing been employed. Further, we would have recorded an asset in the same amount. Monthly lease payments equal the monthly interest expense on such debt securities. The Master Lease currently qualifies as an operating lease for financial reporting purposes.

The initial term of the Master Lease expires on June 20, 2004 and may be extended until June 20, 2009. In June 2004, we have the right to: (i) either purchase the facility for the original acquisition cost of $425 million, plus the present value of the lease payments that would otherwise have been paid through June 2009; (ii) terminate the Master Lease and dispose of the facility; or (iii) otherwise extend the Master Lease to 2009. If the Master Lease is terminated in 2004, KeySpan has guaranteed an amount generally equal to 83% of the residual value of the original cost of the property, plus the present value of the lease payments that would have otherwise been paid through June 20, 2009. In June 2009, when the Master Lease terminates, we may purchase the facility in an amount equal to the original acquisition cost, subject to adjustment, or surrender the facility to the lessor. If we elect not to purchase the property, the Ravenswood facility will be sold by the lessor. We have guaranteed to the lessor 84% of the residual value of the original cost of the property.

In January 2003, the FASB issued FIN 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." FIN 46 requires KeySpan, based upon its current status as the primary beneficiary, to consolidate this variable interest entity for the first interim period ending after June 15, 2003. It also requires that assets, liabilities and non-controlling interests of the variable interest entity be consolidated at fair value, except to the extent that to do so would result in a gain to KeySpan. KeySpan believes that the fair market value of he Ravenswood facility exceeds the fair market value of the lease bligation.

Prospectively, KeySpan will have a $425 million asset that will be nortized over the economic life of the leased property. However, upon plementation, there will be a cumulative catch-up adjustment for a nge in accounting policy as if the asset had been owned from ption, or June 20, 1999. Therefore, at July 1, 2003, assuming a 35 economic life, KeySpan will be deemed to have owned the asset pproximately 4 years and it is anticipated that we will record a 6 million, after-tax charge, or $0.20 per share, change in accounting principle on the Consolidated Statement of Income. Upon implementation of FIN 46, therefore, and we anticipate recording an asset of approximately $376 million and debt of $425 million.

Based upon expected average outstanding shares, we anticipate the incremental impact of the additional depreciation expense for the remaining six months of 2003 to be approximately $0.02 per share. In addition, KeySpan is also conducting a study to determine the fair value of the Ravenswood facility. Although considered unlikely, to the extent the fair value of the Ravenswood facility was less than the value of the lease obligation, then a loss would be recognized upon consolidation.

If our subsidiary that leases the Ravenswood facility was not able to fulfill its payment obligations with respect to the Master Lease payments, then the maximum amount KeySpan would be exposed to under its current guarantees would be $425 million plus the present value of the remaining lease payments through June 20, 2009.

KeySpan is currently exploring various options associated with the Master Lease, including but not limited to, restructuring the current leasing arrangement. At this time, we cannot predict the future structure of the leasing arrangement nor the impact on our financial position, results of operations or cash flows.

Financial Guarantees: KeySpan has issued financial guarantees in the normal course of business, primarily on behalf of its subsidiaries, to various third party creditors. At December 31, 2002, the following amounts would have to be paid by KeySpan in the event of non-payment by the primary obligor at the time payment is due:

		(In Thousands of Dollars)	
Nature of Guarantee		Amount of Exposure	Expiration Dates
Guarantees for Subsidiaries			
Medium-term Notes - KEDLI	(i)	$ 525,000	2008-2010
Master Lease - Ravenswood	(ii)	425,000	2004
Revolving Credit Agreement - KeySpan Canada	(iii)	130,000	2004
Surety Bonds	(iv)	153,900	Revolving
Commodity Guarantees and Other	(v)	65,700	2005
Letters of Credit	(vi)	64,400	2003
Guarantees for Non-affiliates			
Third Party Line of Credit	(vii)	25,000	2004
		$1,389,000	

The following is a description of KeySpan's outstanding subsidiary guarantees:

(i) KeySpan has fully and unconditionally guaranteed $525 million to holders of Medium-Term Notes issued by KEDLI. These notes are due to be repaid on January 15, 2008 and February 1, 2010. KEDLI is required to comply with certain financial covenants under the debt agreements. Currently, KEDLI is in compliance with all covenants and management does not anticipate that KEDLI will have any difficulty maintaining such compliance. The face value of these notes are included in Long-Term Debt on the Consolidated Balance Sheet.

(ii) KeySpan has guaranteed all payment and performance obliga-

facility. The initial term of the lease expires on June 20, 2004 and may be extended until June 20, 2009. For further information, see Variable Interest Entity above.

(iii) KeySpan has fully and unconditionally guaranteed a US $130 million revolving credit agreement associated with KeySpan Canada. The term of the agreement expires July 1, 2004.

(iv) KeySpan has purchased various surety and performance bonds associated with certain construction projects currently being performed by subsidiaries within the Energy Services segment. In the event that the operating companies in the Energy Services segment fail to perform their obligation under contract, the injured party may demand that the surety make payments or provide services under the bond. KeySpan would then be obligated to reimburse the surety for any expenses or cash outlays it incurs.

(v) KeySpan has guaranteed commodity-related payments for subsidiaries within the Energy Services segment, as well as KeySpan Ravenswood, LLC. These guarantees are provided to third parties to facilitate physical and financial transactions involved in the purchase of natural gas, oil and other petroleum products for electric production and marketing activities. The guarantees cover actual purchases by these subsidiaries that are still outstanding as of December 31, 2002.

(vi) KeySpan has issued stand-by letters of credit in the amount of $64.4 million to third parties that have extended credit to certain subsidiaries. Certain vendors require us to post letters of credit to guarantee subsidiary performance under our contracts and to ensure payment to our subsidiary subcontractors and vendors under those contracts. Certain of our vendors also require letters of credit to ensure reimbursement for amounts they are disbursing on behalf of our subsidiaries, such as to beneficiaries under our self-funded insurance programs. Such letters of credit are generally issued by a bank or similar financial institution. The letters of credit commit the issuer to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, KeySpan would be required to reimburse the issuer of the letter of credit.

To date, KeySpan has not had a claim made against it for any of the above guarantees and we have no reason to believe that our subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact such details may have on our consolidated results of operations, financial condition or cash flows.

The following is a description of KeySpan's outstanding guarantees to non-affiliates:

(vii) KeySpan has agreed to support a line of credit up to $25 million on behalf of Hawkeye Construction ("Hawkeye"), a non-affiliated company. It also assisted Hawkeye in obtaining performance bonds. The guarantees related to their line of credit extend through 2004. To the extent Hawkeye does not meet its obligations, KeySpan could be liable for the amount of the outstanding guarantees. At December 31, 2002, the amount guaranteed was $25 million.

If Hawkeye fails to perform under a contract or to pay subcontractors and vendors, the counter-party that requested the performance bond may demand that the surety make payments or provide services under the bond. KeySpan would then have to reimburse the surety for any expenses or outlays the surety incurs. To date, we have not had a claim made against either the guarantee associated with the line of credit or the performance bonds. KeySpan is presently engaged in a legal action with Hawkeye as discussed further in "Legal Matters" below.

Fixed Charges Under Firm Contracts: Our utility subsidiaries and the Ravenswood facility have entered into various contracts for gas delivery, storage and supply services. The contracts have remaining terms that cover from one to thirteen years. Certain of these contracts require payment of annual demand charges in the aggregate amount of approximately $462.3 million. We are liable for these payments regardless of the level of service we require from third parties. Such charges are currently recovered from utility customers through the gas adjustment clause.

Legal Matters: From time to time we are subject to various legal proceedings arising out of the ordinary course of our business. Except as described below, 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, financial condition or cash flows.

KeySpan has been cooperating in preliminary inquiries regarding trading in KeySpan Corporation stock by individual officers of KeySpan prior to the July 17, 2001 announcement that KeySpan was taking a special charge in its Energy Services business and otherwise reducing its 2001 earnings forecast. These inquiries are being conducted by the U.S. Attorney's Office, Southern District of New York and the SEC.

As previously reported, as part of its continuing inquiry, on March 5, 2002, the SEC issued a formal order of investigation, pursuant to which it will review the trading activity of certain company insiders from May 1, 2001 to the present, as well as KeySpan's compliance with its reporting rules and regulations, generally during the period following the acquisition of the Roy Kay companies through the July 17th announcement.

Furthermore, KeySpan and certain of its officers and directors are defendants in a number of class action lawsuits filed in the United States District Court for the Eastern District of New York after the July 17th announcement. These lawsuits allege, among other things, violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), in connection with disclosures relating to or following the acquisition of the Roy Kay companies by KeySpan Services, Inc., a KeySpan subsidiary and the announcement of the agreement to acquire Eastern and ENI. Finally, in October 2001, a shareholder's derivative action was commenced in the same court against certain officers and directors of KeySpan, alleging, among other

things, breaches of fiduciary duty, violations of the New York Business Corporation Law and violations of Section 20(a) of the Exchange Act. In addition, a second derivative action has been commenced asserting similar allegations. Each of the proceedings seek monetary damages in an unspecified amount. We have filed a motion to dismiss the class action lawsuits which is currently pending. We are unable to determine the outcome of these proceedings and what effect, if any, such outcome will have on our financial condition, results of operations or cash flows.

In June 2002, Hawkeye Electric, LLC et al. ("Hawkeye") commenced an action in New York State Supreme Court, Suffolk County against KeySpan and certain of its subsidiaries alleging, among other things, that KeySpan and its subsidiaries breached certain contractual obligations to Hawkeye with respect to the provision of certain gas, electric and telecommunications construction services offered by Hawkeye. Hawkeye is seeking damages in excess of $90 million and KeySpan has alleged a number of counterclaims seeking damages in excess of $4 million. At this time, we are unable to determine the outcome of this proceeding and what effect, if any, such outcome will have on our financial position, results of operations or cash flows.

KeySpan subsidiaries, along with several other parties, have been named as defendants in numerous proceedings filed by plaintiffs claiming various degrees of injury from asbestos exposure. Most of these proceedings have been commenced in the New York State Supreme Court for New York County by alleged present or former employees of various contractors, allegedly as a result of exposure to asbestos in connection with the construction and maintenance of our electric generating facilities. Certain subsidiaries have also been named as defendants in proceedings involving facilities not owned by KeySpan. At the present time, KeySpan is unable to determine the outcome of these proceedings, but does not believe that such outcome, if adverse, will have a material effect on its financial condition, results of operations or cash flows.

KeySpan, through its subsidiary, formerly known as Roy Kay, Inc., has terminated the employment of the former owners of the Roy Kay companies and commenced a proceeding in the Chancery Division of the Superior Court, Monmouth County, New Jersey (Docket No. Mon. C. 95-01) as a result of the alleged fraudulent acts of the former owners, both before and after the acquisition of the Roy Kay companies in January 2000. KeySpan believes the former owners misstated the financial statements of the Roy Kay companies and certain underlying work-in-progress schedules. KeySpan is seeking damages in excess of $76 million, as well as a judicial determination that KeySpan is not required to pay the former owners any further amounts under the terms of the stock purchase agreement entered into in connection with the acquisition of the Roy Kay companies. The causes of action include breach of contract and fiduciary duty, fraud, and violation of the New Jersey Securities Laws. The former owners have filed counterclaims against KeySpan and certain of its subsidiaries, as well as certain of their respective officers, to recover damages they claim to have incurred as a result of, among other things, their alleged improper termination and the alleged fraud on the part of KeySpan in failing to disclose the limitations imposed upon the Roy Kay companies, with respect to the performance of certain services under PUHCA. The fraud claims asserted by the former owners include claims under the New Jersey Uniform Securities Law and RICO statutes. We are unable to predict the outcome of these proceedings or what effect, if any, such outcome will have on our financial condition, results of operations or cash flows.

Environmental Matters

Air: With respect to NOx emissions reduction requirements for our existing power plants, we are required to be in compliance with the Phase III reduction requirements of the Ozone Transportation Commission memorandum by May 1, 2003, and we fully expect to achieve such emission reductions on time and in a cost-effective manner. Our expenditures to address emission reduction requirements through the year 2003 are expected to be between $10 million and $15 million.

Water: Additional capital expenditures associated with the renewal of the surface water discharge permits for our power plants may be required by the Department of Environmental Conservation ("DEC"). Until our monitoring obligations are completed and changes to the Environmental Protection Agency regulations under Section 316 of the Clean Water Act are promulgated, the need for and the cost of equipment upgrades cannot be determined.

Land, Manufactured Gas Plants and Related Facilities

New York Sites: Within the State of New York we have identified 28 manufactured gas plant ("MGP") sites and related facilities, which were historically owned or operated by KeySpan subsidiaries or such companies' predecessors. These former sites, some of which are no longer owned by us, have been identified to both the DEC for inclusion on appropriate site inventories and listing with the NYPSC.

We have identified 18 sites associated with the historic operations of KEDNY. Administrative Orders on Consent ("ACO") or Voluntary Cleanup Agreements have been executed with the DEC to address the investigation and remediation activities associated with three of these sites. In 2001, KEDNY filed a complaint for the recovery of its remediation costs in the New York State Supreme Court against the various insurance companies that issued general comprehensive liability policies to KEDNY. The outcome of this proceeding cannot yet be determined. We presently estimate the remaining environmental cleanup activities of these sites will be $81.1 million, which amount has been accrued by us. Expenditures incurred to date by us with respect to MGP-related activities total $26.8 million.

We have identified nine sites associated with the historic operations of KEDLI, six of which are the subject of two separate ACOs, which we executed with the DEC in 1999. Field investigations and, in some cases, interim remedial measures, are underway or scheduled to occur at each of these sites under the supervision of the DEC and the New York State Department of Health. Pursuant to a separate ACO also entered into in 1999, we have performed preliminary site assessments at five other sites, which were formerly owned by KEDLI. For one of these sites, the DEC has advised us that no further action is required. At another site, the DEC has indicated that a remedial investigation will be required. For the remaining three sites, KeySpan awaits the DEC's comments.

In January 1998, KEDLI filed a complaint for the recovery of its remediation costs in the New York State Supreme Court against the various insurance companies that issued general comprehensive liability

policies to KEDLI. The outcome of this proceeding cannot yet be determined. We presently estimate the remaining environmental cleanup activities of these sites will be $61.1 million, which amount has been accrued by us. Expenditures incurred to date by us with respect to KEDLI MGP-related activities total $22.3 million.

We presently estimate the remaining cost of our New York/Long Island MGP-related environmental cleanup activities will be $142.2 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred to date by us with respect to these MGP-related activities total $49.1 million.

With respect to remediation costs, the KEDNY rate plan provides, among other things, that if the total cost of investigation and remediation varies from that which is specifically estimated for a site under investigation and/or remediation, then KEDNY will retain or absorb up to 10% of the variation. The KEDLI rate plan also provides for the recovery of investigation and remediation costs but with no consideration of the difference between estimated and actual costs. Under prior rate orders, KEDNY has offset certain amounts due to ratepayers against its estimated environmental cleanup costs for MGP sites. At December 31, 2002, we have reflected a regulatory asset of $123.7 million for our New York/Long Island MGP sites.

We are also responsible for environmental obligations associated with the Ravenswood facility, purchased from Consolidated Edison in 1999, including remediation activities associated with its historic operations and those of the MGP facilities that formerly operated at the site. We are not responsible for liabilities arising from disposal of waste at off-site locations prior to the acquisition closing and any monetary fines arising from Consolidated Edison's pre-closing conduct. We presently estimate the remaining environmental clean up activities for this site will be $3.6 million, which amount has been accrued by us. Expenditures incurred to date total $1.4 million.

New England Sites: Within the Commonwealth of Massachusetts and the State of New Hampshire, we are aware of 76 former MGP sites and related facilities within the existing or former service territories of KEDNE.

Boston Gas Company, Colonial Gas Company and Essex Gas Company may have or share responsibility under applicable environmental laws for the remediation of 66 MGP sites and related facilities. A subsidiary of National Grid USA ("National Grid"), formerly New England Electric System, has assumed responsibility for remediating 11 of these sites, subject to a limited contribution from Boston Gas Company, and has provided full indemnification to Boston Gas Company with respect to eight other sites. At this time, there is substantial uncertainty as to whether Boston Gas Company, Colonial Gas Company or Essex Gas Company have or share responsibility for remediating any of these other sites. No notice of responsibility has been issued to us for any of these sites from any governmental environmental authority.

In March 1999, Boston Gas Company and a subsidiary of National Grid filed a complaint for the recovery of remediation costs in the Massachusetts Superior Court against various insurance companies that issued comprehensive general liability policies to National Grid and its predecessors with respect to, among other things, the 11 sites for which Boston Gas Company has agreed to make a limited contribution. The outcome of this proceeding cannot be determined at this time.

We presently estimate the remaining cost of these Massachusetts KEDNE MGP-related environmental cleanup activities will be $32.4 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred since November 8, 2000 with respect to these MGP-related activities total $10.7 million.

We may have or share responsibility under applicable environmental laws for the remediation of 10 MGP sites and related facilities associated with the historical operations of EnergyNorth. EnergyNorth has received notice of its potential responsibility for contamination at two former MGP sites and, together with other potentially responsible parties, has received notice of potential responsibility for contamination associated with four other sites.

With respect to the Laconia and Nashua sites, EnergyNorth has entered into separate cost sharing agreements with Public Service of New Hampshire ("PSNH"). Under the agreements PSNH is obligated to indemnify EnergyNorth for future remediation costs, with limited exceptions, at the Laconia site and PSNH will pay EnergyNorth up to $4.8 million toward the costs of the investigation and remediation at the Nashua site. EnergyNorth also has entered into an agreement with the United States Environmental Protection Agency ("EPA") for the contamination from the Nashua site that was allegedly commingled with asbestos at the so-called Nashua River Asbestos Site, adjacent to the Nashua MGP site.

EnergyNorth has filed suit in both the New Hampshire Superior Court and the United States District Court for the District of New Hampshire for recovery of its remediation costs against the various insurance companies that issued comprehensive general liability and excess liability insurance policies to EnergyNorth and its predecessors. Settlements have been reached with some of the carriers and one carrier was dismissed from a Superior Court action on summary judgment. The outcome of the remaining proceedings cannot yet be determined. EnergyNorth has also filed a contribution action in the United States District Court for the District of New Hampshire against an entity it alleges shares liability for the Manchester MGP study and remediation costs.

We presently estimate the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $14.7 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred since November 8, 2000, with respect to these MGP-related activities total $5.3 million.

By rate orders, the DTE and the NHPUC provide for the recovery of site investigation and remediation costs and, accordingly, at December 31, 2002, we have reflected a regulatory asset of $58.7 million for the KEDNE MGP sites. As previously mentioned, Colonial Gas Company and Essex Gas Company are not subject to the provisions of SFAS 71 and therefore have recorded no regulatory asset. However, rate plans currently in effect for these subsidiaries provide for the recovery of investigation and remediation costs.

KeySpan New England LLC Sites: We are aware of three non-utility sites associated with the historic operations of KeySpan New England, LLC, a successor company to Eastern Enterprises for which we may have or share environmental remediation responsibility or ongoing maintenance: the former Philadelphia Coke site located in Pennsylvania; the

former Connecticut Coke site located in New Haven, Connecticut; and the former Everett Coal Tar Processing Facility (the "Everett Facility") located in Massachusetts. Honeywell International, Inc. and Beazer East, Inc. (both former owners and operators of the Everett Facility) together with KeySpan, have entered into an ACO with the Massachusetts Department of Environmental Protection for the investigation and development of a remedial response plan for the site.

KeySpan, Honeywell and Beazer East have entered into a cost-sharing agreement under which each company has agreed to pay one-third of the costs of compliance with the consent order, while preserving any claims it may have against the other companies. The companies have completed preliminary remedial measures, including abatement of seepage of materials into the adjacent tidal river. In 2002, Beazer East commenced an action with the U.S. District Court for the Southern District of New York which seeks a judicial determination on the allocation of liability for the Everett Facility. The outcome of this proceeding cannot yet be determined.

KeySpan also is recovering certain legal defense costs and may be entitled to recover remediation costs from its insurers. We presently estimate the remaining cost of our environmental cleanup activities for the three non-utility sites will be approximately $39.2 million, which amount has been accrued by us as a reasonable estimate of probable costs for known sites. Expenditures incurred since November 8, 2000, with respect to these sites total $4.0 million.

We believe that in the aggregate, the accrued liability for investigation and remediation of sites and related facilities identified above are reasonable estimates of likely cost within a range of reasonable, foreseeable costs. We may be required to investigate and, if necessary, remediate each of these, or other currently unknown former sites and related facility sites, the cost of which is not presently determinable but may be material to our financial position, results of operations or cash flows. Remediation costs for each site may be materially higher than noted, depending upon remediation experience, selected end use for each site, and actual environmental conditions encountered.

Note 8. Hedging, Derivative Financial Instruments and Fair Values

Financially-Settled Commodity Derivative Instruments: From time to time KeySpan has utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging exposure to commodity price risk and to hedge the cash flow variability associated with a portion of peak electric energy sales.

Houston Exploration has utilized collars, as well as over-the-counter ("OTC") swaps to hedge the cash flow variability associated with forecasted sales of a portion of its natural gas production. As of December 31, 2002, Houston Exploration has hedged approximately 67% and 20% of its estimated 2003 and 2004 production, respectively. Further, Houston Exploration may enter into additional derivative positions for 2003 and 2004. Houston Exploration used standard New York Mercantile Exchange ("NYMEX") futures prices and published volatility in its Black-Scholes calculation to value its outstanding derivatives. The maximum length of time over which Houston Exploration has hedged such cash flow variability is through December 2004. The estimated amount of losses associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $34.9 million or, $22.7 million after-tax.

With respect to price exposure associated with fuel purchases for the Ravenswood facility, KeySpan employs standard NYMEX natural gas futures contracts and over-the-counter financially settled natural gas basis swaps to hedge the cash flow variability of a portion of forecasted purchases of natural gas. KeySpan also employs the use of financially-settled oil swap contracts to hedge the cash flow variability of a portion of forecasted purchases of fuel oil that will be consumed at the Ravenswood facility. The maximum length of time over which we have hedged cash flow variability associated with: (i) forecasted purchases of natural gas is through December 2003; and (ii) forecasted purchases of fuel oil is through April 2004. We used standard NYMEX futures prices to value the gas futures contracts and industry published oil indices for number 6 grade fuel oil to value the oil swap contracts. The estimated amount of gains associated with all such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $4.5 million or, $2.9 million after-tax.

Our retail gas and electric marketing subsidiary, our domestic gas distribution operations and KeySpan Canada employed NYMEX natural gas futures contracts and natural gas swaps to lock-in a price for expected future natural gas purchases. As applicable, we used standard NYMEX futures prices and relevant natural gas indices to value the outstanding contracts. The maximum length of time over which we have hedged such cash flow variability is through December 2003. The estimated amount of gains associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $4.9 million or, $3.2 million after-tax.

We have also engaged in the use of cash-settled swap instruments to hedge the cash flow variability associated with (i) a portion of forecasted peak electric energy sales from the Ravenswood facility and (ii) forecasted sales of Unforced Capacity ("UCAP") to the NYISO. The maximum length of time over which we have hedged cash flow variability is through March 2004. We used NYISO-location zone published indices as well as published NYISO bidding prices to value these outstanding derivatives. The estimated amount of losses associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $1.1 million or, $0.7 million after-tax.

KeySpan Canada also has employed electricity swap contracts to lock-in the purchase price of electricity needed to operate its gas processing plants. These contracts are not exchange-traded and local published indices were used to value these outstanding swap agreements. The maximum length of time over which we have hedged such cash flow variability is through December 2003. The estimated amount of losses associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $1.5 million or, $1.0 million after-tax.

The following tables set forth selected financial data associated with these derivative financial instruments noted above that were outstanding at December 31, 2002.

Type of Contract	Year of Maturity	Volumes mmcf	Floor $	Ceiling $	Fixed Price $	Current Price $	Fair Value ($000)
Gas							
Collars	2003	54,300	3.48	4.92	—	4.43-4.99	(14,681)
	2004	18,300	3.50	4.75	—	4.03-4.81	(3,767)
Swaps/Futures - Short							
Natural Gas	2003	14,751	—	—	2.91-3.52	3.87-4.99	(20,694)
Swaps/Futures - Long							
Natural Gas	2003	10,580	—	—	3.10-5.38	4.43-5.02	7,428
		97,931					(31,714)

Type of Contract	Year of Maturity	Volumes Barrels	Fixed Price $	Current Price $	Fair Value ($000)
Oil					
Swaps - Short Fuel Oil	2003	90,000	28.50	28.14-31.00	(145)
Swaps - Long Fuel Oil	2003	320,815	20.05-27.20	23.72-33.81	2,633
	2004	5,548	20.50-23.70	22.66-23.19	6
		416,363			2,494

Type of Contract	Year of Maturity	Capacity	MWh	Fixed Margin/ Price $	Current Price $	Fair Value ($000)
Electricity						
Swaps - Energy	2003		119,680	12.70-57.80	14.15-48.09	(1,889)
	2004		68,800	14.00	22.25-22.34	(823)
Swaps - Capacity	2003	1,000		7.75	7.00-9.41	(696)
		1,000	188,480			(3,408)

Change in Fair Value of Derivative Instruments ($000)	2002
Fair value of contracts at January 1,	$ 55,097
(Gain) on contracts realized	(26,204)
Fair value of new contracts when entered into during period	—
(Decrease) in fair value of all open contracts	(61,521)
Fair value of contracts outstanding at December 31,	$ (32,628)

NYMEX futures are also used to economically hedge the cash flow variability associated with the purchase of fuel for a portion of our fleet vehicles. Further, KeySpan Canada has a portfolio of financially-settled natural gas collars and natural gas liquid swap transactions. Such contracts are executed by KeySpan Canada to: (i) synthetically fix the price that is paid or received by KeySpan Canada for certain physical transactions involving natural gas and natural gas liquids and (ii) transfer the price exposure of such instruments to other trading partners. In addition, our retail gas and electric marketing subsidiary has bought options to economically hedge the cash flow variability associated with a portion of expected future natural gas purchases. These derivative financial instruments do not qualify for hedge accounting under SFAS 133. At December 31, 2002, these instruments had a net fair market value of ($0.4) million, that was recorded on the Consolidated Balance Sheet. Based on the non-hedge designation of these instruments, the loss was recognized in the Consolidated Statement of Income.

Firm Gas Sales Derivative Instruments – Regulated Utilities: We also use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New Hampshire service territories. Since these derivative instruments are employed to reduce the variability of the purchase price of natural gas to be sold to regulated firm gas sales customers, the accounting for these derivative instruments is subject to SFAS 71. Therefore, changes in the market value of these derivatives have been recorded as a Regulatory Asset or Regulatory Liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers during the appropriate winter heating season consistent with regulatory requirements.

The following table sets forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2002.

Type of Contract	Year of Maturity	Volumes mmcf	Fixed Price $	Current Price $	Fair Value ($000)
Options	2003	5,560	3.90-4.50	4.27	3,250
Swaps	2003	2,080	3.85-4.50	4.79-4.95	1,586
		7,640			4,836

Physically-Settled Commodity Derivative Instruments: On April 1, 2002 we implemented Derivative Implementation Group ("DIG") Issue C15 and C16 of Statement of Financial Accounting Standard 133, "Accounting for Derivative Instruments and Hedging Activities", as amended and interpreted, incorporating SFAS 137 and SFAS 138 and certain implementation issues (collectively "SFAS 133"). Issue C15 establishes new criteria that must be satisfied in order for option-type

and forward contracts in electricity to be exempted as normal purchases and sales, while Issue C16 relates to the exemption (as normal purchases and normal sales) of contracts that combine a forward contract and a purchased option contract. Based upon a review of our physical commodity contracts, we determined that certain contracts for the physical purchase of natural gas can no longer be exempted as normal purchases from the requirements of SFAS 133. At December 31, 2002, the fair value of these contracts was $1.2 million. Since these contracts are for the purchase of natural gas sold to regulated firm gas sales customers, the accounting for these contracts is subject to SFAS 71. Therefore, changes in the market value of these contracts have been recorded as a Regulatory Asset or Regulatory Liability on the Consolidated Balance Sheet.

Interest Rate Derivative Instruments: During most of 2002, we had interest rate swap agreements in which approximately $1.3 billion of fixed rate debt had been synthetically modified to floating rate debt. Under the terms of the agreements, we received the fixed coupon rate associated with these bonds and paid the counter-parties a variable interest rate that was reset on a quarterly basis. These swaps were designated as fair-value hedges and qualified for "short-cut" hedge accounting treatment under SFAS 133. Through the utilization of these agreements, we reduced recorded interest expense by $35.6 million for the twelve months ended December 31, 2002.

In early November 2002, we terminated two interest rate swap agreements with an aggregate notional amount of $1.0 billion and received $80.9 million from our swap counter-parties, of which $23.4 million represented accrued swap interest. The difference between the termination settlement amount and the amount of accrued swap interest, $57.4 million, will be amortized to earnings (as an adjustment to interest expense) on a level yield basis over the remaining lives of the originally hedged debt obligations. The remaining swap, which had a notional amount of $270.0 million, and a fair market value of $15.6 million at December 31, 2002, was terminated on February 25, 2003. We received $18.4 million from our swap counter-parties, of which $8.1 million represents accrued swap interest. The difference between the termination settlement amount and the amount of accrued interest, $10.3 million, will be recorded to earnings in the first quarter of 2003. This swap was used to hedge a portion of our outstanding promissory notes to LIPA. As discussed in Note 6, "Long-Term Debt" we intend to redeem a portion of these promissory notes before the end of the first quarter of 2003.

Additionally, we also have an interest rate swap agreement that hedges the cash flow variability associated with the forecasted issuance of a series of commercial paper offerings. The maximum length of time over which we have hedged such cash flow variability is through March 2003. The estimated amount of loss associated with such derivative instruments that are reported in Other Comprehensive Income and that are expected to be reclassified into earnings over the next twelve months is $0.6 million or, $0.4 million after tax.

Weather Derivatives: The utility tariffs associated with KEDNE's operations do not contain weather normalization adjustments. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate a substantial portion of the effect of fluctuations from normal weather on our financial position and cash flows, we sold heating degree-day call options and purchased heating degree-day put options for the November 2002 – March 2003 winter season. With respect to sold call options, KeySpan is required to make a payment of $40,000 per heating degree day to its counter-parties when actual weather experienced during the November 2002 – March 2003 time frame is above 4,470 heating degree days, which equates to approximately 1% colder than normal weather. With respect to purchased put options, KeySpan will receive a $20,000 per heating degree day payment from its counter-parties when actual weather is below 4,150 heating degree days, or is approximately 7% warmer than normal. Based on the terms of such contracts, as discussed in Note 1 "Summary of Significant Accounting Policies," we account for such instruments pursuant to the requirements of EITF 99-2, "Accounting for Weather Derivatives." In this regard, we account for such instruments using the "intrinsic value method" as set forth in such guidance. During the fourth quarter of 2002, weather was 7% colder than normal and, as a result, $3.3 million has been recorded as a reduction to revenues.

Derivative contracts are primarily used to manage exposure to market risk arising from changes in commodity prices and interest rates. In the event of nonperformance by a counter-party to a derivative contract, the desired impact may not be achieved. The risk of a counter-party nonperformance is generally considered credit risk and is actively managed by assessing each counter-party credit profile and negotiating appropriate levels of collateral and credit support.

Fair Values of Long-Term Debt

	(In Thousands of Dollars)	
At December 31,	2002	2001
First Mortgage Bonds	$ 180,666	$ 182,666
Notes	3,441,619	3,076,455
Gas Facilities Revenue Bonds	674,828	630,845
Authority Financing Notes	66,005	66,005
Promissory Notes	616,240	617,933
MEDS Equity Units	525,918	—
	$ 5,505,276	$ 4,573,904

Carrying Values of Long-Term Debt

	(In Thousands of Dollars)	
At December 31,	2002	2001
First Mortgage Bonds	$ 163,625	$ 179,122
Notes	2,985,000	2,985,000
Gas Facilities Revenue Bonds	648,500	648,500
Authority Financing Notes	66,005	66,005
Promissory Notes	602,427	602,427
MEDS Equity Units	460,000	—
	$ 4,925,557	$ 4,481,054

Our subsidiary debt is carried at an amount approximating fair value because interest rates are based on current market rates. All other financial instruments included in the Consolidated Balance Sheet such as cash, commercial paper, accounts receivable and accounts payable, are also stated at amounts that approximate fair value.

Note 9. Discontinued Operations

On November 8, 2000, KeySpan acquired Midland Enterprises LLC ("Midland"), an inland marine transportation subsidiary, as part of the Eastern acquisition. In its order approving the acquisition, the SEC required KeySpan to sell this subsidiary by November 8, 2003 because Midland's operations were not functionally related to KeySpan's core utility operations. On July 2, 2002, the sale of Midland to Ingram Industries Inc. was completed and net proceeds of $175.1 million were received from the sale.

Discontinued operations for the year ended December 31, 2001 included an anticipated after-tax loss on disposal of $30.4 million. As a result of a change in the tax structuring strategy related to the sale of Midland, in the second quarter of 2002 we recorded an additional provision for city and state taxes and made adjustments to the estimates used in the December 31, 2001 loss provision. These changes resulted in an additional after tax loss on disposal of $19.7 million.

The following is selected financial information for Midland for the period January 1, 2002 through July 2, 2002 and the year ended December 31, 2001 and for the period November 8, 2000 through December 31, 2000:

		(In Thousands of Dollars)	
	2002	2001	2000
Revenues	$116,149	$266,792	$40,788
Pre-tax income (loss)	(4,624)	18,489	(2,970)
Income tax (expense) benefit	1,268	(7,571)	1,027
Income (loss) from discontinued operations	(3,356)	10,918	(1,943)
Estimated book gain on disposal	5,980	44,580	—
Tax expense associated with disposal	(22,286)	(74,936)	—
Estimated loss on disposal	(16,306)	(30,356)	—
Loss from discontinued operations	$(19,662)	$ (19,438)	$ (1,943)

Assets and liabilities of the discontinued operations are as follows:

	(In Thousands of Dollars)
	2001
Current assets	$139,522
Property, plant and equipment, net	316,626
Long-term assets	35,233
Current liabilities	(58,835)
Long-term liabilities	(241,491)
Assets held for disposal	$191,055

Note 10. Roy Kay Operations

During 2001, we undertook a complete evaluation of the strategy, operating controls and organizational structure of the Roy Kay companies - plumbing, mechanical, electrical and general contracting companies acquired by us in January 2000. We decided to discontinue the general contracting business conducted by these companies based upon our view that the general contracting business is not a core competency of these companies. Certain remaining activities engaged in by the Roy Kay companies have been integrated with those of other KeySpan energy-related businesses. During 2002, substantially all of the remaining field work on outstanding construction projects was completed. We are now engaged in the finalization of claims and collections and, as a result, their operations will continue to be consolidated in our Consolidated Financial Statements until such time as this process is complete.

For the year ended December 31, 2001, the Roy Kay companies incurred an after-tax loss of $95.0 million ($137.8 million pre-tax) reflecting: (i) unanticipated costs to complete work on certain construction projects; (ii) the impact of inaccuracies in the books of these companies relating to their overall financial and operational performance; (iii) discontinuance costs of the general contracting activities of those companies, including the write-off of goodwill, and certain account and retainage receivables; and (iv) operating losses. For the years ended December 31, 2002, 2001 and 2000 the Roy Kay companies recorded EBIT losses of $10.8 million, $137.8 million and EBIT earnings of $1.3 million, respectively. KeySpan and the former Roy Kay companies are currently engaged in litigation relating to the termination of the former owners, as well as other matters relating to the acquisition of the Roy Kay companies. (See Note 7 "Contractual Obligations and Contingencies" - Legal Matters.)

Note 11. Class Action Settlement

During 2001, we reversed a previously recorded loss provision regarding certain pending rate refund issues relating to the 1989 RICO class action settlement. This adjustment resulted from a favorable United States Court of Appeals ruling received on September 28, 2001, overturning a lower court decision, and resulted in a positive pre-tax adjustment to earnings of $33.5 million, or $20.1 million after-tax. This adjustment has been reflected as a $22.0 million reduction to Operations and Maintenance expense and a reduction of $11.5 million to Interest Expense on the Consolidated Statement of Income.

Note 12. KeySpan Gas East Corporation Summary Financial Data

KEDLI is a wholly owned subsidiary of KeySpan. KEDLI was formed on May 7, 1998 and on May 28, 1998 acquired substantially all of the assets related to the gas distribution business of LILCO. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway peninsula of Queens county. KEDLI established a program for the issuance, from time to time, of up to $600 million aggregate principal amount of Medium-Term Notes, which will be fully and unconditionally guaranteed by the parent, KeySpan Corporation. On February 1, 2000, KEDLI issued $400 million of 7.875% Medium-Term Notes due 2010. In January 2001, KEDLI issued an additional $125 million of Medium-Term Notes at 6.9% due 2008. The following condensed financial statements are required to be disclosed by SEC regulations and set forth those of KEDLI, KeySpan Corporation as guarantor of the Medium-Term Notes and our other subsidiaries on a combined basis. The December 31, 2001 and 2000 disclosures have been revised to separately present our other subsidiaries.

Statement of Income

Year Ended December 31, 2002 *(In Thousands of Dollars)*

	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Revenues	$ 463	$810,601	$5,160,065	$ (463)	$5,970,666
Operating Expenses					
Purchased gas	—	379,742	1,273,531	—	1,653,273
Fuel and purchased power	—	—	385,059	—	385,059
Operations and maintenance	13,325	45,357	2,043,215	—	2,101,897
Intercompany expense	2,772	79,826	(79,826)	(2,772)	—
Depreciation and amortization	(44)	65,911	448,746	—	514,613
Operating taxes	(2,149)	85,614	327,186	—	410,651
Total Operating Expenses	13,904	656,450	4,397,911	(2,772)	5,065,493
Operating Income (Loss)	(13,441)	154,151	762,154	2,309	905,173
Interest Expense	(200,920)	(62,520)	(295,209)	257,145	(301,504)
Other Income and (Deductions)	565,366	8,152	78,625	(633,068)	19,075
Total Other Income and (Deductions)	364,446	(54,368)	(216,584)	(375,923)	(282,429)
Income (Loss) before income taxes	351,005	99,783	545,570	(373,614)	622,744
Income Taxes (Benefit)	(26,683)	31,188	220,889	—	225,394
Earnings from Continuing Operations	$ 377,688	$ 68,595	$ 324,681	$ (373,614)	$ 397,350
Discontinued Operations	—	—	(19,662)	—	(19,662)
Net Income	$ 377,688	$ 68,595	$ 305,019	$ (373,614)	$ 377,688

Statement of Income

Year Ended December 31, 2001					*(In Thousands of Dollars)*
	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Revenues	$ 504	$889,693	$5,743,422	$ (504)	$6,633,115
Operating Expenses					
Purchased gas	—	464,780	1,706,333	—	2,171,113
Fuel and purchased power	—	—	538,532	—	538,532
Operations and maintenance	(24,537)	45,106	2,094,190	—	2,114,759
Intercompany expense	278	87,738	(87,738)	(278)	—
Depreciation and amortization	4,273	56,274	498,591	—	559,138
Operating taxes	1,094	91,204	356,626	—	448,924
Total Operating Expenses	(18,892)	745,102	5,106,534	(278)	5,832,466
Operating Income (Loss)	19,396	144,591	636,888	(226)	800,649
Interest Expense	(230,618)	(65,206)	(264,286)	206,640	(353,470)
Other Income and (Deductions)	426,346	9,721	18,455	(447,316)	7,206
Total Other Income and (Deductions)	195,728	(55,485)	(245,831)	(240,676)	(346,264)
Income (Loss) before income taxes	215,124	89,106	391,057	(240,902)	454,385
Income Taxes (Benefit)	(9,130)	28,319	191,504	—	210,693
Earnings from Continuing Operations	$ 224,254	$ 60,787	$ 199,553	$(240,902)	$ 243,692
Discontinued Operations	—	—	(19,438)	—	(19,438)
Net Income	$ 224,254	$ 60,787	$ 180,115	$(240,902)	$ 224,254

Statement of Income

Year Ended December 31, 2000					*(In Thousands of Dollars)*
	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Revenues	$ 1,799	$794,965	$4,285,737	$ (1,799)	$5,080,702
Operating Expenses					
Purchased gas		408,087	1,000,593	—	1,408,680
Fuel and purchased power	—	—	460,841	—	460,841
Operations and maintenance	61,520	127,780	1,535,611	—	1,724,911
Intercompany expense	1,799	10,718	(10,718)	(1,799)	—
Depreciation and amortization	4,273	46,017	280,632	—	330,922
Operating taxes	(8,172)	92,684	337,424	—	421,936
Total Operating Expenses	59,420	685,286	3,604,383	(1,799)	4,347,290
Operating Income (Loss)	(57,621)	109,679	681,354	—	733,412
Interest Expense	(97,007)	(53,656)	(118,044)	67,393	(201,314)
Other Income and (Deductions)	417,411	(707)	(67,606)	(361,184)	(12,086)
Total Other Income and (Deductions)	320,404	(54,363)	(185,650)	(293,791)	(213,400)
Income (Loss) before income taxes	262,783	55,316	495,704	(293,791)	520,012
Income Taxes (Benefit)	(38,024)	18,362	236,924	—	217,262
Earnings from Continuing Operations	$300,807	$ 36,954	$ 258,780	$(293,791)	$ 302,750
Discontinued Operations	—	—	(1,943)	—	(1,943)
Net Income	$300,807	$ 36,954	$ 256,837	$(293,791)	$ 300,807

Balance Sheet

December 31, 2002	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
					(In Thousands of Dollars)
Assets					
Current Assets					
Cash and temporary cash investments	$ 88,308	$ 6,472	$ 75,837	$ —	$ 170,617
Accounts receivable, net	23,982	208,512	1,299,559	—	1,532,053
Other current assets	1,757	79,206	432,816	—	513,779
	114,047	294,190	1,808,212	—	2,216,449
Equity Investments	3,797,964	—	792,050	(4,330,826)	259,188
Property					
Gas	—	1,771,780	4,352,501	—	6,124,281
Other	—	—	4,807,724	—	4,807,724
Accumulated depreciation and depletion	—	(322,236)	(3,392,169)	—	(3,714,405)
	—	1,449,544	5,768,056	—	7,217,600
Intercompany Accounts Receivable	3,619,515	54,549	354,747	(4,028,811)	—
Deferred Charges	339,443	195,369	2,386,257	—	2,921,069
Total Assets	$7,870,969	$1,993,652	$11,109,322	$(8,359,637)	$12,614,306
Liabilities and Capitalization					
Current Liabilities					
Accounts payable	$ 240,571	$ 68,772	$ 752,306	$ —	$ 1,061,649
Commercial paper	915,697	—	—	—	915,697
Other current liabilities	—	104,975	137,907	—	242,882
	1,156,268	173,747	890,213	—	2,220,228
Intercompany Accounts Payable	—	233,392	1,714,035	(1,947,427)	—
Deferred Credits and Other Liabilities					
Deferred income tax	(43,110)	139,715	780,408	—	877,013
Other deferred credits and liabilities	481,964	98,805	453,353	—	1,034,122
	438,854	238,520	1,233,761	—	1,911,135
Capitalization					
Common shareholders' equity	2,983,214	647,089	3,645,115	(4,330,826)	2,944,592
Preferred stock	83,849	—	—	—	83,849
Long-term debt	3,208,784	700,904	3,395,777	(2,081,384)	5,224,081
Total Capitalization	6,275,847	1,347,993	7,040,892	(6,412,210)	8,252,522
Minority Interest in Subsidiary Companies	—	—	230,421	—	230,421
Total Liabilities and Capitalization	$7,870,969	$1,993,652	$11,109,322	$(8,359,637)	$12,614,306

Balance Sheet

December 31, 2001					*(In Thousands of Dollars)*
	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Assets					
Current Assets					
Cash and temporary cash investments	$ —	$ —	$ 159,252	$ —	$ 159,252
Accounts receivable, net	25,037	178,464	1,069,098	—	1,272,599
Other current assets	658	112,317	453,661	—	566,636
	25,695	290,781	1,682,011	—	1,998,487
Assets Held for Disposal	—	—	191,055	—	191,055
Equity Investments	3,539,546	—	756,111	(4,072,408)	223,249
Property					
Gas	—	1,629,963	4,074,894	—	5,704,857
Other	—	—	4,231,262	—	4,231,262
Accumulated depreciation and depletion	—	(294,400)	(3,035,788)	—	(3,330,188)
	—	1,335,563	5,270,368	—	6,605,931
Intercompany Accounts Receivable	3,578,204	54,549	445,947	(4,078,700)	—
Deferred Charges	156,001	199,855	2,415,028	—	2,770,884
Total Assets	$7,299,446	$1,880,748	$10,760,520	$(8,151,108)	$11,789,606
Liabilities and Capitalization					
Current Liabilities					
Accounts payable	$ 455,947	$ 115,557	$ 519,926	$ —	$ 1,091,430
Commercial paper	1,048,450	—	—	—	1,048,450
Other current liabilities	(255)	23,844	221,240	—	244,829
	1,504,142	139,401	741,166	—	2,384,709
Intercompany Accounts Payable	—	324,592	1,667,846	(1,992,438)	—
Deferred Credits and Other Liabilities					
Deferred income tax	(60,261)	4,772	653,561	—	598,072
Other deferred credits and liabilities	320,510	100,452	521,152	—	942,114
	260,249	105,224	1,174,713	—	1,540,186
Capitalization					
Common shareholders' equity	2,823,177	610,627	3,529,206	(4,072,408)	2,890,602
Preferred stock	84,077	—	—	—	84,077
Long-term debt	2,627,801	700,904	3,455,206	(2,086,262)	4,697,649
Total Capitalization	5,535,055	1,311,531	6,984,412	(6,158,670)	7,672,328
Minority Interest in Subsidiary Companies	—	—	192,383	—	192,383
Total Liabilities and Capitalization	$7,299,446	$1,880,748	$10,760,520	$(8,151,108)	$11,789,606

Statement of Cash Flows

Year Ended December 31, 2002				*(In Thousands of Dollars)*
	Guarantor	KEDLI	Other Subsidiaries	Consolidated
Operating Activities				
Net Cash (Used In) Provided by Operating Activities	$ (97,981)	$ 191,826	$ 715,232	$ 809,077
Investing Activities				
Capital expenditures	—	(148,418)	(985,459)	(1,133,877)
Other	—	—	147,531	147,531
Net Cash (Used in) Investing Activities	—	(148,418)	(837,928)	(986,346)
Financing Activities				
Treasury stock issued	86,710	—	—	86,710
Issuance (payment) of debt, net	327,247	—	(35,711)	291,536
Common and preferred stock dividends paid	(256,656)	—	—	(256,656)
Termination of interest rate swaps and other	70,299	—	(3,255)	67,044
Net intercompany accounts	(41,311)	(36,936)	78,247	—
Net Cash Provided by (Used In) Financing Activities	186,289	(36,936)	39,281	188,634
Net (Decrease) Increase in Cash and Cash Equivalents	$ 88,308	$ 6,472	$ (83,415)	$ 11,365
Cash and Cash Equivalents at Beginning of Period	—	—	159,252	159,252
Cash and Cash Equivalents at End of Period	$ 88,308	$ 6,472	$ 75,837	$ 170,617

Statement of Cash Flows

Year Ended December 31, 2001				*(In Thousands of Dollars)*
	Guarantor	KEDLI	Other Subsidiaries	Consolidated
Operating Activities				
Net Cash Provided by Operating Activities	$ 121,028	$ 64,294	$ 704,859	$ 890,181
Investing Activities				
Capital expenditures	—	(131,568)	(928,191)	(1,059,759)
Other	—	—	18,452	18,452
Net Cash (Used in) Investing Activities	—	(131,568)	(909,739)	(1,041,307)
Financing Activities				
Treasury stock issued	88,786	—	—	88,786
Issuance (payment) of debt, net	248,213	125,000	3,706	376,919
Common and preferred stock dividends paid	(251,502)	—	—	(251,502)
Other	10,582	—	2,264	12,846
Net intercompany accounts	(217,107)	(57,726)	274,833	—
Net Cash Provided by (Used In) Financing Activities	(121,028)	67,274	280,803	227,049
Net Increase in Cash and Cash Equivalents	$ —	$ —	$ 75,923	$ 75,923
Cash and Cash Equivalents at Beginning of Period	—	—	83,329	83,329
Cash and Cash Equivalents at End of Period	$ —	$ —	$ 159,252	$ 159,252

Statement of Cash Flows

Year Ended December 31, 2000				*(In Thousands of Dollars)*
	Guarantor	KEDLI	Other Subsidiaries	Consolidated
Operating Activities				
Net Cash Provided by Operating Activities	$ 245,497	$ 112,738	$ 80,491	$ 438,726
Investing Activities				
Capital expenditures	—	(114,977)	(518,058)	(633,035)
Other	(1,946,043)	—	(292,732)	(2,238,775)
Net Cash (Used In) Investing Activities	(1,946,043)	(114,977)	(810,790)	(2,871,810)
Financing Activities				
Treasury stock issued	72,289	—	—	72,289
Receipt/payment of dividends	—	(125,000)	125,000	—
Redemption of preferred stock	(363,000)	—	—	(363,000)
Issuance (payment) of debt, net	2,741,937	400,000	(107,975)	3,033,962
Debt received (paid)	397,000	(397,000)	—	—
Common and preferred stock dividends paid	(260,001)	—	—	(260,001)
Termination of interest rate swaps and other	(41,799)	—	(53,640)	(95,439)
Net intercompany accounts	(845,880)	124,239	721,641	—
Net Cash Provided by Financing Activities	1,700,546	2,239	685,026	2,387,811
Net (Decrease) in Cash and Cash Equivalents	$ —	$ —	$ (45,273)	$ (45,273)
Cash and Cash Equivalents at Beginning of Period	—	—	128,602	128,602
Cash and Cash Equivalents at End of Period	$ —	$ —	$ 83,329	$ 83,329

Note 13. Eastern/EnergyNorth Acquisition

On November 8, 2000, we purchased all of the outstanding stock of Eastern for $64.56 per share in cash and all of the outstanding common stock of ENI for $61.46 per share in cash. Itemization of the purchase price is as follows:

	(In Thousands of Dollars)
Eastern Enterprises Common Stock	$1,754,400
EnergyNorth Common Stock	204,200
Transaction costs	10,200
Other	2,000
Total Consideration	$1,970,800

The transactions have been accounted for using the purchase method of accounting for business combinations. Accordingly, the accompanying Consolidated Statement of Income includes Eastern and ENI results commencing November 8, 2000. The purchase price was allocated to the net assets acquired based upon their fair value. The historical cost basis of Eastern's and ENI's assets and liabilities, with minor exceptions, was determined to represent the fair value due to the existence of regulatory-approved rate plans based upon the recovery of historical costs and a fair return thereon. The allocation of the purchase price to the assets and liabilities acquired from Eastern and ENI was as follows:

			(In Thousands of Dollars)
	Eastern	ENI	Total
Gas Plant	$ 599,900	$124,800	$ 724,700
Other Plant (non-regulated)	704,600	—	704,600
Investments and regulatory assets	82,100	—	82,100
Current assets	322,500	40,200	362,700
Other deferred charges	63,300	14,700	78,000
Current liabilities	(333,400)	(77,000)	(410,400)
Other liabilities	(498,000)	(23,600)	(521,600)
Long-term debt	(502,100)	(45,200)	(547,300)
Net assets acquired*	$ 438,900	$ 33,900	$ 472,800
Goodwill	1,325,600	172,400	1,498,000
Total purchase price	$1,764,500	$206,300	$1,970,800

** Certain non-regulated long-term assets of Eastern were increased by approximately $25 million to reflect the fair value of such assets at the date of acquisition. Further, no intangible assets were acquired as part of this transaction.*

The following is the comparative unaudited proforma condensed financial information for the year ended December 31, 2000. The proforma disclosures reflect the results of the operations of Eastern and ENI as if our acquisitions were consummated on January 1, 2000.

	(In Thousands of Dollars, Except Per Share Amounts)
	Year Ended December 31, 2000
Revenues	$6,130,158
Operating Income	$ 671,081
Net Income	$ 114,393
Earnings Per Share	$ 0.71

Included in the 2000 pro-forma earnings are merger related costs of $76.0 million, after-tax, recorded by Eastern and ENI in connection with our acquisition of these companies. Excluding these costs, pro-forma earnings were $1.27 per share for the year ended December 31, 2000. These pro-forma results may not be indicative of future results. Further, the consolidated pro-forma results for 2000 do not take into account: (i) continued gas sales growth throughout our service territories, especially on Long Island and in New England; (ii) earnings enhancement from our gas exploration and production operations; and (iii) the continued successful integration of acquired companies providing energy-related services within our Energy Services segment.

Note 14. Workforce Reduction Programs

As a result of the Eastern and ENI acquisitions, we implemented early retirement and severance programs in an effort to reduce our workforce. The early retirement program was completed in December 2000, at which time KeySpan recorded a charge of $51.4 million to reflect termination benefits related to employees who voluntarily elected early retirement. In addition, KeySpan recorded a $13.8 million liability associated with severance programs; Eastern and ENI had previously recorded an additional liability of $8.9 million. The combined liability, therefore, was $22.7 million. During the year ended December 31, 2001, we reduced this liability by $4.1 million as a result of lower than anticipated costs per employee and recorded a corresponding reduction to goodwill. During 2002, we paid $3.5 million for the program and, in total, $13.6 million was distributed to employees during the past two years. The remaining liability of $5.0 million was reversed and recorded to earnings in 2002.

Note 15. Shareholder Rights Plan

On March 30, 1999, our Board of Directors adopted a Shareholder Rights Plan (the "Plan") designed to protect shareholders in the event of a proposed takeover. The Plan creates a mechanism that would dilute the ownership interest of a potential unauthorized acquirer. The Plan establishes one preferred stock purchase "right" for each outstanding share of common stock to shareholders of record on April 14, 1999. Each right, when exercisable, entitles the holder to purchase 1/100th of a share of Series D Preferred Stock, at a price of $95.00. The rights generally become exercisable following the acquisition of more than 20 percent of our common stock without the consent of the Board of Directors. Prior to becoming exercisable, the rights are redeemable by the Board of Directors for $0.01 per right. If not so redeemed, the rights will expire on March 30, 2009.

Note 16. Subsequent Events

Subsequent to December 31, 2002, the following events occurred:

On January 17, 2003, KeySpan sold 13.9 million shares of common stock in a public offering. The offering generated net proceeds of approximately $473 million. All shares were offered by KeySpan pursuant to the effective shelf registration statement filed with the SEC. Net proceeds from the sale were used initially to pay down commercial paper.

On February 25, 2003 we terminated an interest rate swap agreement that had a notional amount of $270 million and received $18.4 million from our swap counter-parties of which $8.1 million represents accrued swap interest. The difference between the termination settlement amount and the amount of accrued swap interest, $10.3 million, will be recorded through earnings in the first quarter of 2003. This swap was used to hedge a portion of our outstanding promissory notes to LIPA. As discussed in Note 6 "Long-Term Debt," we intend to redeem a portion of these promissory notes before the end of the first quarter of 2003.

On February 26, 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 56% following the repurchase, by Houston Exploration, of 3 million shares of stock previously owned by KeySpan. The net proceeds of approximately $79 million received in connection with this repurchase were used to pay down commercial paper. Additionally there is an over-allotment option for 300,000 shares, which if exercised, would further reduce our ownership in Houston Exploration to 55%.

In connection with the class action lawsuit discussed in Note 7 regarding, among other things, alleged violations of Sections 10 (b) and 20 (a) of the Exchange Act, on March 18, 2003, the court granted our motion to dismiss the complaint. The court's order dismissed certain class allegations with prejudice but provided the plaintiffs a final opportunity to file an amended complaint concerning the remaining allegations. (Unaudited)

Note 17. Supplemental Gas and Oil Disclosures (Unaudited)

This information includes amounts attributable to 100% of Houston Exploration and KeySpan Exploration and Production, LLC at December 31, 2002. Shareholders other than KeySpan had a minority interest of approximately 34% in Houston Exploration at December 31, 2002, 33% in 2001 and 30% in 2000. Gas and oil operations, and reserves, were located in the United States in all years.

Capitalized Costs Relating to Gas and Oil Producing Activities

(In Thousands of Dollars)

At December 31,	2002	2001	2000
Unproved properties not being amortized	$ 110,623	$ 195,478	$ 166,479
Properties being amortized – productive and nonproductive	1,917,287	1,590,014	1,235,436
Total capitalized costs	2,027,910	1,785,492	1,401,915
Accumulated depletion	(968,713)	(791,194)	(617,628)
Net capitalized costs	$1,059,197	$ 994,298	$ 784,287

Costs Incurred in Property Acquisition, Exploration and Development Activities

			(In Thousands of Dollars)
At December 31,	2002	2001	2000
Acquisition of properties –			
Unproved properties	$ 14,600	$ 31,718	$ 7,992
Proved properties	90,004	85,435	40,960
Exploration	28,343	74,497	70,511
Development	139,108	191,927	111,078
Total costs incurred	$272,055	$383,577	$230,541

Costs included in development costs to develop proved undeveloped reserves for the years ended December 31, 2002, 2001 and 2000 were $11.0 million, $19.9 million and $9.7 million, respectively.

Results of Operations from Gas and Oil Producing Activities*

			(In Thousands of Dollars)
At December 31,	2002	2001	2000
Revenues	$356,233	$396,734	$274,209
Production and lifting costs	44,822	37,574	33,508
Depletion	177,519	173,566	90,280
Total expenses	222,341	211,140	123,788
Income before taxes	133,892	185,594	150,421
Income taxes	45,836	64,118	51,767
Results of operations	$ 88,056	$121,476	$ 98,654

* *(Excluding corporate overhead and interest costs)*

Summary of Production and Lifting Costs

			(In Thousands of Dollars)
At December 31,	2002	2001	2000
Pumping, gauging and other labor	$ 7,846	$ 5,342	$ 6,199
Compressors and other rental equipment	4,135	3,023	1,990
Property taxes and insurance	6,801	3,640	2,195
Transportation	2,131	3,162	3,430
Processing fees	3,078	2,267	622
Workover and well stimulation	2,348	1,478	3,310
Repairs, maintenance and supplies	2,972	2,204	2,177
Fuel and chemicals	2,582	1,424	818
Environmental, regulatory and other	3,307	3,639	3,010
Severance taxes	9,622	11,395	9,757
Total production and lifting costs	$44,822	$37,574	$33,508

The gas and oil reserves information is based on estimates of proved reserves attributable to the interest of Houston Exploration and KeySpan Exploration and Production, LLC as of December 31 for each of the years presented. These estimates principally were prepared by independent petroleum consultants. Proved reserves are estimated quantities of natural gas and crude oil which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions.

Reserve Quantity Information Natural Gas (MMcf)

			(In Thousands of Dollars)
At December 31,	2002	2001	2000
Proved reserves			
Beginning of year	585,659	545,858	534,306
Revisions of previous estimates	(15,324)	(39,994)	4,479
Extensions and discoveries	105,798	86,401	77,645
Production	(2,669)	(90,754)	(78,493)
Purchases of reserves in place	48,777	84,148	7,921
Sales of reserves in place	(107,507)	—	—
Proved reserves – End of year (1)	614,734	585,659	545,858
Proved developed reserves			
Beginning of year	448,921	431,536	399,482
End of Year (2)	435,629	448,921	431,536

(1) Includes minority interest of 208,516, 188,077 and 167,730 in 2002, 2001, and 2000, respectively.
(2) Includes minority interest of 148,811, 148,593 and 133,271in 2002, 2001, and 2000, respectively.

Crude Oil, Condensate and Natural Gas Liquids (MBbls)

			(In Thousands of Dollars)
At December 31,	2002	2001	2000
Proved reserves			
Beginning of Year	10,234	7,912	3,136
Revisions of previous estimates	21	(289)	108
Extension and discoveries	—	3,061	4,326
Production	(166)	(536)	(320)
Purchases of reserves in place	—	115	662
Sales of reserves in place	(469)	(29)	—
Proved reserves – End of year (1)	9,620	10,234	7,912
Proved developed reserves			
Beginning of year	2,479	2,126	2,059
End of year (2)	2,413	2,479	2,126

(1) Includes minority interest of 2,256, 2,186 and 1,695 in 2002, 2001, and 2000, respectively.
(2) Includes minority interest of 824, 821 and 573 in 2002, 2001, and 2000, respectively.

The standardized measure of discounted future net cash flows was prepared by applying year-end prices of gas and oil to the proved reserves. The standardized measure does not purport, nor should it be interpreted, to present the fair value of gas and oil reserves of Houston Exploration or KeySpan Exploration and Production LLC. An estimate of fair value would also take into account, among other things, the recovery of reserves not presently classified as proved, anticipated future changes in prices and costs, and a discount factor more representative of the time value of money and the risks inherent in reserve estimates.

Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Gas and Oil Reserves

		(In Thousands of Dollars)	
At December 31,	2002	2001	2000
Future cash flows	$2,951,622	$1,580,077	$ 5,415,587
Future costs –			
Production	(495,097)	(316,421)	(558,384)
Development	(263,926)	(227,158)	(182,242)
Future net inflows before income tax	2,192,599	1,036,498	4,674,961
Future income taxes	(559,853)	(221,324)	(1,299,965)
Future net cash flows	1,632,746	815,174	3,374,996
10% discount factor	(528,829)	(228,988)	(1,209,237)
Standardized measure of discounted future net cash flows (1)	$1,103,917	$ 586,186	$2,165,759

(1) Includes minority interest of 361,435, 182,555 and 653,046 in 2002, 2001 and 2000, respectively.

Costs included in future development costs related to proved and undeveloped reserves for the years ending December 31, 2003, 2004 and 2005 are $155.6 million, $38.2 million and $7.0 million, respectively.

Changes in Standardized Measure of Discounted Future Net Cash Flows from Proved Reserve Quantities

		(In Thousands of Dollars)	
At December 31,	2002	2001	2000
Standardized measure – beginning of year	$ 586,186	$2,165,759	$ 480,632
Sales and transfers, net of production costs	(285,603)	(359,163)	(240,702)
Net change in sales and transfer prices, net of production costs	589,632	(2,250,252)	2,142,932
Extensions and discoveries and improved recovery, net of related costs	242,055	117,326	472,658
Changes in estimated future development costs	(6,453)	(23,395)	(38,839)
Development costs incurred during the period that reduced future development costs	42,075	75,652	77,197
Revisions of quantity estimates	(36,368)	(52,928)	24,650
Accretion of discount	68,986	293,581	54,460
Net change in income taxes	(215,369)	666,373	(706,074)
Net purchases of reserves in place	99,741	51,674	23,118
Sales of reserves in place	(31,488)	(133)	—
Changes in production rates (timing) and other	50,523	(98,308)	(124,273)
Standardized measure – end of year	$1,103,917	$ 586,186	$2,165,759

Average Sales Prices and Production Costs Per Unit

Year Ended December 31,	2002	2001	2000
Average sales price*			
Natural gas ($/MCF)	3.16	4.09	3.97
Oil, condensate and natural gas liquid ($/Bbl)	24.06	23.09	27.29
Production cost per equivalent MCF ($)	0.42	0.40	0.42

** Represents the cash price received which excludes the effect of any hedging transactions.*

Acreage

At December 31, 2002	Gross	Net
Producing	396,988	262,659
Undeveloped	267,666	228,428

Number of Producing Wells

At December 31, 2002	Gross	Net
Gas wells	1,593.0	861.3
Oil wells	10.0	6.1

Drilling Activity (Net)

At December 31, 2002	Producing	Dry	Total
Net developmental wells	65.1	9.4	74.5
Net exploratory wells	4.0	2.2	6.2

At December 31, 2001	Producing	Dry	Total
Net developmental wells	51.9	10.2	62.1
Net exploratory wells	5.3	4.3	9.6

At December 31, 2000	Producing	Dry	Total
Net developmental wells	40.4	4.4	44.8
Net exploratory wells	5.1	1.7	6.8

Wells in Process

At December 31, 2002	Gross	Net
Exploratory	5.0	2.8
Developmental	7.0	6.2

Note 18. Summary of Quarterly Information (Unaudited)

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2002.

	(In Thousands of Dollars, Except Per Share Amounts)			
	Quarter Ended 3/31/02	Quarter Ended 6/30/02	Quarter Ended 9/30/02	Quarter Ended 12/31/02
Operating revenues	1,871,366	1,215,911	1,076,066	1,807,323
Earnings before interest charges and taxes	406,063	112,272	86,230	319,683
Earnings from continuing operations	214,631	29,174	4,964	148,581
Loss from discontinued operations	—	(19,662)	—	—
Earnings for common stock	213,155	8,036	3,629	147,115
Basic earnings per common share from continuing operations less preferred stock dividends (a)	1.52	0.20	0.03	1.03
Basic earnings per common share from discontinued operations (a)	—	(0.14)	—	
Basic earnings per common share (a)	1.52	0.06	0.03	1.03
Diluted earnings per common share (a)	1.51	0.06	0.02	1.03
Dividends declared	0.445	0.445	0.445	0.445

(a) Quarterly earnings per share are based on the average number of shares outstanding during each quarter. Because of the changing number of common shares outstanding in each quarter, the sum of quarterly earnings per share does not necessarily equal earnings per share for the year.

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2001.

	(In Thousands of Dollars, Except Per Share Amounts)			
	Quarter Ended 3/31/01	Quarter Ended 6/30/01 (a)	Quarter Ended 9/30/01 (b)	Quarter Ended 12/31/01 (c)
Operating revenues	2,575,088	1,339,302	1,102,439	1,616,286
Earnings before interest charges and taxes	462,104	85,224	49,792	210,735
Earnings (loss) from continuing operations	224,114	(10,417)	(37,427)	67,422
Earnings (loss) from discontinued operations	661	3,892	2,253	(26,244)
Earnings (loss) for common stock	223,299	(8,001)	(36,647)	39,699
Basic earnings per common share from continuing operations less preferred stock dividends (d)	1.63	(0.09)	(0.28)	0.48
Basic earnings per common share from discontinued operations (d)	—	0.03	0.02	(0.19)
Basic earnings per common share (d)	1.63	(0.06)	(0.26)	0.29
Diluted earnings per common share (d)	1.61	(0.06)	(0.26)	0.28
Dividends declared	0.445	0.445	0.445	0.445

(a) Reflects costs to complete work on certain construction projects, as well as operating losses of the Roy Kay Companies of $35.6 million after-tax.

(b) Reflects the reversal of a previously recorded loss provision regarding certain pending rate refund issues of $20.1 after-tax. Also includes losses incurred by the Roy Kay Companies of $56.6 million after-tax related to the discontinuance of the general contracting activities of these companies.

(c) Reflects an after-tax non-cash impairment charge of $26.2 million to recognize the effect of lower wellhead prices on the valuation of proved gas reserves, as well as after-tax operating losses of the Roy Kay Companies of $2.8 million.

(d) Quarterly earnings per share are based on the average number of shares outstanding during each quarter. Because of the changing number of common shares outstanding in each quarter, the sum of quarterly earnings per share does not necessarily equal earnings per share for the year.

Selected Financial Data

(In Thousands of Dollars, Except Per Share Amounts)

	Year Ended December 31, 2002	Year Ended December 31, 2001	Year Ended December 31, 2000	Year Ended December 31, 1999	Nine Months Ended December 31, 1998
Income Summary					
Revenues					
Gas Distribution	$ 3,163,761	$3,613,551	$ 2,555,785	$1,753,132	$ 856,172
Electric Services	1,421,043	1,421,079	1,444,711	861,582	408,305
Electric Distribution	—	—	—	—	330,011
Energy Services	938,761	1,100,167	770,110	186,529	63,064
Energy Investments and other	447,101	498,318	310,096	153,370	70,929
Total revenues	5,970,666	6,633,115	5,080,702	2,954,613	1,728,481
Operating expenses					
Purchased gas for resale	1,653,273	2,171,113	1,408,680	744,432	331,690
Fuel and purchased power	385,059	538,532	460,841	17,252	91,762
Operations and maintenance	2,101,897	2,114,759	1,659,736	1,091,166	777,678
Depreciation, depletion and amortization	514,613	559,138	330,922	253,440	254,859
Early retirement and severance charges	—	—	65,175	—	64,635
Operating taxes	410,651	448,924	421,936	366,154	257,124
Operating income	905,173	800,649	733,412	482,169	(49,267)
Other income (deductions)	(282,429)	(346,264)	(213,400)	(87,196)	(177,460)
Income (loss) before income taxes	622,744	454,385	520,012	394,973	(226,727)
Income taxes (credits)	225,394	210,693	217,262	136,362	(59,794)
Earnings (loss) from continuing operations	397,350	243,692	302,750	258,611	(166,933)
Discontinued Operations					
Income (loss) from operations, net of tax	(3,356)	10,918	(1,943)	—	—
Loss on disposal, net of tax	(16,306)	(30,356)	—	—	—
Loss from discontinued operations	(19,662)	(19,438)	(1,943)	—	—
Net Income (loss)	377,688	224,254	300,807	258,611	(166,933)
Preferred stock dividend requirements	5,753	5,904	18,113	34,752	28,604
Earnings (loss) for Common Stock	$ 371,935	$ 218,350	$ 282,694	$ 223,859	$ (195,537)
Financial Summary					
Basic earnings (loss) per share ($)	2.63	1.58	2.10	1.62	(1.34)
Cash dividends declared per share ($)	1.78	1.78	1.78	1.78	1.19
Book value per share, year-end ($)	20.67	20.73	20.65	20.26	20.90
Market value per share, year-end ($)	35.24	34.65	42.38	23.19	31.00
Shareholders, year-end	78,281	82,300	86,900	90,500	103,239
Capital expenditures ($)	1,161,456	1,059,759	925,257	725,670	676,563
Total assets ($)	12,614,306	11,789,606	11,307,465	6,730,691	6,895,102
Common shareholders' equity ($)	2,944,592	2,890,602	2,815,816	2,712,325	3,022,908
Redeemable preferred stock ($)	—	—	—	363,000	363,000
Preferred stock ($)	83,849	84,077	84,205	84,339	447,973
Long-term debt ($)	5,224,081	4,697,649	4,116,441	1,682,702	1,619,067
Total capitalization ($)	8,252,522	7,672,328	7,016,462	4,479,366	5,089,948
Utility Operating Statistics					
Firm gas and transportation sales (MDTH)	348,454	347,659	271,543	244,659	87,179
Other sales (MDTH)	209,002	188,037	126,372	85,773	38,088
Total active gas meters	2,523,974	2,499,170	2,483,730	1,628,497	1,610,202

KeySpan Corporation Directors and Officers

Board of Directors *(as of December 31, 2002)*

Robert B. Catell
Chairman and
Chief Executive Officer
KeySpan Corporation

Andrea S. Christensen
Partner
Kaye Scholer LLP

Donald H. Elliott
Partner
Hollyer Brady Smith
& Hines LLP

Alan H. Fishman
President and
Chief Executive Officer
Independence Community
Bank Corp.

J. Atwood Ives
Former Chairman and
Chief Executive Officer
Eastern Enterprises

James R. Jones
Co-Chairman and
Chief Executive Officer
Manatt Jones Global
Strategies, LLC

James L. Larocca
Dean and
Distinguished Professor
Southampton College
Long Island University

Stephen W. McKessy
Retired Vice Chairman
PricewaterhouseCoopers

Edward D. Miller
Former President
and Chief Executive Officer
AXA Financial, Inc.

Edward Travaglianti
Former Chairman and
Chief Executive Officer
European American Bank

Committees of the Board

Executive Committee

Robert B. Catell,
Chairman
Alan H. Fishman
J. Atwood Ives
Stephen W. McKessy
Edward D. Miller

Audit Committee

Alan H. Fishman,
Chairman
Andrea S. Christensen
James L. Larocca
Stephen W. McKessy
Edward Travaglianti

Compensation and Nominating Committee

Edward D. Miller,
Chairman
Donald H. Elliott
James R. Jones
James L. Larocca
Stephen W. McKessy

Corporate Responsibility and Governance Committee

Donald H. Elliott,
Chairman
Andrea S. Christensen
James R. Jones
James L. Larocca

Principal Officers

Office of the Chairman

Robert B. Catell
Chairman and
Chief Executive Officer
KeySpan Corporation

Robert J. Fani
President
Energy Assets
and Supply Group

Wallace P. Parker Jr.
President
Energy Delivery and
Customer Relationship Group

Steven L. Zelkowitz
Executive Vice President and
Chief Administrative Officer

Executive Vice Presidents

John A. Caroselli
Executive Vice President
and Chief Strategy Officer

Gerald Luterman
Executive Vice President
and Chief Financial Officer

Anthony Nozzolillo
Executive Vice President
Electric Operations

Lenore F. Puleo
Executive Vice President
Client Services

Nickolas Stavropoulos
Executive Vice President
KeySpan Energy Delivery.
New England

Senior Vice Presidents

John J. Bishar, Jr.
Senior Vice President and
General Counsel

Joseph F. Bodanza, Jr.
Senior Vice President
Finance Operations and
Regulatory Affairs

John F. Haran
Senior Vice President
KeySpan Energy Delivery

David J. Manning
Senior Vice President
Corporate Affairs

H. Neil Nichols
Senior Vice President
Corporate Development
and Asset Management

Colin P. Watson
Senior Vice President
Strategic Marketing and
E-Business

Elaine Weinstein
Senior Vice President
Human Resources

Other Officers

Kamal Dua
Vice President and
General Auditor

Ronald S. Jendras
Vice President, Controller
and Chief Accounting Officer

Richard A. Rapp, Jr.
Vice President, Secretary
and Deputy General Counsel

Cassandra R. Schultz
Vice President and
Chief Risk Officer

Michael J. Taunton
Vice President and Treasurer

Shareholder Information

General Office
KeySpan Corporation
One MetroTech Center
Brooklyn, New York 11201-3850

Annual Meeting of Shareholders
The Annual Meeting of Shareholders of KeySpan Corporation will be held at 10:00 a.m. Eastern Time, on Thursday, May 8, 2003, at KeySpan Corporation, One MetroTech Center, Brooklyn, New York.

Stock Listings
KeySpan common stock is traded primarily on the New York Stock Exchange (NYSE) under the trading symbol 'KSE.' The common stock of The Houston Exploration Company is primarily traded on the NYSE under the trading symbol 'THX.' Daily stock quotes are listed in most major newspapers under the headings 'KeySpan' and 'HoustEx,' respectively.

KeySpan Investor Program ('Dividend Reinvestment Plan')
The KeySpan Investor Program is an Open Enrollment/Dividend Reinvestment Plan. The Plan offers individuals a convenient and cost-effective way of purchasing KeySpan common stock. This Plan is open to everyone (NOT just existing shareholders). There is no enrollment fee for joining the Plan.

We welcome your participation in the KeySpan Investor Program. If you are interested in receiving Program material, please contact KeySpan's Stock Transfer Agent, EquiServe (electronic request line) at 1-800-948-1691.

To enroll in the Plan, individuals must complete an application and mail in an initial investment of at least $250, or authorize electronic deductions of at least $25. Individuals may also enroll in the Plan via our web site http://investor.keyspanenergy.com.

Parameters
Eligibility: Open Enrollment

Investment Fee: None

Initial Investment	Ongoing Investment
Minimum: $250	Minimum: $25
Maximum: $150,000	Maximum: $150,000

Investment Frequency: Weekly on Thursday
Source of Shares: Treasury (as of March 2002)
Sales Frequency: Daily
Sales Fee: $5.00 + 5 cents per share
Full or Partial Reinvestment: Yes
Electronic Debits/Credits: Yes
Safekeeping of Shares: Yes

Dividends
KeySpan's annual common dividend is $1.78 per share. All of the dividends paid to holders of common stock of KeySpan Corporation during the calendar year 2002 are considered to be ordinary dividend income, and are, therefore, taxable (subject to review by the IRS). Tax Forms 1099-Div were mailed by January 31, 2003. Please consult your tax advisor for further information.

Proposed Dividend Payment Dates

Declaration Date	Record Date	Payment Date
Dec. 19, 2002	Jan. 15, 2003	Feb. 1, 2003
Mar. 6, 2003	Apr. 16, 2003	May 1, 2003
Jun. 25, 2003	Jul. 16, 2003	Aug. 1, 2003
Sept. 25, 2003	Oct. 15, 2003	Nov. 1, 2003
Dec. 18, 2003	Jan. 14, 2004	Feb. 1, 2004

Stock Plans Group
Please direct inquiries to:
KeySpan Corporation
Stock Plans Group
One MetroTech Center
22nd Floor
Brooklyn, New York 11201-3850
Or call: 1-718-403-3196 E-mail: financial@keyspanenergy.com

Investor Relations
Inquiries from security analysts, stockbrokers, investment managers and other members of the financial community should be addressed to Michael J. Taunton, Vice President and Treasurer, at 1-718-403-3265, or by e-mail, mtaunton@keyspanenergy.com. Company information, including financial reports, is available at **http://investor.keyspanenergy.com**.

Stock Transfer Agent and Registrar
EquiServe Trust Company, N.A.
Investment Plan Services
P.O. Box 43069
Providence, RI 02940-3069
Call: 1-800-482-3638

Annual Report – Form 10-K
The Company files an annual report on Form 10-K with the Securities and Exchange Commission, which includes additional information about the Company. This report is available to shareholders upon request to Investor Relations.

Independent Public Accountants
Deloitte & Touche LLP
2 World Financial Center
New York, NY 10281
1-212-436-2000

Web Address
For more information on KeySpan, or for copies of our press releases and quarterly reports, please visit our web site at **http://investor.keyspanenergy.com.**

Design: MGT Design, Inc. Portrait Photography: Peter Vidor Additional Photography: Rocco Calaiato, Tony Lopez, Stu Rosner, Carl Santoro and Eugene Sorensen Printing: Pictorial Offset Corporation

This Annual Report is Printed on Recycled Paper

Trust

Strategy

Stability

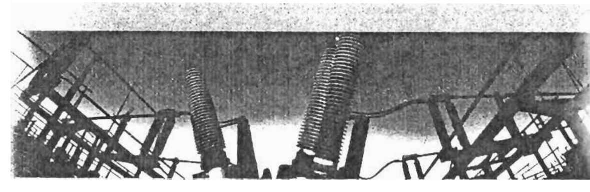
Accountability

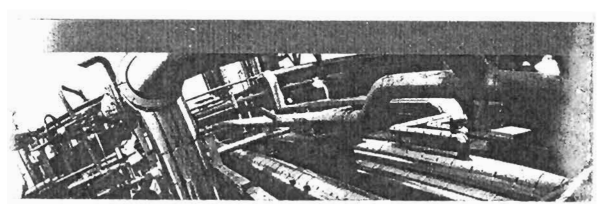
Responsibility

Vision

One MetroTech Center
Brooklyn, New York 11201-3850
www.keyspanenergy.com

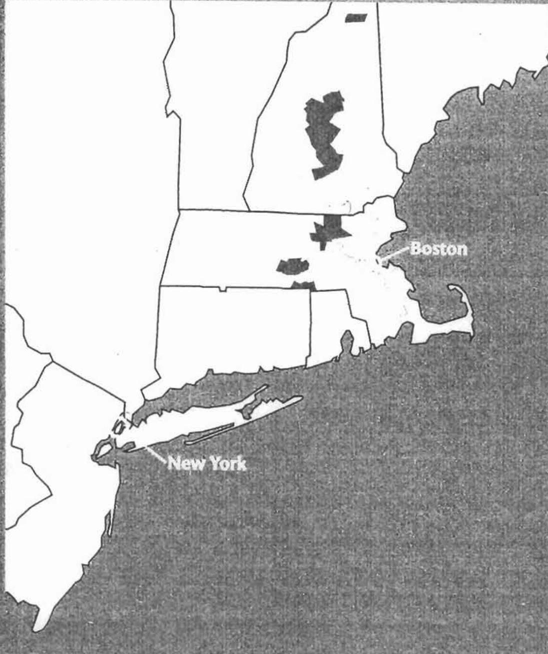
Focusing on our STRENGTHS





2003 ANNUAL REPORT

AREAS WE SERVE



KeySpan Energy Delivery

KeySpan Business Solutions

KeySpan Home Energy Services

Served By All Companies

WHO WE ARE

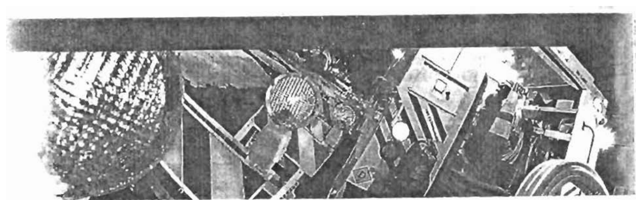
A member of the Standard & Poor's 500 Index, KeySpan Corporation (NYSE: KSE) is the fifth largest distributor of natural gas in the United States and the largest in the Northeast, operating regulated gas utilities in New York, Massachusetts and New Hampshire, with 2.5 million customers. These customer-focused businesses are complemented by a portfolio of service companies which offer energy-related products, services and solutions to homes and businesses. KeySpan is also the largest electric generator in New York State. We own approximately 6,600 megawatts of generating capacity, providing power to 1.1 million customers of the Long Island Power Authority on Long Island and supplying approximately 25 percent of New York City's capacity needs. In addition to these assets, KeySpan has strategic investments in natural gas exploration, production, pipeline transportation, distribution and storage, and Canadian gas processing. In 2003 KeySpan had consolidated revenues of $7 billion and realized earnings of $417.3 million, or $2.64 per share from continuing operations. At December 31, 2003, KeySpan had consolidated assets of nearly $15 billion. KeySpan has headquarters in Brooklyn, New England and Long Island. For more information, visit KeySpan's web site at www.keyspanenergy.com.

Contents

1 Business Segments
2 Letter to Shareholders
4 Review of Operations
15 Financial Review and Analysis
45-50 Consolidated Financial Statements
89 Selected Financial Data
90 Directors and Officers
91 Shareholder Information

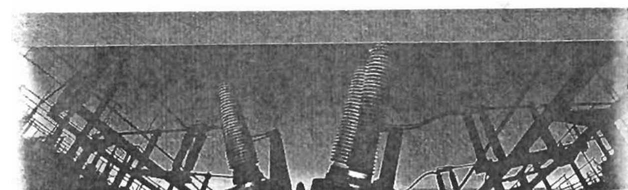
Our Business Segments

GAS DISTRIBUTION



KeySpan is the largest gas distribution company in the Northeast with 2.5 million customers. Its subsidiaries include a number of companies operating under the KeySpan brand. KeySpan Energy Delivery New York provides gas distribution services to customers in the New York City boroughs of Brooklyn, Staten Island and a portion of Queens. KeySpan Energy Delivery Long Island provides similar services to customers on Long Island and the Rockaway Peninsula in Queens. Other subsidiaries, doing business as KeySpan Energy Delivery New England provide gas distribution services to customers in Massachusetts and New Hampshire.

ELECTRIC SERVICES



KeySpan's electric services is the largest electric generator in New York State. We own and operate electric generation in New York City and Long Island with total capacity of approximately 6,600 megawatts, including a new 250 megawatt generating plant at the Company's Ravenswood facility – the first base-load generating facility built in New York City since deregulation. This business segment also manages Long Island's electric transmission and distribution system for 1.1 million customers under long-term contracts with the Long Island Power Authority.

ENERGY SERVICES

The energy services segment markets services in the New York City metropolitan area as well as Rhode Island, Pennsylvania, Massachusetts and New Hampshire. Lines of business include KeySpan Home Energy Services, a group of energy product, repair and services companies for residential and small commercial customers and KeySpan Business Solutions, an integrated engineering, mechanical contracting and facility services company for large commercial and industrial customers.

ENERGY INVESTMENTS

The energy investments segment consists of strategic investments in natural gas exploration and production, gas processing assets, pipeline transportation, distribution and storage. At year's end these investments primarily included a 55 percent ownership of The Houston Exploration Company, a 60 percent ownership in KeySpan Canada and a 20 percent interest in the Iroquois gas pipeline in the Northeast United States.

To Our Shareholders

2003 marked the five year anniversary of the merger that created KeySpan. Much has changed in our industry and in the business world in those five years. We've seen corporate giants collapse, energy policy stall and our national economy struggle and rebound. In the last year alone, our country has become involved in an international conflict that could dramatically impact future energy supplies and we experienced an unprecedented regional electric blackout that raised questions regarding the reliability of our energy delivery systems. We certainly live in challenging times.

And these challenges have created opportunities. We continue to leverage our strengths and grow the energy businesses that best fit our competencies and strategies. We have reconfirmed that we had the right strategic vision for KeySpan's growth over the next decade.

Over the last two years, KeySpan has executed a straightforward strategy that delivers solid, steady growth and maximizes shareholder value.

We demonstrated that a corporate strategy doesn't have to be rocket science. It simply has to deliver. Over the last two years, KeySpan has executed a straightforward strategy that delivers solid, steady growth and maximizes shareholder value.

Our financial results for 2003 are a reflection of that disciplined growth strategy. Consolidated earnings from continuing operations for the twelve months ended December 31, 2003 were $417.3 million, or $2.64 per share. The results represent a 7 percent increase over total 2002 earnings and exceed the Company's 2003 earnings guidance of $2.45 to $2.60 per share. Core earnings – which exclude earnings from exploration and production operations – were $2.16 per share. We continued our history of paying a solid, stable dividend at $1.78 per share and we continue to explore opportunities to increase the dividend in the future.

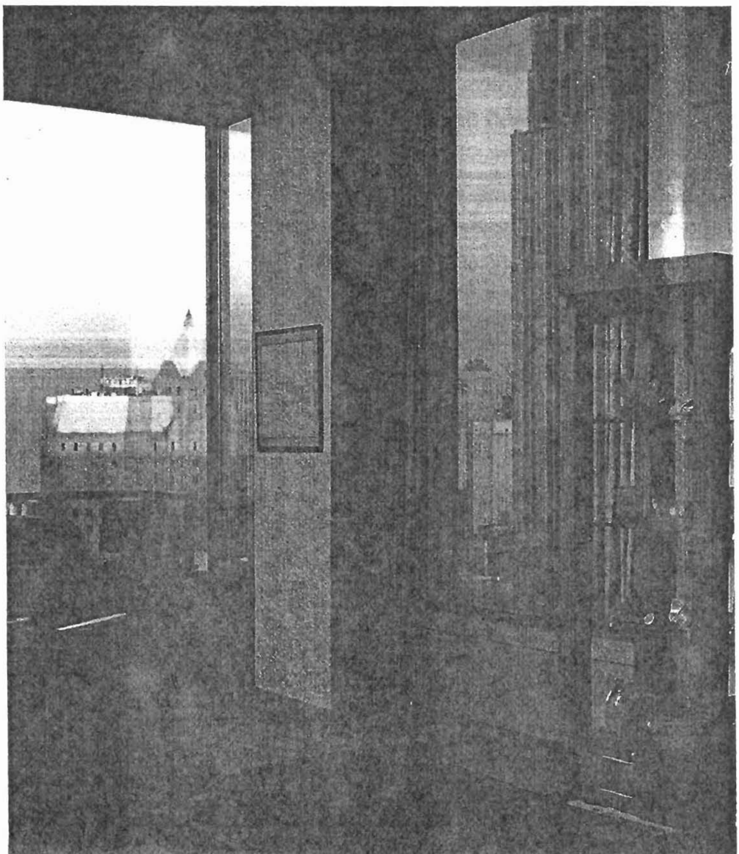
We are proud to have delivered shareholder value in 2003 and, over the course of the year, we have taken a number of steps to ensure that we continue to deliver in the future. In January 2003, we realigned our business segments into two groups – a customer-focused group and an energy asset and supply management group – to optimize the execution of our strategy. We launched a multi-year, enterprise-wide business review process to increase efficiency of operations and reduce costs, and we strengthened our risk mitigation measures.

We also made significant strides in improving our balance sheet. Through a number of financial steps, the strategic monetization of certain non-core assets, and the issuance of equity early in the year, we reduced KeySpan's debt level from 65 percent to 58 percent. We remain committed to continuing to monetize assets that are not aligned with our core businesses. We also remain committed to 5 to 6 percent annual growth in our core gas, electric, services and energy asset businesses, and with our strong dividend yield we offer a total return of 10 to 11 percent to our shareholders.

Our gas distribution business, serving New York City, Long Island and New England, continued to grow in 2003, exceeding 2002 results by $44 million or 8 percent. Electric Services' year-end contribution to operating income was $269 million, lower than originally projected, due to cooler than normal summer conditions and a maintenance outage at a generating facility in early 2003. However, projections for 2004 in our core electric business are in the range of $305 to $325 million, an increase of approximately 12 percent over 2003 projections, assuming normal weather conditions.

We continue to work to achieve our financial objectives in our Energy Services segment, which posted a year-end operating loss. But the business plays a key role in supporting the core utility, contributing to a customer satisfaction rate of more than 90 percent. We continue to refine the business model for Energy Services and believe that we will deliver a modest earnings contribution in 2004.

We remain committed to investing in assets that support our core operations. In late 2002, we purchased a 600,000 barrel liquefied natural gas (LNG) storage and receiving facility in Providence, Rhode Island. The facility is a key component in the supply mix in the Northeast, playing a critical role in meeting peak-day gas supply. In 2003, we began exploring a major expansion of that facility, to increase its vaporization capacity and to enable it to accept marine deliveries by 2005. The expansion would



liability and create more diversity in supply, putting
ı the forefront of providing additional supplies to
east.

.he electric side of our business, we have completed the
.ion of a new 250 megawatt generating plant at our
'ood generating station, the first base load plant built in
:k City since deregulation. The new facility brings critically
power to the New York City load pocket, in time for a
r that is projected to need additional electric supply.

ɜfining our strategy, realigning our businesses, strengthening
.lance sheet, investing in infrastructure critical to our core
tions – all steps taken to ensure KeySpan's competitive edge.
ur Company's success going forward will ultimately depend on
ıed leadership – leadership that is focused on the future.

To ensure depth and continuity in KeySpan's leadership, our
'd of Directors engaged in a very detailed management succes-
ı process in 2003, resulting in the September promotion of
ɔert J. Fani to the position of President and Chief Operating
'icer. Bob has distinguished himself across a spectrum of leader-
ıp roles at KeySpan over the last 27 years and brings strong
anagement skills to the day-to-day execution of our near and long
ːrm strategies. I look forward to working closely with him to
osition KeySpan for solid growth in the years ahead.

Steven L. Zelkowitz, Chief Administrative Officer, steps into
3ob's former role of President of KeySpan's Energy Assets and
Supply Group, bringing broad industry knowledge and regulatory
affairs expertise. They join Wallace P. Parker Jr., President of
KeySpan's Energy Delivery, in
the Office of the Chairman.

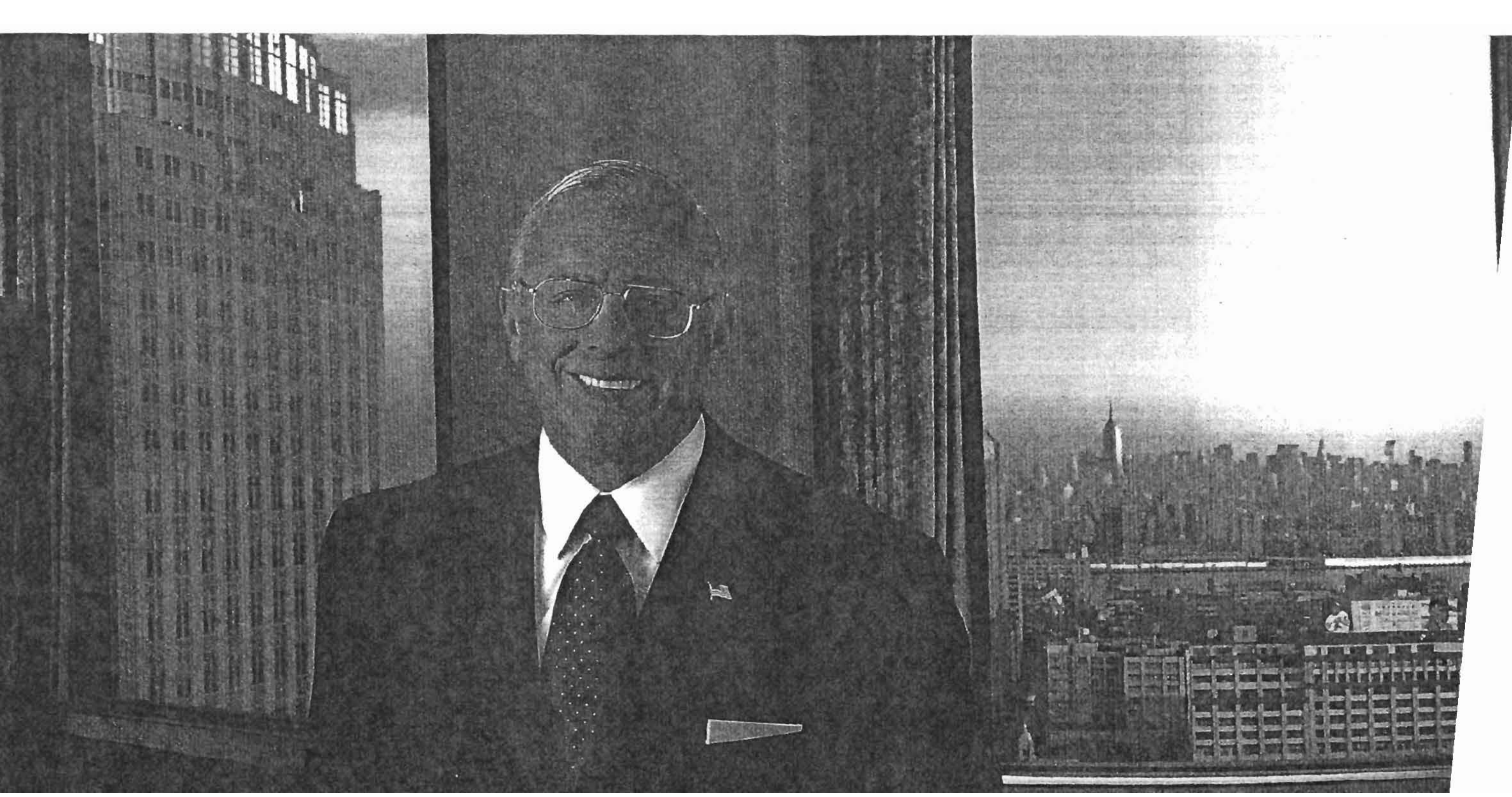
The leadership of the Company was further enhanced by the addition of Gloria Cordes Larson and Vikki L. Pryor to the Board of Directors. Gloria Larson, currently co-chair of the Government Practices Group at the law firm of Foley Hoag LLP, is a former Massachusetts Secretary of Economic Affairs. Vikki Pryor is president and CEO of SBLI USA Mutual Life Insurance Co., Inc. Both bring a wealth of business and financial experience to the Board, and help us broaden the diversity of our top leadership.

I thank the Board for their hard work in guiding us over the last year, and I thank you – our valued shareholders – for your continuing commitment to your Company. But I would especially like to thank KeySpan's employees for their contribution to our success in 2003. Through external challenges and internal transformation, they continued to work hard for our customers and shareholders. They are the ones who ultimately deliver success. I congratulate them on their fine performance over the last year. Together, we make KeySpan work.

Robert B. Catell

Robert B. Catell
Chairman and Chief Executive Officer

March 10, 2004



Review of Operations

Focusing on our strengths – this has been the foundation of KeySpan's strategy and our success. As simple as the concept seems, it was not long ago that companies – particularly energy companies – that stuck to what they were good at were thought to be behind the times. At KeySpan, we believed that the things we were good at were the things that were going to allow us to grow. It seems we have been proven right.

Over the last five years, we have completed a merger and several strategic acquisitions. We believed then, as we believe now, that size matters when it comes to delivering value in our industry. Size allows us to be an important player in regional – and national – energy policy decisions. It also matters in achieving the economies of scale that are so critical to our bottom line. But in growing our business, we have always focused on opportunities that played to our core competencies. We've tried to balance a desire to grow with a good dose of common sense.

Because of that, even in a difficult economy, KeySpan has performed well. We've covered our bases, adjusting our strategic initiatives to compensate for the economic environment and for changes in the volatile energy industry. The result has been strong financial performance and a sturdy foundation for continued growth.

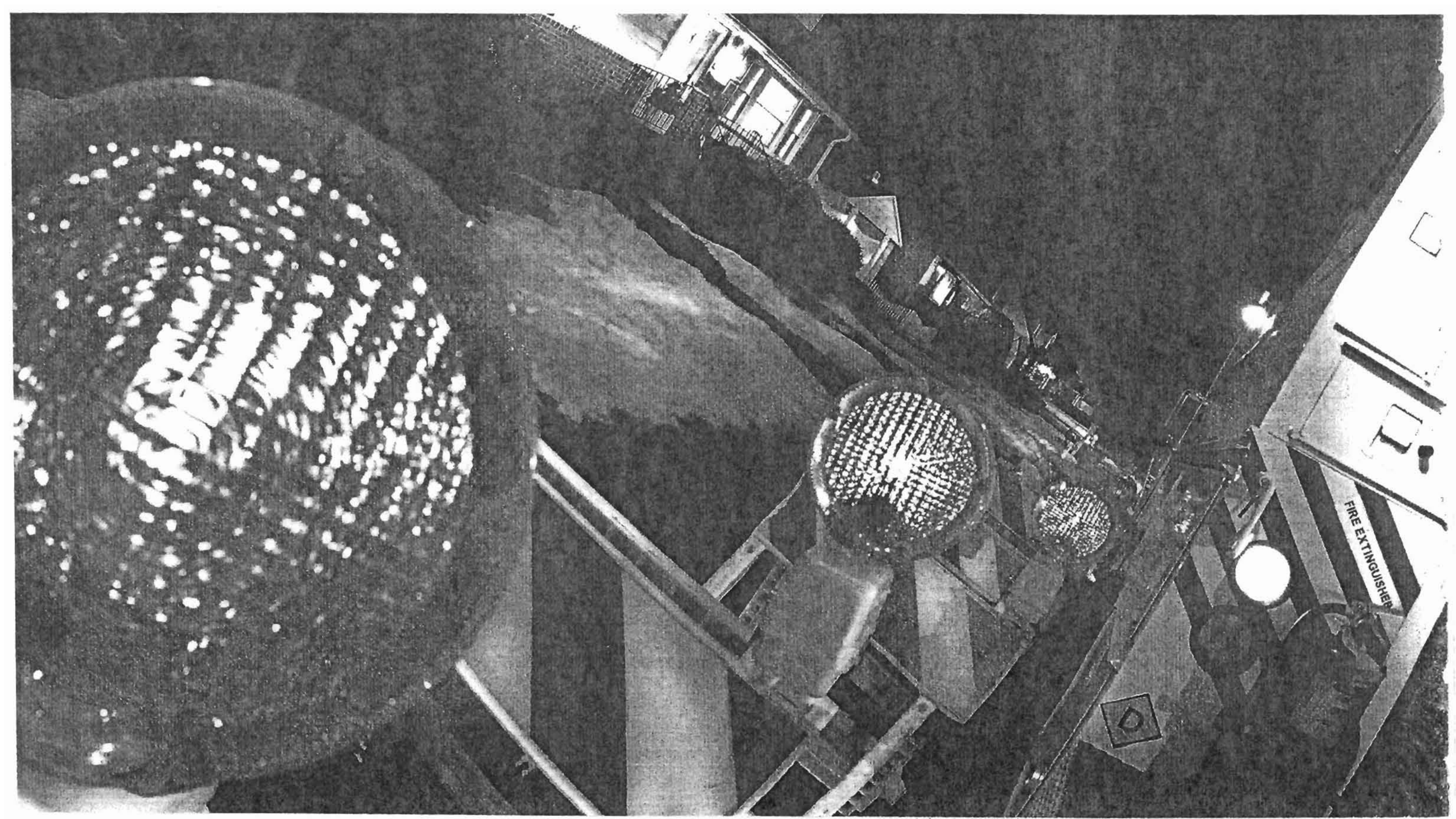
Focusing on Natural Gas

Growing the Gas Business

The primary driver of growth in 2003 was, not surprisingly, our core gas distribution business. Operating income increased by approximately $44 million, or 8 percent, over 2002 results, aided by winter weather that was 15 percent colder than the previous year. While cold winters add to revenues through increased customer consumption, they also can severely test our distribution infrastructure, impacting operating costs. We did see operating expenses increase in 2003, but overall, the system performed commendably in some of the coldest weather we have seen in many years. We can credit this solid performance to our continued emphasis on maintaining and upgrading our physical infrastructure, as well as our employees' dedication to ensuring uninterrupted service to our customers.

In addition to increased consumption by existing gas customers, customer conversions continued to be strong last year. In 2003, KeySpan completed more than 57,000 gas installations, adding $55 million in new gross profit margin. Those results translate into a growth rate that is twice the industry average.

KeySpan currently serves 2.5 million gas customers in the Northeast and still has significant growth potential in the years ahead. With a residential market that is only a little more than 50 percent saturated, we have more than a million additional prospects and $650 million in potential gross profit margin. Our commercial market has comparable growth potential, with a saturation level of approximately 60 percent across our territories. That equates to approximately 150,000 additional prospects and $300 million in

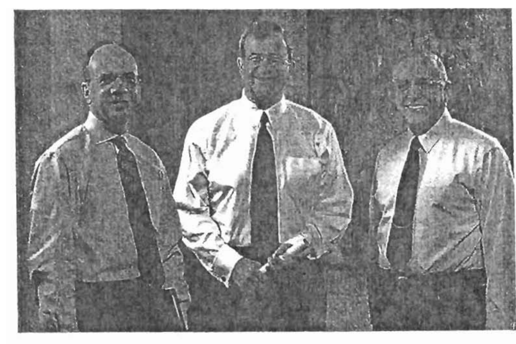


potent'a gross profit margin. A large number of tnese prospects are on or close to a gas main, requiring little or no capital investment.

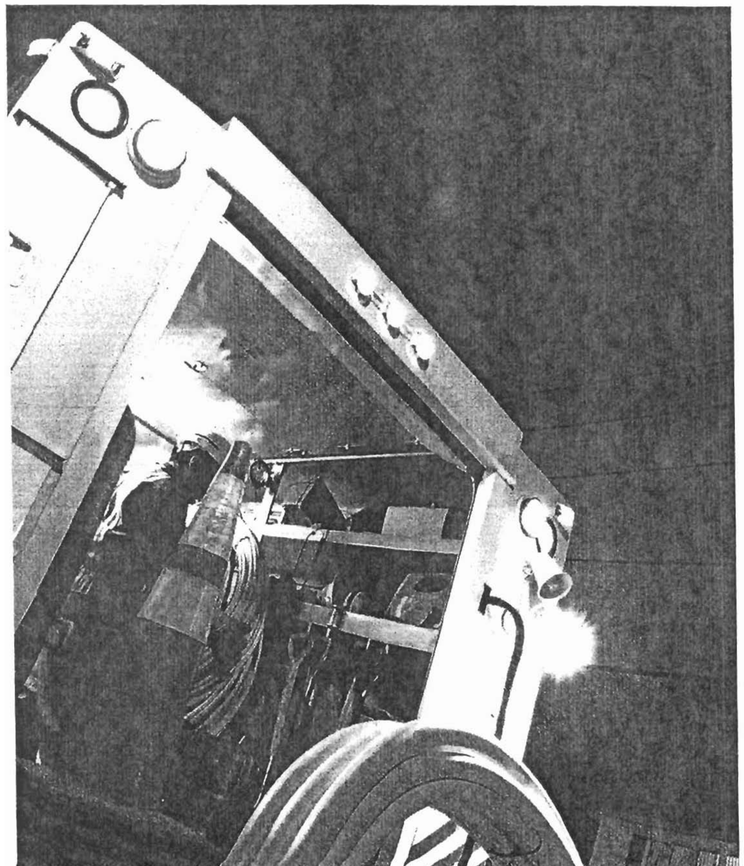
The challenge is to continue to deliver on that growth potential in the most cost-effective manner. In January 2003, we realigned our business segments into two groups – a customer-focused group, and an energy asset and supply management group – to optimize the execution of our strategy. The idea behind the customer-focused group is to take all customer-facing functions and bring them together in one business unit, to maximize the customer relationship. At KeySpan, that means combining the gas business unit, which is the fifth largest in the country, with a client services division that touches the customer about 25 million times a year. We add to that our strategic unregulated energy services businesses and the natural synergies allow us to grow, as a whole, faster and more efficiently than would be possible for any of the parts.

While we are looking to address customer needs in a comprehensive manner, we are keenly aware of the need to maximize profitability. Over the last few years, we have selectively added more than five million feet of new gas main, which has significantly improved the gas infrastructure and has created new sales opportunities by bringing potential prospects closer to our system. It is those prospects that we will focus on, as they increase gross profit margin significantly while requiring the least capital investment.

To add these prime prospects, we developed a sales optimiza tion model – an information-based management tool. The model takes information from eight different data bank sources and identifies the most profitable market segments with the highest load potent'a.s. Once ident fied, we allocate our resources d rectly to the



KeySpan's leadership comes from a talented and experienced group, including six senior executives who make up the Company's Strategic Management Committee (SMC). Above: CEO Bob Catell (R) is joined by Executive Vice Presidents John Caroselli (L) and Gerry Luterman. Right: Presidents Wally Parker (L) and Steve Zelkowitz (R) and President and COO Bob Fani (C) who, in addition to taking part in the SMC, comprise the Office of the Chairman with Bob Catell.

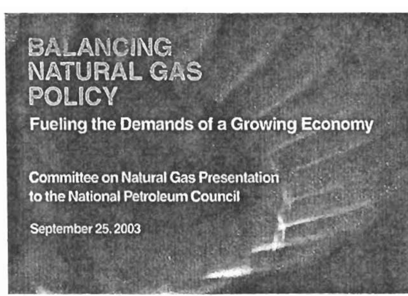


Offering an Appealing Product in an Attractive Market

The continued growth of KeySpan's gas business can be attributed to many factors, including understanding the markets we operate in and the customers – existing and potential customers – we serve. With some of the highest median income levels in the country and more than one million residential heating prospects, the Northeast region presents a unique growth opportunity. And grow we have, completing more than 150,000 gas installations the last three years. In 2004 we will continue to optimize our resources, targeting new customers requiring minimum capital investment so that more and more customers can enjoy the benefits of clean, efficient and reliable natural gas.

KeySpan's natural gas system performed commendably in some of the coldest winter weather our region has experienced in years, thanks to a strong emphasis on maintaining and enhancing our physical infrastructure and a workforce dedicated to ensuring uninterrupted customer service.

KeySpan CEO Bob Catell played a pivotal role in addressing natural gas supply issues as vice chair of the National Petroleum Council's study of the future of gas markets, commissioned by the U.S. Secretary of Energy.



segments that will produce the greatest return on investment.

In 2003, we completed the sales optimization model for the residential market and began building a similar model for the business market, which we believe will deliver tangible results in 2004.

Realigning Our Services

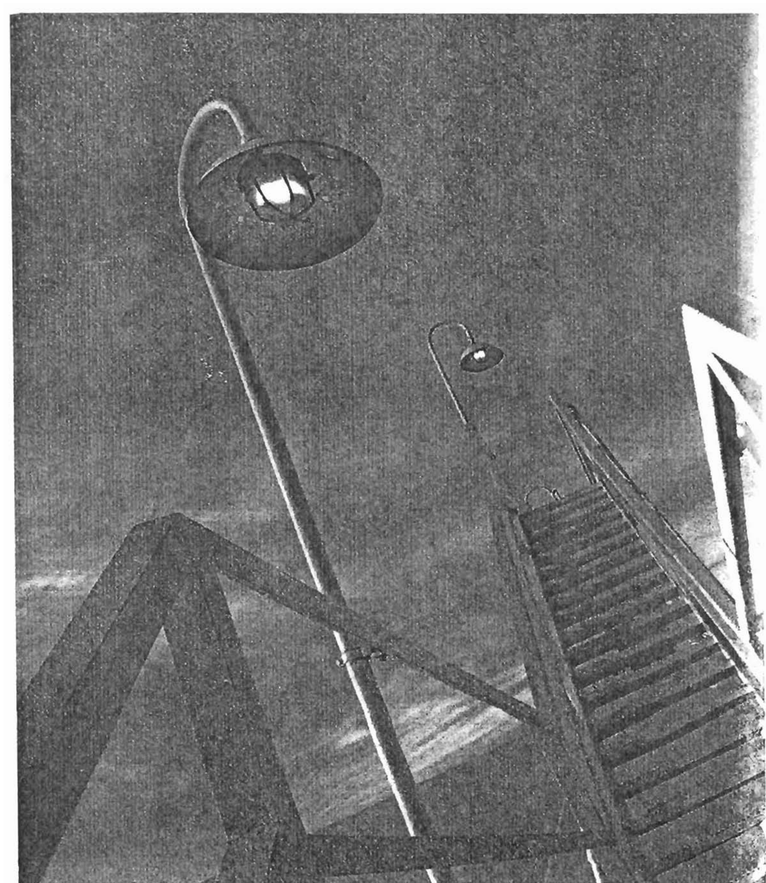
Our Energy Services segment is comprised of our unregulated energy services businesses, under the umbrella of KeySpan Services, Incorporated (KSI). KSI is a strategic component of our customer-focused strategy and has contributed to a customer satisfaction level of more than 90 percent in our core gas business. The segment serves two specific markets, the residential and small commercial market through KeySpan Home Energy Services (KHES), and the large commercial market through KeySpan Business Solutions (KBS).

In 2003, KHES delivered record numbers in both service contracts and installations. We exceeded our goal of 200,000 service contracts and will continue to focus on increasing the number of premium service contracts, which combine both heating and air conditioning service. The percentage of premium contracts grew from 7 percent to approximately 12 percent in 2003 and we expect additional growth in 2004. In 2003, total installations of HVAC products increased nearly 19 percent to a record level of 22,473 due in part to new products, such as fireplaces, being added to the product mix.

Results from KBS were disappointing in 2003. The economy, specifically a soft Northeast construction industry, delayed engineering design and construction projects, which decreased volumes and lowered margins. However, despite reporting a loss in 2003, KBS

Ensuring a Consistent and Diverse Gas Supply

At KeySpan, we're always trying to improve our gas supply network to ensure that our customers have a reliable supply of natural gas at an affordable price. Liquefied natural gas (LNG), long a part of KeySpan's supply strategy, is drawing increased attention these days as a viable resource to meet future demands for natural gas. KeySpan is partnering with BG LNG Services to upgrade KeySpan's existing LNG storage and receiving terminal in Providence, Rhode Island to accept marine deliveries. Expansion of this facility will increase the gas supply in the New England region, aiding economic growth and potentially reducing supply-related price volatility.



finished the year with a backlog of $537 million in awarded contracts which, added to our focus on profit margin, should provide for future opportunities.

Over the last year, we have taken several steps to ensure that our unregulated businesses deliver shareholder value in the coming years. We analyzed KSI operations across the board and implemented a series of cost control initiatives. We integrated the business more effectively with corporate shared services capabilities, resulting in a dramatic reduction in the cost for support service functions in KSI. We expect these changes will significantly enhance the KSI business profitability going forward.

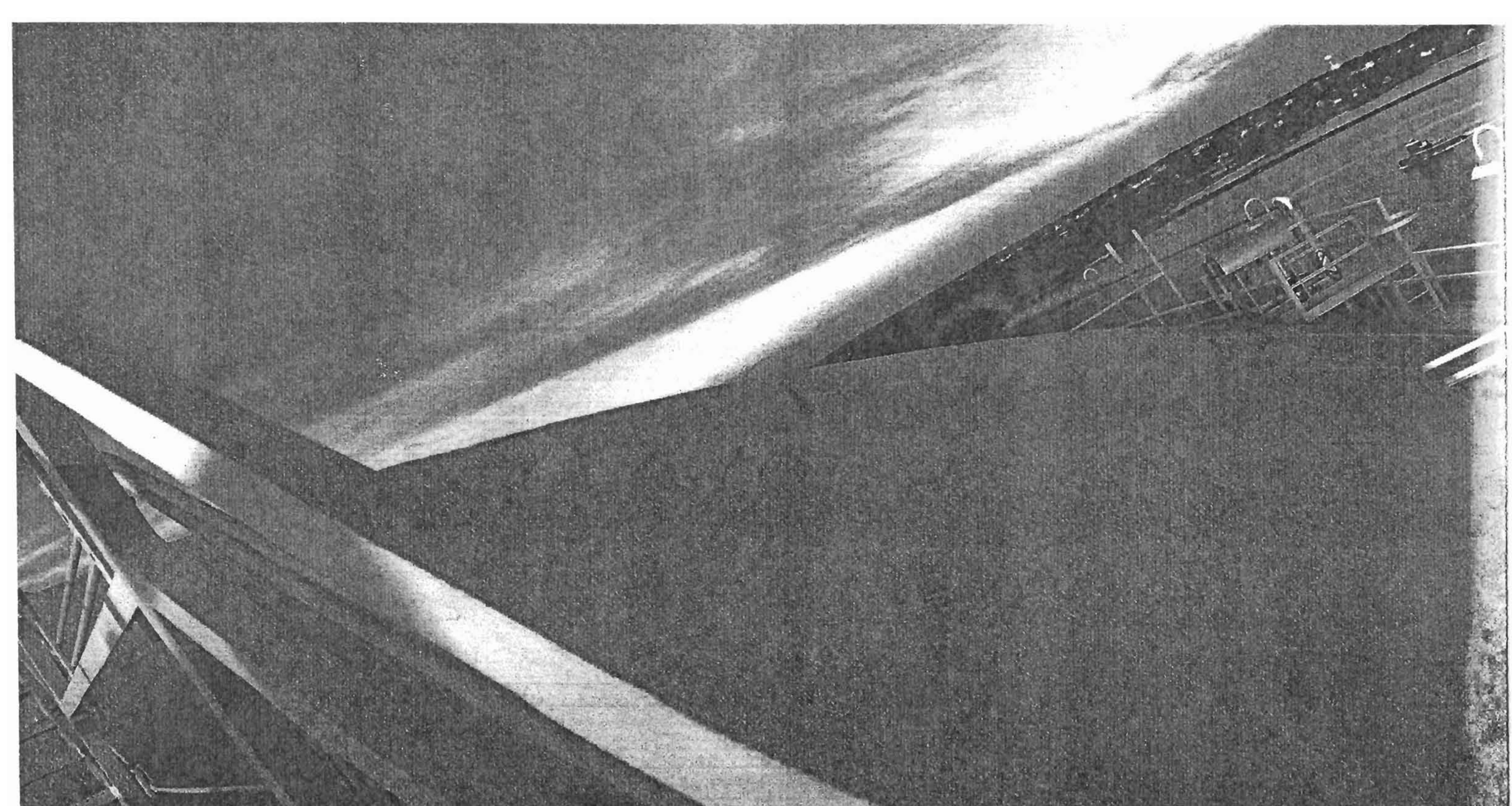
Keeping Supply at the Forefront

KeySpan has always been aware of the importance of maintaining a more than adequate supply of natural gas for our customers. In 2003, as always, we worked proactively to ensure that we had sufficient gas supply for even the coldest winter, at the best possible price to our customers. Prices continued to be volatile in 2003, due to the dramatic growth in natural gas demand over the last few years, with limited additions to the delivery infrastructure. As the cleanest burning fossil fuel, natural gas is being used increasingly for heating homes, for manufacturing and for generating our country's electricity. And while there remains adequate supply to meet the national demand, demand continues to rise, causing supplies to tighten. Accessing new gas supplies through new pipelines will be critical to balancing supply and demand, and moderating gas prices in the future.

The issues of gas supply and pricing dominated the news in 2003, on both a regional and national level. In early spring, Federal Reserve Chairman Alan Greenspan testified before Congress, raising concerns about our nation's natural gas position. His testimony put a spotlight on U.S. natural gas inventories, which were nearly 50 percent below the five-year average. The resulting news coverage sparked a national debate about future gas supplies and their impact on the country's economy. As it turned out, both national and KeySpan storage were filled to adequate levels coming into 2003.

To address critical supply issues, Secretary of Energy Spencer Abraham commissioned the National Petroleum Council (NPC), an energy industry organization that includes KeySpan, to conduct a comprehensive study of the future of natural gas markets through 2025. Because of KeySpan's unique position in the natural gas marketplace, Chairman and CEO Bob Catell was asked to serve as vice chair of the NPC study, along with the chief executive officers of Exxon and Kinder-Morgan. Catell chaired the demand portion of the study and, with his fellow vice chairs, delivered a comprehensive report to the Secretary of Energy in September 2003. The report provided a wide range of solutions that could go a long way toward balancing the supply/demand equation and included short-term solutions such as increased energy efficiency and conservation, as well as longer term recommendations on increased access to domestic gas supplies and investment in renewable energy sources, pipeline and liquefied natural gas (LNG) infrastructure. LNG imports emerged as a potential large-scale resource for meeting future demand while stabilizing natural gas costs.

KeySpan had already recognized the value of LNG for increas-



ing the reliability and diversity of the Northeast energy supply. Our regulated utilities in New York and New England already owned approximately 20 percent of the total LNG storage in the United States. In December 2002, we expanded our LNG assets with the strategic acquisition of Algonquin LNG – an LNG storage facility in Rhode Island. In October 2003, we announced plans to explore upgrading this facility in a joint initiative with BG LNG Services, LLC, the leading importer of LNG into the United States. Currently, storage supplies are filled each summer by tanker trucks coming from Boston. An upgrade would enable the facility to accept marine deliveries, as well as triple its vaporization capability and improve infrastructure to allow gas to be transported via the Algonquin Pipeline G-System. The upgrade could be completed as early as 2005 and would make Algonquin the first new LNG import terminal in the U.S. in more than 20 years. It would strengthen and diversify gas supply in the New England region and add to our profitability in this segment.

LNG is just one facet of KeySpan's diverse portfolio of natural gas supplies, which includes pipeline supplies from both Western Canada and the Gulf of Mexico. In our ongoing efforts to ensure future supply and deliverability, we have partnered with Duke Energy on the Islander East pipeline, to bring gas from new sources in Eastern Canada to the New York area. We have received approval from the Federal Energy Regulatory Commission for the Islander East project, which would help increase reliability and moderate prices. The pipeline could be completed as early as next winter, pending resolution of some issues with the State of Connecticut. We are also supporting the Millennium Pipeline project, which would bring additional supply from Canada down through Buffalo and into downstate New York, with the goal of boosting supply in the tight New York metropolitan market. The Millennium pipeline would also serve as the connection between several other pipelines, providing interconnectedness between Canada, the Midwest and the Mid-Atlantic Coast.

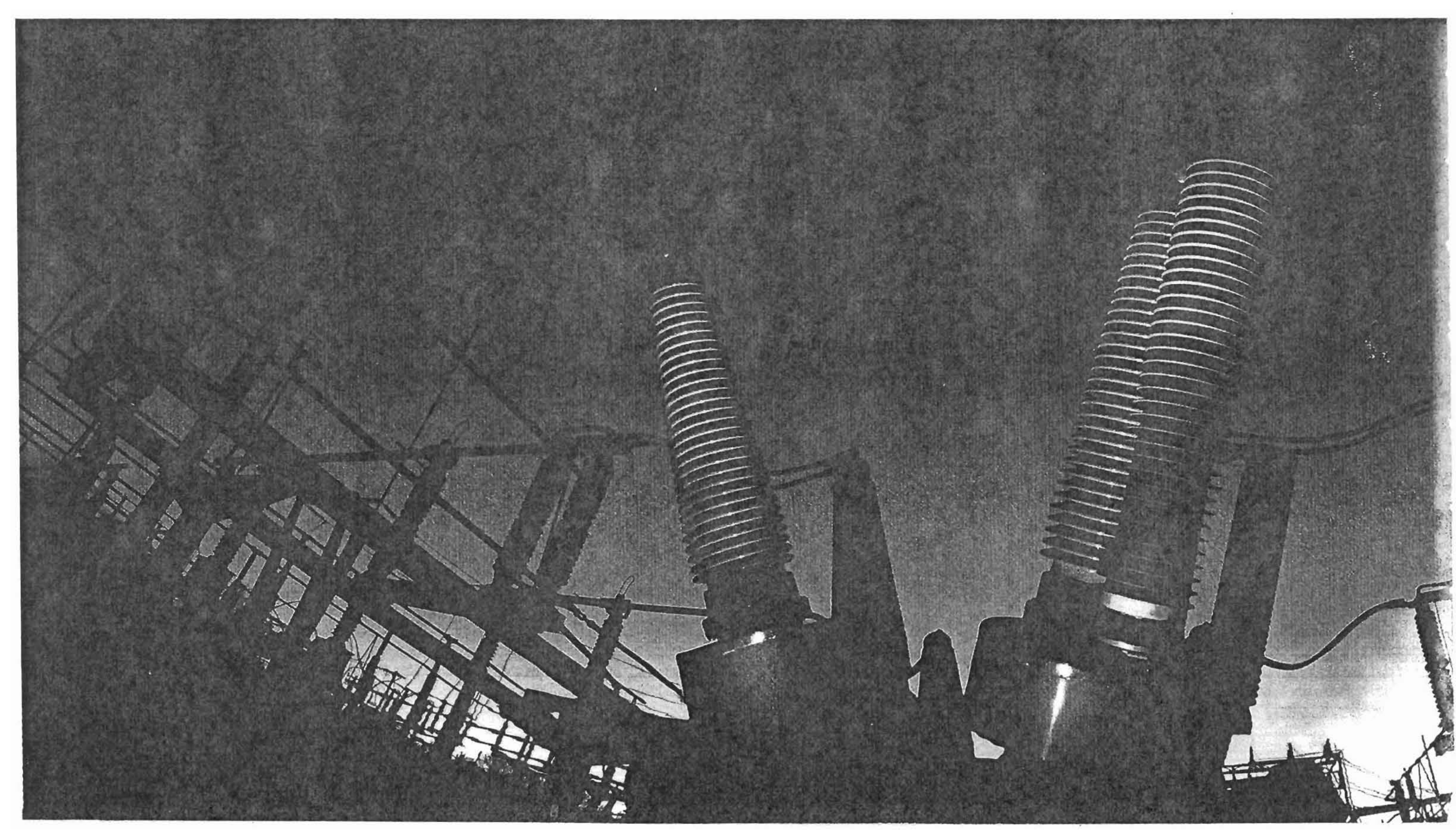
Focusing on ELECTRIC

Keeping the Lights On

KeySpan Electric Services, our Company's second core business, provides approximately $1.4 billion in revenue and is a major driver of our earnings, contributing approximately 25 percent of our operating income. The electric services business is comprised of two major components: generation services, and transmission and distribution (T&D) management.

KeySpan's generation business owns, leases and operates approximately 6,600 megawatts (MW) of generating capacity, making us the largest generator in New York State. In 2003, we provided the vast bulk of Long Island's power requirements, under long-term contracts to the Long Island Power Authority (LIPA), as well as supplying 25 percent of New York City's requirements from our Ravenswood generating station. The T&D management business operates and maintains Long Island's electric transmission and distribution system, serving LIPA's 1.1 million customers.

Operating income from the electric services business was $269 million in 2003, slightly lower than in the previous year, due primarily to higher operating costs and cooler summer weather



that resulted in lower revenues from our Ravenswood facility.

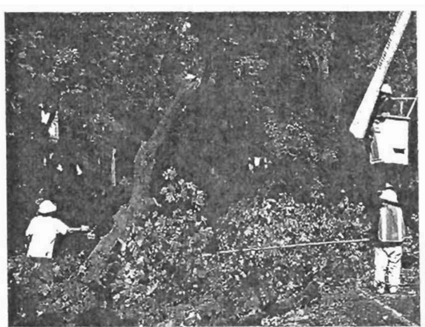
In 2004, we are projecting an increase in operating income of approximately 12 percent from this segment. The increase will come from both the long-term contracts we have in place with LIPA and the Ravenswood facility. The LIPA contracts contribute approximately one-third of the operating income in this segment and are a reliable, predictable earnings stream. We earn capacity charges and management fees under the contracts and have performed extremely well over the last several years, earning significant performance-based incentives.

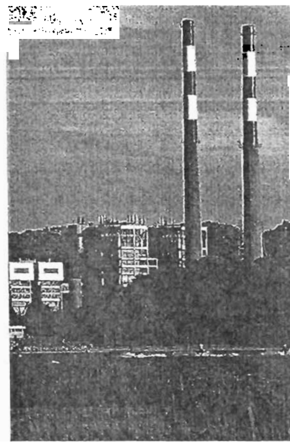
The remaining two-thirds of operating income in this segment comes from the Ravenswood generating station. We are fortunate to operate this facility in the capacity constrained New York City load pocket, which delivers solid capacity and energy payments.

A Restoration to Remember

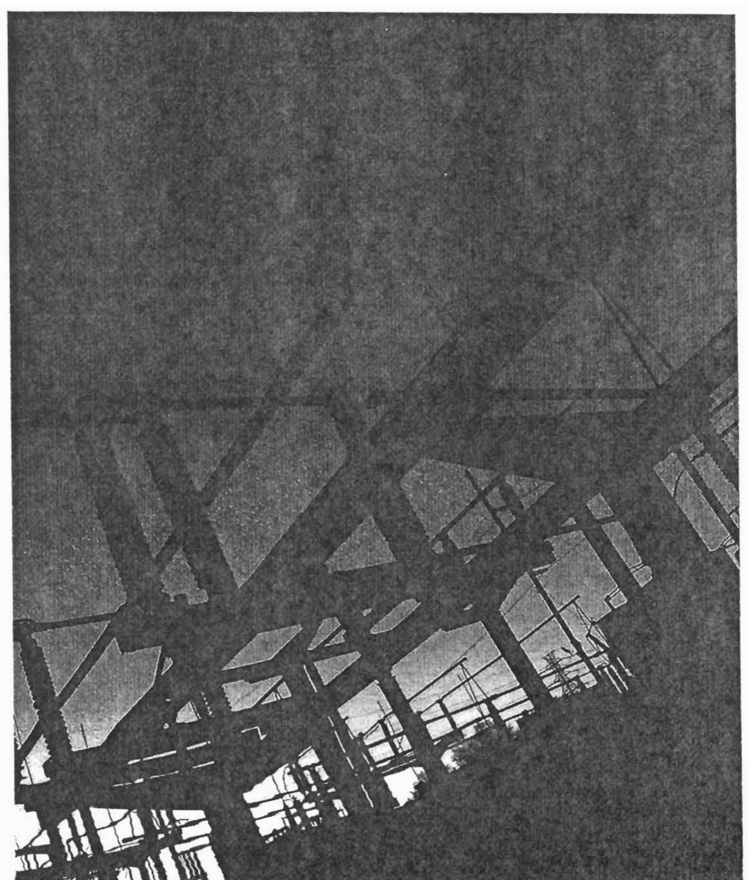
If supply was a major focus for the natural gas world in 2003, reliability was the primary issue for the electric industry, following the unprecedented blackout of August 14. A system disturbance in Northern Ohio triggered a domino effect that in the space of only a few minutes, led to the biggest power outage in United States history. The lights went out for more than 50 million people across approximately 9,300 square miles, including Ohio, Michigan, Pennsylvania, New York, New Jersey, Connecticut, Vermont and Ontario.

At KeySpan, operators in the control room that oversee the transmission and distribution system for LIPA watched in disbelief as electric load went from 4,500 megawatts to zero in less than three





Hurricanes, ice storms, even an unprecedented regional blackout – KeySpan electric crews can handle whatever comes their way, consistently delivering for LIPA the best restoration time of any overhead utility in New York State.



Accomplishing Reliability through Effective Management

In addition to being the largest electric generator in New York State, KeySpan also manages Long Island's electric transmission and distribution system through contractual agreements with the Long Island Power Authority (LIPA). KeySpan's dedicated employees maintain more than 12,000 miles of overhead and underground transmission and distribution lines as well as maintain the continuity of electric service for more than one million customers. We also maintain and construct substations, perform system improvements and provide electric engineering, planning and design services. It's this kind of expertise that's enabled us to consistently rank first in customer restoration time in New York State.

Electric demand continues to grow in the already tight New York and Long Island electric markets. KeySpan's new generating facility at our Ravenswood power station brings 250 MW of additional electricity just in time for the critical summer season.

minutes. Although questions still remain as to exactly what caused the outage, KeySpan employees, working hand-in-hand with LIPA, came through in the crisis, restoring power to more than 80 percent of Long Island customers in 14 hours, and returning the system to normal in just over 24 hours.

KeySpan's performance in this crisis was no surprise, as our experienced and competent employees continue to operate LIPA's T&D system at the highest performance levels in New York State. They prepare diligently for all kinds of system disruptions and are highly skilled in fast, efficient electric restoration. In 2003, KeySpan employees once again ranked first in customer restoration time, delivering a performance that was 40 percent faster than the New York State average.

If an amazing restoration effort was one bright spot during the blackout, distributed generation was another. While most of the New York metropolitan area was in the dark on August 14, hospitals, businesses, and office and apartment buildings that generate their own electricity had power throughout the blackout.

Distributed generation – which includes such technologies as microturbines, cogeneration and fuel cells – allows large customers to generate their own power independent of the local electric grid. KeySpan designs, installs and maintains on-site generation systems throughout the tri-state area. The large-scale failure of the Northeast electric T&D system had no effect on KeySpan's distributed generation customers, including the critical New York City Police Department Central Park station.

KeySpan and LIPA, along with government agencies and utilities across the Northeast, will continue to investigate the cause of

Adding Capacity where It's Needed Most

As demand for electricity continues to grow, new power plants are needed to ensure adequate electricity supplies in the future. New York City will get its first new base-load generating plant since deregulation of the electric industry in the late 1990s with the expansion of KeySpan's Ravenswood generating facility. The new plant increases Ravenswood's capacity by 250 megawatts and will be online in time for the expected summer 2004 electric demand. Ravenswood currently provides 2,200 megawatts of power, or about 25 percent of New York City's electric needs. This expansion will increase Ravenswood's capacity by 11 percent to 2,450 megawatts.

the blackout and what steps must be taken to prevent such a widespread occurrence in the future. We are advocating changes in the nation's electric infrastructure and operations that will safeguard our system against another such event.

Filling the Generation Gap

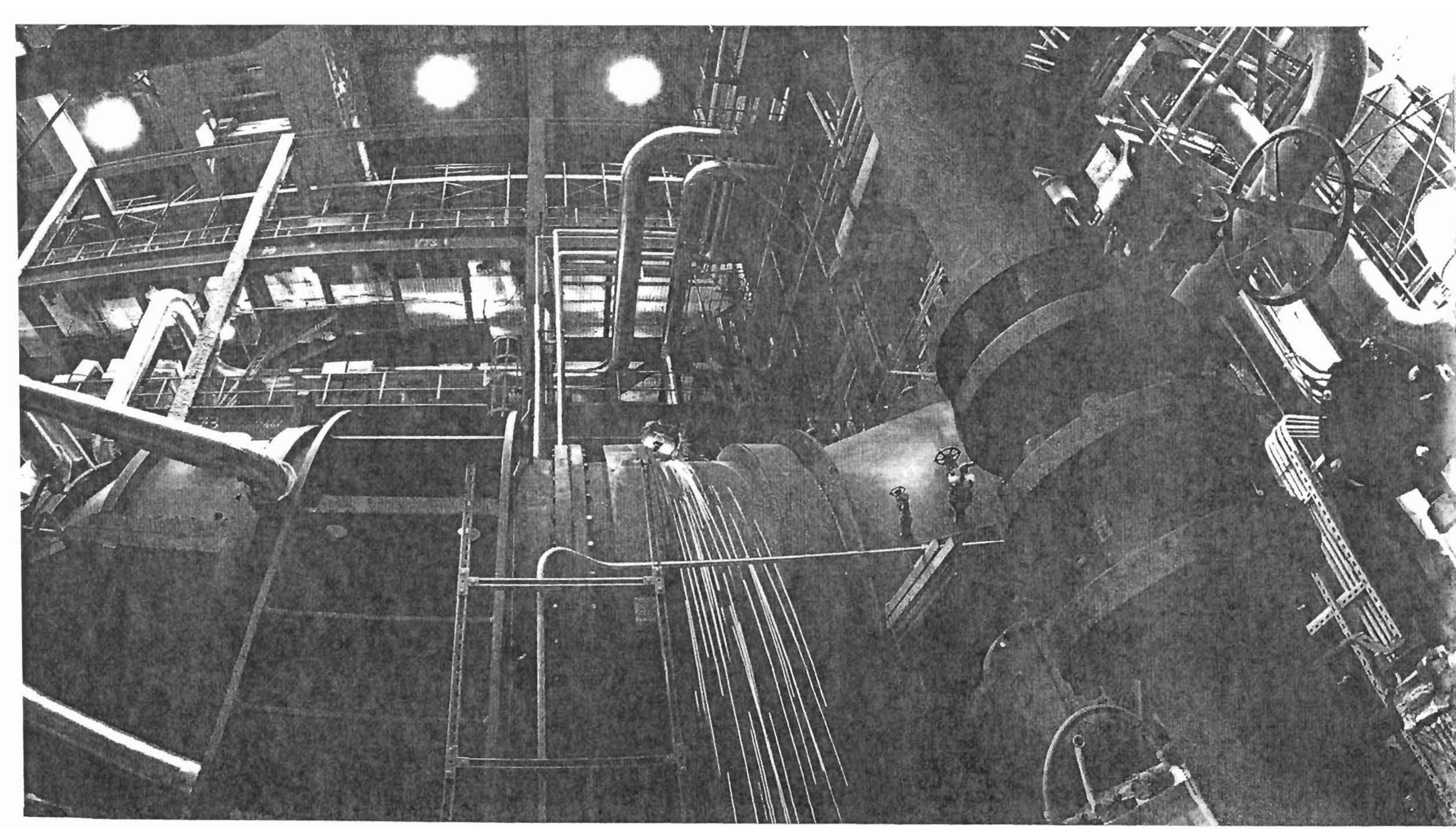
While the blackout did not result from a lack of generation, it did point out weaknesses in the national electric infrastructure, as well as our vulnerability to power outages. In the New York City and Long Island load pockets, we have been dealing with the issue of infrastructure upgrades and the need for new generation infrastructure and operating procedures for a number of years. At our existing generating facilities, we continue to implement extensive annual maintenance programs designed to keep our generators in the best possible operating condition. Through these efforts, our Long Island generating facilities performed at more than 97 percent availability, and our Ravenswood facility at better than 96 percent, during the critical summer season. But with electric demand continuing to rise in both markets, peak top performance from our generating assets is not enough. New electric generation is necessary to keep the region's lights on. Unfortunately, obtaining regulatory approvals to build additional generation in New York State is a challenging undertaking.

KeySpan, however, is uniquely positioned to provide new generation for New York and Long Island. We have completed a new, 250 MW electric generating plant at our existing Ravenswood facility in New York City, the first base-load plant built in the city since deregulation of the electric industry. The new plant increases Ravenswood's total capacity by 11 percent to 2,450 MW, more than 25 percent of New York City's current electric needs. The official launch this spring comes just in time to help meet a summer demand that is expected to be higher than last year, in an already tight supply situation.

The Long Island market is also facing increasing electric demand and tight electric supplies. With the ability to import power limited, new on-Island generation is critical to continued economic growth. In September 2003, KeySpan took steps to remedy that situation, announcing a unique joint venture with American National Power, Inc. (ANP).

In response to a LIPA request for proposal (RFP) for new energy sources, we are partnering with ANP on a proposal to build two 250 MW natural gas-fired combined cycle generating facilities, one in Melville and the other in the Town of Brookhaven. Because both KeySpan and ANP had been developing the plants as separate projects, both plants have already completed the Article X environmental siting process. With these approvals in hand, the KeySpan/ANP proposal is unique in its ability to provide new base load generation by 2006.

The joint proposal combines the resources, expertise and environmental reputations of two of the region's most experienced developers. It also links ANP's project development and electric marketing skills with KeySpan's core competencies in fuel supply and generating plant operations. With all responses to the LIPA RFP in, we expect LIPA to announce a decision shortly.



Focusing on Our Assets

Building on a Solid Portfolio

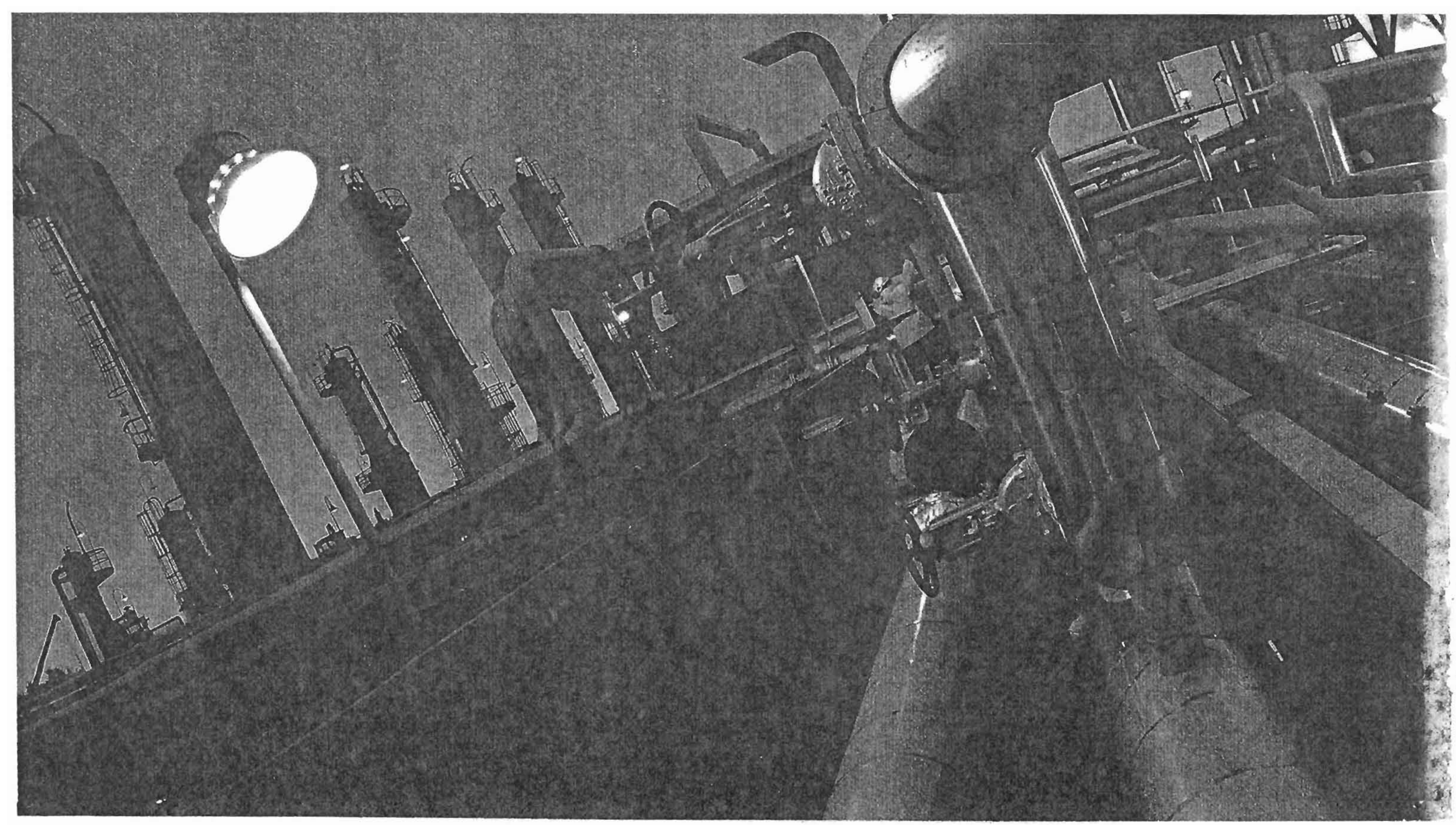
Growing our electric generation, as well acquiring the Algonquin LNG facility, is part of our energy asset and supply strategy. The strategy of the Energy Asset & Supply Business is to optimize the operation of our assets and maximize returns in our core businesses. We are focused in our primary service area, the Northeast Energy Hub. In support of our core businesses, KeySpan manages a portfolio of assets that includes electric generation, pipeline, LNG and storage, as well as contracts for physical capacity and storage, to meet the needs of our customers. We are continually evaluating opportunities to acquire or build new assets to further enhance our growth in this business segment.

Our portfolio also includes some non-core assets outside of our Northeast territory, primarily our exploration and production operations in Houston and our gas processing business in Western Canada. We are continuously exploring opportunities to monetize these non-core assets in a manner that contributes to shareholder value.

It is easy to see how growing our electric generation portfolio, partnering in pipeline projects and investing in LNG support our core operations. But KeySpan has also received some significant benefit from our non-core assets. In 2003, our exploration and production business delivered $197 million in operating income, significantly exceeding projections, due to favorable gas prices. And beyond the ability to contribute directly to earnings, our involvement in the non-core exploration and production and gas processing businesses has allowed us to gain hands-on experience all along the supply stream. It has put us at the table with key players in the energy industry and enabled us to become an integral part of the national energy debate. And it has allowed us a deeper understanding of the energy marketplace, helping us to spot trends and identify opportunities where perhaps some of our peers did not. We have used the knowledge gained from both our core and non-core businesses to fine-tune our strategy and position KeySpan for future success.

Having refined our strategy to focus on our core operations, we are working to responsibly monetize non-core assets. In 2003, we made significant progress in that regard. We reduced our ownership in The Houston Exploration Company from 66 percent to the current level of 55 percent, receiving net proceeds of $79 million. We monetized approximately 39 percent of our ownership interest in KeySpan Canada through an Income Trust and sold our 20 percent interest in Taylor Natural Gas Liquids, receiving net proceeds of approximately $120 million. And, finally, in December of 2003, we completed the sale of our 24.5 percent interest in Phoenix Natural Gas, a gas distribution company in Northern Ireland, for approximately $95 million.

The proceeds from these transactions have been used to reduce our debt level, in support of our continuing efforts to strengthen our balance sheet. In 2004, we will consider additional opportunities to monetize non-core assets in ways that maximize shareholder value. To that end, in February, we sold an additional 36 percent interest in KeySpan Canada and, when this transaction closes, we will realize



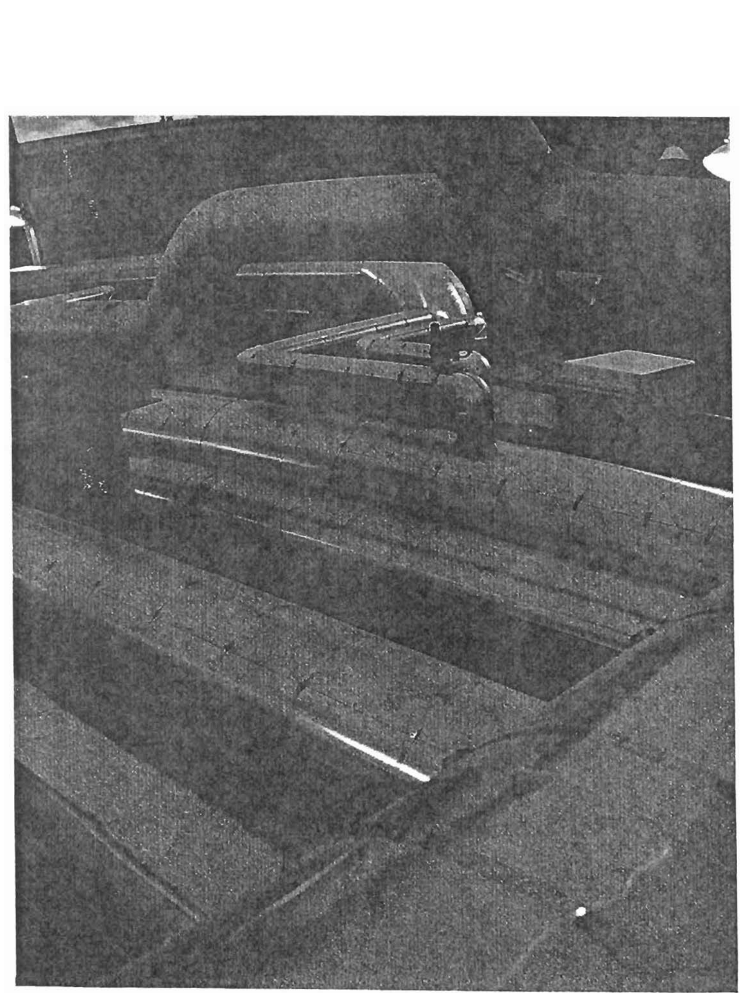
net proceeds of approximately $139 million. We will also continue to seek opportunities to invest in assets that help us strategically grow our core businesses.

Focusing on VALUE

2003 was a year in which we truly focused on our resources – regulated and unregulated, physical and human – and put them to work with a strategy that can deliver shareholder value for years to come. We made changes where changes were needed, but always within the scope of our core competencies for growth.

We paid a great deal of attention to allocation of our resources, ensuring that expenses were closely aligned with contributions to the bottom line. Having employees at all levels focused on expense management paid off, as we successfully reduced expenses by more than $100 million in 2003. Our focus on expense management is part of an ongoing emphasis on transforming both our business and our culture. Areas across the company are continually examining not only what we are achieving, but how we are achieving our results. Part of that assessment includes a re-emphasis on our high performance culture. KeySpan's employees deliver results, year after year, because they understand that meeting customer needs efficiently and effectively will help our business grow. They know that paying attention to the customer helps a business thrive, and a thriving business brings value to its investors and provides a stimulating work environment. Not rocket science – just effective strategy. We believe it will serve us well as we continue to deliver on our value promise. ■

2003 MARKED KEYSPAN'S FIVE-YEAR ANNIVERSARY, A PERIOD IN WHICH WE TRIPLED REVENUES AND TRULY BECAME THE PREMIER ENERGY SERVICES COMPANY IN THE NORTHEAST. BOB CATELL AND TEAM COMMEMORATED THE OCCASION BY RINGING THE CLOSING BELL AT THE NEW YORK STOCK EXCHANGE.



Increasing the VALUE of Our Assets

KeySpan continues its commitment to focus on growing our core businesses and to monetize our non-core assets such as KeySpan Canada, a company with gas processing plants and gathering facilities in Western Canada. In 2003, we sold approximately 39 percent of KeySpan Canada through an income trust fund and are in the process of selling an additional 36 percent. Also in 2003, we completed the sale of our 24.5 percent interest in Phoenix Natural Gas and the Company's interest in Taylor Natural Gas Liquids. These transactions, along with the partial sale of ownership in The Houston Exploration Company, helped to lower KeySpan's debt ratio from 65 percent to 58 percent. We continue to evaluate our non-core investments and will monetize them in a manner that maximizes value to our investors.

Financial
Review

Abbreviations and Glossary

Bbl Abbreviation for barrel. One barrel is the equivalent of 42 standard US gallons

BCFe A billion cubic feet

Btu British Thermal Unit

Degree Days A measure of the number of degrees the average daily outside temperature is below 65° F

Dekatherm One dekatherm equals 10 therms or one million Btu

DTE Department of Telecommunications and Energy. Massachusetts agency responsible for regulating pricing, service quality and safety of utilities

Dth Abbreviation for dekatherm

FERC Federal Energy Regulatory Commission. The US agency that regulates interstate energy activities

LDC Local Distribution Company

LILCO Long Island Lighting Company

LIPA Long Island Power Authority

LNG Liquefied Natural Gas

Mbbls A thousand barrels

Mcf Abbreviation for a thousand cubic feet

MDTH One thousand dekatherms

MGP Manufactured Gas Plant

Mmcf Abbreviation for a million cubic feet

MW Abbreviation for megawatt. One million watts of electricity (enough to power approximately one thousand homes)

NHPUC New Hampshire Public Utilities Commission. Agency responsible for regulating pricing, service quality and safety of utilities

NYISO New York Independent System Operator. An agency with operational control over most of the state's transmission facilities to ensure reliability

NYMEX New York Mercantile Exchange

NYPSC New York Public Service Commission. Agency responsible for regulating pricing, service quality and safety of utilities

Peaking Facility A power plant with generating units designed to operate during periods of maximum demand for electricity, as opposed to the units of a baseload plant, which usually operate continuously

Proved Gas Reserves Gas that has been discovered and determined to be recoverable under existing economic and operating conditions

PUHCA Public Utility Holding Company Act of 1935

Realized Gas Prices Average wellhead price received for production including hedging gains and losses

RTO Regional Transmission Organization

Therm A unit of heating value equivalent to 100,000 Btus

Wellhead Prices The cost of gas as it comes from well excluding cleaning, compression, transportation and distribution charges.

Contents

15	Financial Review and Analysis
45-50	Consolidated Financial Statements
51	Notes to Consolidated Financial Statements
89	Selected Financial Data
90	Directors and Officers
91	Shareholder Information

Financial Review and Analysis

KeySpan Corporation (referred to herein as "KeySpan", "we", "us" and "our") is a registered holding company under the Public Utility Holding Company Act of 1935, as amended ("PUHCA"). KeySpan operates six regulated utilities that distribute natural gas to approximately 2.5 million customers in New York City, Long Island, Massachusetts and New Hampshire, making us the fifth largest gas distribution company in the United States and the largest in the Northeast. We also own and operate electric generating plants in Nassau and Suffolk Counties on Long Island and in Queens County in New York City and are the largest investor owned generator in New York State. Under contractual arrangements, we provide power, electric transmission and distribution services, billing and other customer services for approximately one million electric customers of the Long Island Power Authority ("LIPA"). KeySpan's other subsidiaries are involved in gas and oil exploration and production; underground gas storage; liquefied natural gas storage; wholesale and retail electric marketing; appliance service; plumbing, heating, ventilation, air conditioning and other mechanical services; large energy-system ownership, installation and management; fiber optic services; and engineering and consulting services. We also invest and participate in the development of natural gas pipelines, natural gas processing plants, electric generation, and other energy-related projects, domestically and internationally. (See Note 2 to the Consolidated Financial Statements "Business Segments" for additional information on each operating segment.)

Consolidated Summary of Results

Operating income by segment, as well as consolidated earnings available for common stock is set forth in the following table for the periods indicated.

(In Thousands of Dollars, Except Per Share Amounts)			
Year Ended December 31,	2003	2002	2001
Gas Distribution	$ 574,254	$531,134	$481,393
Electric Services	268,977	288,796	269,721
Energy Services	(38,066)	(11,935)	(147,485)
Energy Investments	238,554	142,594	178,783
Eliminations and other	(2,062)	(8,507)	31,366
Operating Income	1,041,657	942,082	813,778
Interest charges	(307,694)	(301,504)	(353,470)
Other Income and (deductions)	(32,471)	251	(5,923)
Income taxes	(277,311)	(243,479)	(210,693)
Income from Continuing Operations	424,181	397,350	243,692
Cumulative change in accounting principles	(37,451)	—	—
Loss from discontinued operations	—	(19,662)	(19,438)
Net Income	386,730	377,688	224,254
Preferred stock dividends	5,844	5,753	5,904
Earnings for Common Stock	$ 380,886	$371,935	$218,350
Basic Earnings per Share:			
Continuing operations, less preferred stock dividends	$ 2.64	$ 2.77	$ 1.72
Change in accounting principles	(0.23)	—	—
Discontinued operations	—	(0.14)	(0.14)
	$ 2.41	$ 2.63	$ 1.58

Operating income in 2003 increased $99.6 million, or 11% compared to 2002. This increase in operating income reflects higher earnings from the Energy Investments and Gas Distribution segments, somewhat offset by decreases in earnings from the Electric Services and Energy Services segments. The Energy Investment segment benefited from higher earnings associated with gas exploration and production activities as a result of significantly higher realized gas prices and higher production volumes. The Gas Distribution segment benefited from colder weather during the January through March 2003 heating season compared to the same period last year, as well as from load growth. Further, during 2003 we recorded $15.1 million in gains from property sales, primarily 550 acres of real property located on Long Island. The Energy Services group of companies were adversely impacted by the decline in construction industry activity in the Northeastern United States during most of the year. Lower results from the Electric Services segment were attributable to higher operating costs, as well as lower revenues from our merchant generating facility, due in part to cooler summer weather. (See the discussion under the caption "Review of Operating Segments" for further details on each segment.)

Interest charges increased 2% in 2003, compared to last year, primarily as a result of the termination of certain interest-rate derivative swap instruments that were in effect in 2002. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values.")

Other income and (deductions) reflects a number of significant items that impacted comparative results. During 2003, we monetized a portion of our Canadian and Northern Ireland investments, as well as a portion of our ownership interest in The Houston Exploration Company ("Houston Exploration"), our gas exploration and production subsidiary. During the year, we sold 39.09% of our interest in KeySpan Canada through an income trust fund. KeySpan Canada has natural gas processing plants and gathering facilities in Western Canada. Additionally, we sold our 20% interest in Taylor NGL LP that owns and operates two extraction plants also located in Canada. We recorded a pre-tax loss of $30.3 million ($34.1 million after-tax, or $0.22 per share) associated with these sales. Further, in February 2004 we entered into an agreement to sell an additional 36% of our interest in KeySpan Canada. (See Note 15 to the Consolidated Financial Statements "Subsequent Events.") In the fourth quarter of 2003, we completed the sale of our 24.5% interest in Phoenix Natural Gas, located in Northern Ireland, and recorded a pre-tax gain of $24.7 million, $16.0 million after-tax, or $0.10 per share.

Additionally in 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. We recorded a gain of $19.0 million on this transaction. Income taxes were not provided on this transaction since the transaction was structured as a return of capital.

In total, KeySpan recorded a pre-tax gain of $13.4 million from the monetization of certain non-core assets. The after-tax gain from these

three asset sales, however, was minimal due to the different tax treatment associated with each transaction.

Also in 2003, we called approximately $447 million of outstanding promissory notes that were issued to LIPA in connection with the KeySpan/Long Island Lighting Company ("LILCO") business combination completed in May 1998, and recorded debt redemption charges of $18.2 million in other income and (deductions). Further, Houston Exploration incurred costs of $5.9 million to retire $100 million of 8.625% Notes due 2008.

Other income and (deductions) also reflects severance tax refunds totaling $21.6 million recorded by Houston Exploration for severance taxes paid in 2002 and earlier periods, compared to $9.1 million recorded in 2002, as well as $6.5 million of realized foreign currency translation gains. Finally, other income and (deductions) reflects minority interest adjustments related to Houston Exploration and KeySpan Canada, as well as carrying charges on certain regulatory assets.

The increase in income tax expense in 2003 compared to 2002 generally reflects a higher level of pre-tax earnings. Further income tax expense for 2003 and 2002 includes a number of items impacting comparative results. During 2003, the partial monetization of our Canadian investments resulted in tax expense of $3.8 million, reflecting certain United States partnership tax rules. In addition, we recorded an adjustment to income tax expense of $6.1 million due to the state of Massachusetts disallowing the carry forward of net operating losses incurred by regulated utilities. Offsetting, to some extent, these increases to tax expense, was a tax benefit recorded in 2003 of $9.0 million associated with certain New York City general corporation tax issues. In addition, certain costs associated with employee deferred compensation plans were deducted for federal income tax purposes in 2003. These costs, however, are not expensed for "book" purposes resulting in a beneficial permanent book-to-tax difference of $6.3 million.

Income tax expense for 2002 reflects a tax benefit of $15 million as a result of the favorable resolution of certain outstanding tax issues related to the KeySpan/LILCO merger. Additionally, we recorded an adjustment to deferred income taxes of $177.7 million reflecting a decrease in the tax basis of the assets acquired at the time of the merger. This adjustment was a result of a revised valuation study. Concurrent with the deferred tax adjustment, we reduced current income taxes payable by $183.2 million, resulting in a $5.5 million income tax benefit Also, it should be noted that pre-tax income in the Consolidated Statement of Income reflects minority interest adjustments, whereas income taxes reflect the full amount of subsidiary taxes.

In January 2002, KeySpan announced that it had entered into an agreement to sell Midland Enterprises LLC ("Midland"), its marine barge business. During the fourth quarter of 2001, in anticipation of this divestiture, which closed on July 2, 2002, an estimated loss on the sale of Midland was recorded as discontinued operations, as well as an estimate for Midland's results of operations for the first nine months of 2002. In the second quarter of 2002, we recorded an additional after-tax loss of $19.7 million, primarily reflecting a provision for certain city and state taxes that resulted from a change in our tax structuring strategy.

In January 2003, the Financial Accounting Standards Board ("FASB") issued Financial Interpretation Number 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51"; FIN 46 requires consolidation of variable interest entities. KeySpan has an arrangement with a variable interest entity through which we lease a portion of the 2,200-megawatt Ravenswood electric generating facility ("Ravenswood facility"). Based upon KeySpan's current status as the primary beneficiary, we were required to consolidate the variable interest entity as of December 31, 2003. As a result of implementing FIN 46, we recognized a non-cash, after-tax charge of $37.6 million, or $0.23 per share related to "catch-up" depreciation of the facility since its acquisition in June 1999 and recorded the charge as a cumulative change in accounting principle. (See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for an explanation of the leasing arrangement for the Ravenswood facility, as well as an explanation of the implementation of FIN 46.)

As a result of the above mentioned items, income from continuing operations, less preferred stock dividends, increased $26.7 million, or 7% in 2003 compared to 2002. Earnings per share from continuing operations, however, decreased by $0.13 per share, reflecting the issuance of 13.9 million shares of common stock on January 17, 2003, as well as the re-issuance of shares held in treasury pursuant to dividend reinvestment and employee benefit plans. The increase in average common shares outstanding reduced 2003 earnings per share by $0.32 compared to 2002. Comparative earnings available for common stock, which includes the cumulative change in accounting principle recorded in 2003, as well as the loss on discontinued operations recorded in 2002, increased $9.0 million in 2003 compared to 2002. Earnings per share, however, decreased by $0.22 per share reflecting the higher level of common stock outstanding in 2003.

KeySpan's earnings for 2003 were forecasted to be approximately $2.45 to $2.60 per share, including the effect of the equity issuance in January 2003 and excluding special items. Earnings from continuing core operations (defined for this purpose as all continuing operations other than exploration and production, less preferred stock dividends) were forecasted to be approximately $2.15 to $2.20 per share, while earnings from exploration and production operations were forecasted to be approximately $0.30 to $0.40 per share. Actual 2003 earnings from continuing core operations, as defined, were $2.16 per share, while earnings from exploration and production operations were $0.48 per share.

Operating income for the year ended December 31, 2002, increased $128.3 million compared to the same period in 2001. The increase in operating income primarily reflects the following two significant events that are discussed in more detail below: (i) the discontinuance of goodwill amortization in 2002; and (ii) the recording of special items in 2001 which resulted in the recognition of certain gains and losses. These benefits to comparative operating income were offset, in part, by a decrease in natural gas prices, particularly during the

first quarter of 2002, which reduced earnings associated with gas exploration and production operations. Further, the impact of extremely warm weather during the first quarter of 2002 adversely impacted natural gas consumption by gas distribution customers and operating income in the Gas Distribution segment. (See "Review of Operating Segments" for a detailed discussion of operating income for each of KeySpan's lines of business.)

In January 2002, we adopted Statement of Financial Accounting Standard ("SFAS") 142 "Goodwill and Other Intangible Assets." The key requirements of this Statement include the discontinuance of goodwill amortization, a revised framework for testing goodwill impairment and new criteria for the identification of intangible assets. Consolidated goodwill amortization for 2001 was $49.6 million, or $0.36 per share.

During 2001, we recorded the effects of a number of events that impacted results of operations for that year. These events are as follows: (1) we incurred $137.8 million in pre-tax operating losses attributed to the former Roy Kay companies ($95.0 million after-tax, or $0.69 per share), primarily reflecting costs related to the discontinuance of the general contracting activities of these companies, costs to complete work on certain loss construction projects, as well as operating losses incurred. (See Note 10 to the Consolidated Financial Statements, "Roy Kay Operations" and Note 7 "Contractual Obligations, Financial Guarantees and Contingencies - Legal Matters", for a further discussion of these issues); (2) our gas exploration and production subsidiaries recorded a non-cash, pre-tax impairment charge of $42.0 million to recognize the effect of lower wellhead prices on their valuation of proved gas reserves. Our share of this charge was $26.2 million after-tax, or $0.19 per share. (See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies," Item F for further details); and (3) following a favorable appellate court ruling, we reversed a previously recorded loss provision regarding certain pending rate refund issues relating to the 1989 RICO class action settlement of $20.1 million after-tax, or $0.15 per share. This adjustment has been reflected as a $22.0 million reduction to operations and maintenance expense and a reduction of $11.5 million to interest charges on the Consolidated Statement of Income for the year ended December 31, 2001. (See Note 11 to the Consolidated Financial Statements "Class Action Settlement" for a further discussion of this issue.)

Interest expense decreased $52.0 million in 2002 compared to 2001. The weighted-average interest rate on outstanding commercial paper for 2002 was approximately 2.0% compared to approximately 4.5% in 2001. Further, KeySpan had a number of interest rate swap agreements which effectively converted fixed rate debt to floating rate debt. The use of these derivative instruments reduced interest expense by $35.6 million in 2002. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments, and Fair Values" for a description of these instruments.) Interest expense in 2001 reflects the reversal of $11.5 million in accrued interest expense resulting from the RICO class action settlement, as noted previously.

Income tax expense generally reflects the level of pre-tax income in 2002 and 2001. However, as noted above, during 2002 we finalized the valuation study related to the assets transferred to KeySpan resulting from the KeySpan/LILCO business combination completed in May 1998. As a result of an adjustment to deferred taxes and current income taxes payable, KeySpan recognized a $5.5 million income tax benefit. Income tax expense for 2002 also reflects additional tax benefits of approximately $15 million resulting from the finalization of amended tax returns and the reversal of certain tax reserves.

As a result of the above mentioned items, income from continuing operations, less preferred stock dividends, increased $153.8 million in 2002 compared to 2001; earnings per share from continuing operations increased $1.05 per share. Average common shares outstanding in 2002 increased by 2% compared to 2001 reflecting the re-issuance of shares held in treasury pursuant to dividend reinvestment and employee benefit plans. This increase in average common shares outstanding reduced earnings per share in 2002 by $0.06 compared to 2001.

Net income from gas exploration and production operations decreased by $13.4 million, or $0.11 per share, in 2002 compared to 2001. These operations were adversely impacted by significantly lower realized gas prices in 2002, particularly in the first quarter. As previously mentioned, these operations recorded a non-cash impairment charge in 2001; excluding this charge, the comparative decrease in earnings was $39.6 million, or $0.30 per share.

Financial Outlook for 2004

KeySpan's consolidated earnings for 2004 are forecasted to be in the range of $2.55 to $2.75 per share, excluding special items. Earnings from continuing core operations (defined for this purpose as all continuing operations other than exploration and production, less preferred stock dividends) are forecasted to be in the range of $2.20 to $2.30 per share, while earnings from exploration and production operations are forecasted to be in the range of $0.35 to $0.45 per share.

Consolidated earnings are seasonal in nature due to the significant contribution to earnings of our gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters of our fiscal year.

Review of Operating Segments

In response to new disclosure regulations adopted by the Securities and Exchange Commission ("SEC") as part of its implementation of the Sarbanes-Oxley Act of 2002 - specifically Regulation G, which became effective March 2003 - we are reporting all of KeySpan's segment results on an Operating Income basis for 2003, 2002 and 2001. Management believes that this generally accepted accounting principle ("GAAP") based measure provides a reasonable indication of KeySpan's underlying performance associated with its operations. The following is a discussion of financial results achieved by KeySpan's operating segments presented on an Operating Income basis.

Gas Distribution

KeySpan Energy Delivery New York ("KEDNY") provides gas distribution service to customers in the New York City Boroughs of Brooklyn, Staten Island and a portion of Queens. KeySpan Energy Delivery Long Island ("KEDLI") provides gas distribution service to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. Four natural gas distribution companies – Boston Gas Company, Essex Gas Company, Colonial Gas Company and EnergyNorth Natural Gas, Inc., each doing business under the name KeySpan Energy Delivery New England ("KEDNE"), provide gas distribution service to customers in Massachusetts and New Hampshire.

The table below highlights certain significant financial data and operating statistics for the Gas Distribution segment for the periods indicated.

(In Thousands of Dollars)

Year Ended December 31,	2003	2002	2001
Revenues	$4,161,272	$3,163,761	$3,613,551
Cost of gas	2,444,485	1,569,325	2,017,782
Revenue taxes	90,456	83,066	119,084
Net Gas Revenues	1,626,331	1,511,370	1,476,685
Operating Expenses			
Operations and maintenance	659,932	608,266	593,341
Depreciation and amortization	259,934	237,186	253,523
Operating taxes	147,334	135,687	148,428
Total Operating Expenses	1,067,200	981,139	995,292
Gain on the sale of property	15,123	903	—
Operating Income	$ 574,254	$ 531,134	$ 481,393
Firm gas sales and transportation (MDTH)	328,073	284,281	283,081
Transportation – Electric Generation (MDTH)	34,778	64,173	64,578
Other Sales (MDTH)	158,722	209,002	188,037
Warmer (Colder) than Normal – New York & Long Island	(8.0%)	7.0%	10.0%
Warmer (Colder) than Normal – New England	(10.0%)	4.0%	4.6%

A MDTH is 10,000 therms and reflects the heating content of approximately one million cubic feet of gas. A therm reflects the heating content of approximately 100 cubic feet of gas. One billion cubic feet (BCF) of gas equals approximately 1,000 MDTH.

Net Revenues

Net gas revenues (revenues less the cost of gas and associated revenue taxes) from our gas distribution operations increased by $115.0 million, or 8%, for the year ended December 31, 2003, compared to last year. Both our New York and New England based gas distribution operations benefited from the significantly colder than normal weather experienced throughout the Northeastern United States, particularly during the primary winter heating months, January through March, when our gas distribution operations realize over 60% of their yearly operating income. As measured in heating degree-days, weather during the first quarter of 2003 was approximately 10% colder than normal in our New York and New England service territories. This contrasts with the extremely warm weather experienced during the first quarter of 2002 when weather was approximately 16% – 18% warmer than normal. On a twelve month basis, weather was approximately 8% – 10% colder than normal in 2003 compared to 4% – 7% warmer than normal in 2002.

Net gas revenues from firm gas customers (residential, commercial and industrial customers) in our New York service territories increased by $56.4 million, or 6%, for the twelve months ended December 31, 2003, compared to the same period last year. Customer additions and oil-to-gas conversions, net of attrition and conservation, added approximately $22 million to net revenues during 2003. The effect of higher customer consumption in 2003 due primarily to colder than normal weather, coupled with lower customer consumption in 2002 due to the extremely warmer than normal weather resulted in a comparative increase to firm net revenues of approximately $41.1 million in 2003 compared to 2002. However, KEDNY and KEDLI each operate under a utility tariff that contains a weather normalization adjustment that significantly offsets variations in firm net revenues due to fluctuations from normal weather. These tariff provisions resulted in a $20.4 million refund to firm gas customers during 2003. Also included in net revenues are regulatory incentives that reduced comparative net revenues by $2.1 million and recovery of certain taxes that added $15.8 million to net revenues during 2003. The recovery of taxes through revenues, however, does not impact net income since we expense a similar amount as amortization charges and income taxes, as appropriate, on the Consolidated Statement of Income.

Net gas revenues from firm gas customers in our New England service territories increased $31.7 million, or 7%, for the year ended December 31, 2003, compared to the same period last year. Customer additions and oil-to-gas conversions, net of attrition and conservation, added approximately $13.5 million to net revenues. As with our New York service territories, higher customer consumption in 2003 due to the colder than normal weather, coupled with lower customer consumption in 2002 due to the warmer than normal weather, resulted in an increase in comparative net revenues for our New England based gas distribution utilities of approximately $25.1 million in 2003 compared to 2002. The gas distribution operations of our New England based subsidiaries do not have a weather normalization adjustment. To mitigate the effect of fluctuations from normal weather patterns on KEDNE's results of operations and cash flows, weather derivatives were put in place for the 2002/2003 and 2003/2004 winter heating seasons. Since weather during the first quarter of 2003 was 10% colder than normal in the New England service territories, we recorded an $11.9 million reduction to revenues to reflect the loss on these derivative transactions. Similarly, in 2002 we recorded a $3.3 million reduction to revenues. As a result of these transactions, comparative net revenues were adversely impacted by $8.6 million. Weather derivatives had only a marginal impact on net revenues during the fourth quarter of 2003, since weather was

approximately normal. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values " for further information).

Also included in net revenues for 2003 are $5.6 million of base-rate adjustments resulting from Boston Gas Company's recently concluded rate case. Further, included in net revenues for 2002, was a benefit of $3.9 million as a result of a favorable ruling from the Massachusetts Supreme Judicial Court relating to the appeal by Boston Gas Company of its Performance Based Rate Plan ("PBR"). The net effect of these base-rate adjustments was a favorable impact to comparative net revenues in 2003 of $1.7 million. (See "Regulation and Rate Matters" for a further discussion of these matters.)

Firm gas distribution rates for KEDNY and KEDLI in 2003, other than for the recovery of gas costs, have remained substantially unchanged from rates charged last year. As noted, firm gas distribution rates for KEDNE reflect an increase of $5.6 million resulting from The Boston Gas Company's rate order, which became effective November 1, 2003.

In our large-volume heating and other interruptible (non-firm) markets, which include large apartment houses, government buildings and schools, gas service is provided under rates that are designed to compete with prices of alternative fuel, including No. 2 and No. 6 grade heating oil. Net revenues from sales to these markets increased by $26.8 million during the twelve months ended December 31, 2003, compared to the same period last year. The majority of interruptible profits earned by KEDNE and KEDLI are returned to firm customers as an offset to gas costs.

During 2002, combined net gas revenues from our gas distribution operations increased by $34.7 million, or 2% compared to 2001. Both the New York and New England based gas distribution operations were adversely impacted by the significantly warmer than normal weather experienced throughout the Northeastern United States during 2002, particularly during the first quarter. Weather during the primary heating seasons, January through March, was approximately 16%-18% warmer than normal, across our service territories.

Net revenues from firm gas customers in our New York service territories increased $13.6 million, or 1%, in 2002 compared to 2001. Included in net revenues are regulatory incentives and recovery of certain taxes that added $1.8 million and $20.1 million to net revenues during 2002, respectively. As mentioned previously, the recovery of taxes through revenues does not impact net income. Excluding both the regulatory incentives and tax recoveries, comparative net revenues decreased $8.3 million. During 2002, our New York based gas distribution utilities added approximately $40 million in gross gas load additions through oil-to-gas conversions, as well as from new construction. Further, as mentioned, KEDNY and KEDLI each operate under utility tariffs that contain a weather normalization adjustment. These tariff provisions resulted in an increase to net gas revenues of $22.3 million in 2002. However the benefits from load additions and the weather normalization adjustment were offset by declining usage per customer due to the extremely warm first quarter weather and the use of more efficient gas heating equipment. Additionally, the down-turn in the economy throughout the Northeastern United States adversely impacted gas consumption in 2002.

Net revenues from firm gas customers in the New England service territories increased by $20.5 million, or 5%, in 2002 compared to 2001, primarily as a result of approximately $24 million in gross load additions. Also included in net revenues are base rate adjustments totaling $10.0 million associated with Boston Gas Company's PBR. The largest component of this adjustment reflects the beneficial effect of a favorable ruling of the Massachusetts Supreme Judicial Court relating to the "accumulated inefficiencies" component of the productivity factor in the PBR. This ruling resulted in a benefit to comparative net margins of $6.3 million. (See "Regulation and Rate Matters" for a further discussion of this matter.) Offsetting, to some extent, these benefits to revenues were the adverse effects of declining usage per customer due to the extremely warm first quarter weather and the use of more efficient gas heating equipment. Additionally, the down-turn in the economy throughout the Northeastern United States adversely impacted gas consumption in 2002.

As mentioned previously, the New England-based gas distribution subsidiaries do not have weather normalization adjustments. To lessen, to some extent, the effect of fluctuations from normal weather patterns on KEDNE's results of operations and cash flows, weather derivatives were in place for the 2002/2003 winter heating season. Since weather during the fourth quarter of 2002 was 7% colder than normal in the New England service territories, we recorded a $3.3 million reduction to revenues to reflect the loss on these derivative transactions. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments, and Fair Values" for further information).

Firm gas distribution rates in 2002, excluding gas cost recoveries, remained substantially unchanged from 2001 in all of our service territories.

Net revenues from sales in the large-volume heating and other interruptible (non-firm) markets were consistent between 2002 and 2001.

We are committed to our expansion strategy initiated during the past few years. We believe that significant growth opportunities exist on Long Island and in our New England service territories. We estimate that on Long Island approximately 36% of the residential and multi-family markets, and approximately 58% of the commercial market currently use natural gas for space heating. Further, we estimate that in our New England service territories approximately 53% of the residential and multi-family markets, and approximately 63% of the commercial market, currently use natural gas for space heating purposes. We will continue to seek growth in all our market segments, through the economic expansion of our gas distribution system, as well as through the conversion of residential homes from oil-to-gas for space heating purposes and the pursuit of opportunities to grow the multi-family, industrial and commercial markets.

Firm Sales, Transportation and Other Quantities
Total actual firm gas sales and transportation quantities increased by 15% during the year ended December 31, 2003, compared to the same period in 2002. In the New York service territories actual firm sales increased 17%, while firm sales in the New England service territories increased 13%. Weather normalized sales quantities increased 6% in the New York service territories and 3% in the New England service territories. The increases in both actual and weather normalized gas sale quantities reflect higher customer consumption as a result of the significantly colder than normal weather in 2003, as well as from customer additions and oil-to-gas conversions for space heating purposes. Further, as mentioned previously, gas sales quantities in 2002 were adversely impacted by the exceptionally warm weather.

In 2002, total actual firm gas sales and transportation quantities remained consistent with 2001. In the New York service territories, actual and weather normalized firm gas sales and transportation quantities decreased slightly in 2002 compared to 2001, due to the exceptionally warm 2002 weather. However, in the New England services territories, firm gas sales and transportation quantities increased 4%, despite the warm first quarter weather, due to load additions.

Net revenues are not affected by customers opting to purchase their gas supply from other sources, since delivery rates charged to transportation customers generally are the same as delivery rates charged to sales service customers. Transportation quantities related to electric generation reflect the transportation of gas to our electric generating facilities located on Long Island. Net revenues from these services are not material.

Other sales quantities include on-system interruptible quantities, off-system sales quantities (sales made to customers outside of our service territories) and related transportation. We have an agreement with Coral Resources, L.P. ("Coral"), a subsidiary of Shell Oil Company, under which Coral assists in the origination, structuring, valuation and execution of energy-related transactions on behalf of KEDNY and KEDLI. We also have a portfolio management contract with Entergy Koch Trading, LP ("EKT"), under which EKT provides all of the city gate supply requirements at market prices and manages certain upstream capacity, underground storage and term supply contracts for KEDNE. These agreements expire on March 31, 2006.

Purchased Gas for Resale
The increase in gas costs for the year ended December 31, 2003 compared to the same period in 2002 of $875.2 million, or 56%, reflects an increase of 39% in the price per dekatherm of gas purchased, and a 15% increase in the quantity of gas purchased. The decrease in gas costs in 2002 compared to 2001 of $448.5 million, or 22%, reflects a decrease of 26% in the price per dekatherm of gas purchased, partially offset by a 1.0% increase in the quantity of gas purchased. The current gas rate structure of each of our gas distribution utilities includes a purchased gas adjustment clause, pursuant to which variations between actual gas costs incurred for resale to firm sales customers and gas costs billed to firm sales customers are deferred and refunded to or collected from customers in a subsequent period.

Operating Expenses
Operating expenses in 2003 increased $86.1 million, or 9%, compared to last year. This increase is primarily attributable to higher pension and other postretirement benefit costs, which have increased (net of amounts deferred and subject to regulatory true-ups) by $30.9 million during 2003. The cost of these benefits has risen primarily as a result of lower actual returns on plan assets, as well as increased health care costs. Further, the colder weather experienced during 2003 resulted in a higher level of repair and maintenance work on our gas distribution infrastructure which increased comparative operating expenses by approximately $15 million.

Higher depreciation and amortization expense reflects the continued expansion of the gas distribution system. Further, included in depreciation and amortization expense is the amortization of certain property taxes previously deferred and currently being recovered in revenues. Comparative operating taxes reflect a favorable $9.9 million adjustment recorded during 2002 relating to the reversal of excess tax reserves established for the KeySpan / LILCO combination in May 1998.

Operating expenses decreased by $14.2 million in 2002 compared to 2001. Comparative operating expenses were significantly impacted by the discontinuation of goodwill amortization. As mentioned earlier, in January 2002, we adopted SFAS 142 "Goodwill and Other Intangible Assets," which required, among other things, the discontinuation of goodwill amortization. Goodwill amortization in the gas distribution segment for the twelve months ended December 31, 2001 was $35.6 million. Excluding the effects of this amortization, operating expenses increased by $21.4 million, or 2%, in 2002 compared to 2001.

The increase in operating expense in 2002 is attributable, in part, to higher pension and other postretirement benefits which increased by approximately $25 million, net of amounts deferred and subject to regulatory true-ups, over the level incurred in 2001. Further, depreciation and amortization expense, excluding the 2001 goodwill amortization, increased as a result of the continued expansion of the gas distribution system.

Offsetting, to some extent, these increases to operating expenses is the favorable $9.9 million adjustment to operating taxes recorded in 2002 related to the reversal of certain operating tax reserves established for the KeySpan/LILCO combination as previously noted. Further, we realized cost saving synergies as a result of early retirement and severance programs implemented in the fourth quarter of 2000. The early retirement portion of the program was completed in 2000, but the severance feature continued through 2002.

Sale of Property

During 2003 we recorded $15.1 million in gains from property sales, primarily 550 acres of real property located on Long Island.

Other Matters

As previously mentioned, there remain significant growth opportunities in our Long Island and New England gas distribution service areas. The Northeast region represents a significant portion of the country's population and energy consumption. Cost efficient gas sales growth and customer additions are critical to our earnings in the future. However, the beneficial effect of our growth initiatives may not be fully realized in the short-term since we will continue to make incremental investments in our gas distribution network to optimize the long-term growth opportunities in our service territories.

In order to serve the anticipated market requirements in our New York service territories, KeySpan and Duke Energy Corporation formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Islander East is owned 50% by KeySpan and 50% by Duke Energy, and was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Northport, Long Island. Applications for all necessary regulatory authorizations were filed in 2000 and 2001. To date, Islander East has received a final certificate from the Federal Energy Regulatory Commission ("FERC") and all necessary permits from the State of New York. However, the State of Connecticut has denied Islander East's application for a coastal zone management permit and a permit under Section 401 of the Clean Water Act. Islander East has reinstated its appeal of the State of Connecticut's determination on the coastal zone management issue to the United States Department of Commerce and is evaluating its legal and other options with respect to the Section 401 issue. Once in service, the pipeline is expected to transport up to 260,000 DTH daily to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. The pipeline will also allow KeySpan to diversify the geographic sources of its gas supply. However, we are unable to predict when or if all regulatory approvals required to construct this pipeline will be obtained. Various options for the financing of pipeline construction are currently being evaluated. At December 31, 2003, total expenditures associated with the siting and permitting of the Islander East pipeline were $14.9 million.

Electric Services

The Electric Services segment primarily consists of subsidiaries that own and operate oil and gas fired electric generating plants in the New York City Borough of Queens (the "Ravenswood facility") and the counties of Nassau and Suffolk on Long Island and on the Rockaway Peninsula in Queens. In addition, through long-term contracts of varying lengths, we manage the electric transmission and distribution ("T&D") system, the fuel and electric purchases, and the off-system electric sales for LIPA.

Selected financial data for the Electric Services segment is set forth in the table below for the periods indicated.

			(In Thousands of Dollars)
Year Ended December 31,	2003	2002	2001
Revenues	$1,503,187	$1,421,143	$1,421,179
Purchased fuel	371,134	272,873	281,398
Net Revenues	1,132,053	1,148,270	1,139,781
Operating Expenses			
Operations and maintenance	650,649	659,882	662,083
Depreciation	66,843	61,377	52,284
Operating taxes	145,584	139,694	155,693
Total Operating Expenses	863,076	860,953	870,060
Gain on the sale of property	—	1,479	—
Operating Income	$ 268,977	$ 288,796	$ 269,721
Electric sales (MWH)*	4,743,029	4,998,111	4,932,836
Capacity (MW)*	2,200	2,200	2,200
Cooling degree days	1,010	1,384	1,381

**Reflects the operations of the Ravenswood facility only.*

Net Revenues

Total electric net revenues decreased $16.2 million, or 1% for the year ended December 31, 2003 compared to the same period in 2002.

Net revenues from the Ravenswood facility were $3.1 million lower in 2003 compared to 2002. Comparative net revenues reflect higher capacity revenues of $31.5 million, offset by a decrease in energy margins of $34.6 million. The increase in capacity revenues reflects an increase in the level of capacity sold, as well as an increase in the selling price of capacity. Such increases are the result of two measures. First, in 2002, the New York Independent System Operator ("NYISO") employed a revised methodology to assess the available supply of and demand for installed capacity. This revised methodology resulted in insufficient capacity being procured by the market, which caused a reliability concern. Further, the revised methodology resulted in lower capacity volume sold into the NYISO and depressed capacity pricing during the year ended December 31, 2002. The NYISO, however, recognized a calculation flaw in its revised methodology, and prior to the 2002/2003 winter season capacity auction, corrected the calculation methodology to ensure that sufficient capacity is procured. Elimination of the flaw ensured compliance with New York State reliability rules and resulted in higher capacity revenue realized at the Ravenswood facility in 2003 compared to the prior year.

In addition, on May 20, 2003, the Federal Energy Regulatory Commission ("FERC") approved the NYISO's revised capacity market procurement design with an effective date of May 21, 2003. This revised capacity market procurement design is based on a demand curve rather than relying on deficiency auctions to procure necessary capacity. The deficiency auction with its associated fixed minimum capacity requirements was replaced with a spot market auction that pays gradually declining prices as additional capacity is offered and gradually increasing prices as capacity offers decrease. This new market design recognizes the value of capacity in excess of the minimum requirement and reduces

price spikes during periods of shortage. Essentially, the demand curve design eliminates the high and low cycles inherent in the deficiency auction market design. This new market design also established seasonal electric generator specific price caps. Price caps establish the maximum price per megawatt ("MW") that capacity can be sold into the NYISO by divested electric generators like Ravenswood. Prior to this design change, one price cap was established for the entire year and was effective for all electric generators. For the Ravenswood facility, its 2003 summer price cap was higher than the yearly price cap effective during the 2002 summer. As a result of these market design changes, the Ravenswood facility realized higher capacity revenues during 2003 compared to 2002. It should be noted, however, that Ravenswood's 2003/2004 structured winter price cap will be lower than the yearly price cap effective during the 2002/2003 winter, which was prior to the implementation of the new demand curve methodology.

The decrease in comparative energy margins in 2003 primarily reflects significantly cooler weather during the summer of 2003 compared to the summer of 2002. Measured in cooling degree-days, weather for 2003 was 27% cooler than last year. The cooler weather resulted in lower realized "spark-spreads" (the selling price of electricity less cost of fuel, plus hedging gains or losses), as well as a reduction in megawatt hours sold into the NYISO. Further, more competitive behavior by market participants that bid into the NYISO, as well as certain price mitigation measures imposed by the FERC (as discussed below) have resulted in lower comparative realized "spark-spreads." Energy sales quantities during a portion of 2003 were also adversely impacted by the scheduled major overhaul of our largest generating unit.

We employ derivative financial hedging instruments to hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil consumed at the Ravenswood facility. Further, we have engaged in the use of derivative financial hedging instruments to hedge the cash flow variability associated with a portion of forecasted peak electric energy sales from the Ravenswood facility. These derivative instruments resulted in hedging gains, which are reflected in net electric margins, of $12.3 million for the year ended December 31, 2003 compared to hedging gains of $17.4 million for the year ended December 31, 2002. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments, and Fair Values" for further information).

The rules and regulations for capacity, energy sales and the sale of certain ancillary services to the NYISO energy markets continue to evolve and the FERC has adopted several price mitigation measures that have adversely impacted earnings from the Ravenswood facility. Certain of these mitigation measures are still subject to rehearing and possible judicial review. The final resolution of these issues and their effect on our financial position, results of operations and cash flows cannot be fully determined at this time. (See the discussion under the caption "Market and Credit Risk Management Activities" for more information.)

Net revenues from the service agreements with LIPA decreased by $22.7 million for the year ended December 31, 2003 compared to the same period last year. Included in revenues are billings to LIPA for certain third party costs that were lower than such billings last year. These revenues have minimal or no impact on earnings since we record a similar amount of costs in operating expense and we share any cost under-runs with LIPA. Excluding these third party billings, revenues in 2003 associated with these service agreements increased approximately $7 million compared to last year. The increase reflects a higher level of service fees charged to LIPA for the recovery of past operating costs. In 2003 we earned $16.2 million associated with non-cost performance incentives provided for under these agreements, compared to $16.0 million earned last year. (For a description of the LIPA Agreements, see the discussion under the caption "LIPA Agreements.")

Net revenues from the new electric "peaking" facilities located at Glenwood Landing and Port Jefferson on Long Island were $9.6 million higher in 2003 compared to 2002, reflecting a full year of operation. The Glenwood facility was placed in service on June 1, 2002, while the Port Jefferson facility was placed in service on July 1, 2002. These facilities added a combined 160 megawatts of generating capacity to KeySpan's electric generation portfolio. The capacity of and energy produced by these facilities are dedicated to LIPA under 25 year contracts.

Total electric net revenues increased by $8.5 million for the year ended December 31, 2002, compared to the same period in 2001. Net revenues in 2002 reflect net revenues of $17.3 million from the Glenwood Landing and Port Jefferson facilities.

Net revenues from the LIPA Agreements increased by $47.2 million in 2002, compared to 2001. Included in revenues for 2002, are billings to LIPA for certain third party costs that were significantly higher than such billings in the prior year. As previously mentioned, these revenues have minimal impact on earnings. Excluding these third party billings, revenues for 2002 associated with the LIPA Agreements were comparable to such revenues in 2001. In 2002 we earned $16.0 million associated with non-cost performance incentives provided for under these agreements, compared to $16.2 million earned in 2001.

Net revenues from the Ravenswood facility were $56 million, or 16%, lower in 2002, compared to 2001. Net revenues from capacity sales decreased $45.3 million compared to 2001, while margins associated with the sale of electric energy decreased $10.7 million. During 2002 we changed our classification of certain operating taxes that resulted in a comparative decrease in energy margins. Further, comparative energy sales were adversely impacted by a reduction in "spark-spread." Measured in cooling degree-days, weather during 2002 and 2001 was comparable.

The decrease in net revenues from capacity sales in 2002 was due, in part, to more competitive pricing by the electric generators that bid into the NYISO energy market which lowered capacity clearing prices by approximately 8% compared to 2001. Further, as mentioned earlier, the NYISO revised its methodology employed to determine the available supply of and demand for installed capacity that also had an adverse impact on the capacity market by reducing the capacity required to be purchased by load serving entities such as electric utilities.

Derivative instruments resulted in hedging gains, which are reflected in net electric margins, of $17.4 million for the year ended December 31, 2002 compared to hedging gains of $16.7 million for the year ended December 31, 2001. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments, and Fair Values" for further information).

Operating Expenses

Operating expenses increased $2.1 million for the year ended December 31, 2003, compared to 2002. Included in comparative operating expenses is a decrease in third party capital costs that are fully recoverable from LIPA, as noted previously. Excluding the decrease in these costs, operating expenses increased approximately $32 million. This increase resulted, in part, from higher pension and other postretirement benefit costs. LIPA reimburses KeySpan for costs directly incurred by KeySpan in providing service to LIPA, subject to certain sharing provisions. Variations between pension and other postretirement costs and the estimates used to bill LIPA are deferred and refunded to or collected from LIPA in subsequent periods. As a result of an adjustment recorded in 2002 relating to this "true-up," comparative pension and other postretirement costs were approximately $9.3 million higher in 2003 compared to 2002. In addition, in 2002 we settled certain outstanding issues with LIPA and The Consolidated Edison Company of New York ("Consolidated Edison") that resulted in a $13.0 million decrease to operating expenses in 2002. Operating taxes reflect an increase in property tax rates associated with the Ravenswood facility. The increase in depreciation expense is associated with the Glenwood and Port Jefferson facilities.

Operating expenses were $9.1 million lower in 2002 compared to 2001. Excluding the increase in third party capital costs, operating expenses decreased by approximately $57 million in 2002 compared to 2001. As a result of an adjustment recorded in 2002 relating to the pension and other postretirement benefit "true-up" as previously mentioned, comparative pension and other postretirement costs were approximately $23 million lower in 2002 compared to 2001. Further, during 2002 we settled certain outstanding issues with LIPA and Consolidated Edison, as previously noted, that resulted in a $20.3 million decrease to comparative operating expenses. Also in 2002 we changed our method for recording certain operating taxes that resulted in a comparative decrease in operating taxes. The increase in depreciation and amortization expense primarily reflects depreciation associated with the new peaking facilities.

Other Matters

During 2002, construction began on a new 250 MW combined cycle generating facility at the Ravenswood facility site. The new facility was synchronized to the electric grid in December 2003 and commenced operational testing in January 2004. In March, the facility completed full load Dependable Maximum Net Capacity testing. The capacity and energy produced from this plant are anticipated to be sold into the NYISO energy markets during the second quarter of 2004. KeySpan intends to enter into an approximately $360 million sale/leaseback transaction with third parties to finance the cost of this facility. (See Note 15 to the Consolidated Financial Statements "Subsequent Events" for a further discussion regarding this proposed transaction.)

In 2003, the New York State Board on Electric Generation Siting and the Environment issued an opinion and order which granted a certificate of environmental capability and public need for a 250 MW combined cycle electric generating facility in Melville, Long Island, which is now final and non-appealable. Also in 2003, LIPA issued a Request for Proposal ("RFP") seeking bids from developers to either build and operate a Long Island generating facility, and/or a new cable that will link Long Island to dedicated off-Long Island power of between 250 to 600 MW of electricity by no later than the summer of 2007. KeySpan and American National Power Inc. ("ANP") filed a joint proposal in response to LIPA's RFP. Under the proposal, KeySpan and ANP will jointly own and operate two 250 MW electric generating facilities to be located on Long Island. It is anticipated that LIPA will respond to the joint proposal early in 2004. At December 31, 2003, total expenditures associated with the siting, permitting and construction of the Ravenswood expansion project, and the siting, permitting and procurement of equipment for the Long Island 250 MW combined cycle electric generating facility were $387.7 million.

As part of our growth strategy, we continually evaluate the possible acquisition and development of additional generating facilities in the Northeast. However, we are unable to predict when or if any such facilities will be acquired and the effect any such acquired facilities will have on our financial condition, results of operations or cash flows.

Energy Services

The Energy Services segment includes companies that provide services to clients located primarily within the Northeastern United States, with concentrations in the New York City metropolitan area, including New Jersey and Connecticut, as well as in Rhode Island, Pennsylvania, Massachusetts and New Hampshire. The primary lines of business are: Business Solutions and Home Energy Services.

The table below highlights selected financial information for the Energy Services segment.

			(In Thousands of Dollars)
Year Ended December 31,	2003	2002	2001
Revenues	$649,590	$938,761	$1,100,167
Less: cost of gas and fuel	93,674	206,731	407,734
Net Revenues	555,916	732,030	692,433
Other operating expenses	593,982	743,965	839,918
Operating (Loss)	$ (38,066)	$ (11,935)	$ (147,485)

Revenues decreased 31% for the year ended December 31, 2003 compared to the same period last year, due in part to lower revenues realized by the Business Solutions group of companies as a result of the softness in the construction industry in the Northeastern United States, as well as from the discontinuation of the general contracting business of one of our subsidiaries. The Business Solutions group of companies provide mechanical, contracting, plumbing, engineering, and consulting

services to commercial, institutional, and industrial customers. Further, comparative revenues, as well as gas and fuel costs, were impacted by the assignment of retail natural gas customers, consisting mostly of residential and small commercial customers, to ECONnergy Energy Co., Inc. ("ECONnergy). KeySpan Energy Services will continue its electric marketing activities.

Total operating losses for the Energy Services segment increased $26.1 million in 2003 compared to 2002. Operating losses for the Business Solutions group of companies increased by $32.2 million, reflecting revenue and significant gross margin pressure from the softness in the construction industry, which has delayed the start-up of certain engineering and construction projects, and has generally increased competition for remaining opportunities. In addition, margins were impacted by certain project-specific losses, resulting from costs incurred in excess of cost recoveries, for which some recovery may be possible pending successful claim resolution. Business Solutions' backlog held relatively stable at approximately $537 million at December 31, 2003 (which includes backlog of $33 million purchased in a recent acquisition as discussed below), compared to $514 million at December 31, 2002.

Offsetting, in part, the results of the Business Solutions group of companies, was a comparative increase in operating earnings of $6.1 million for the year ended December 31, 2003 associated with the Home Energy Services group of companies. These companies provide residential and small commercial customers with service and maintenance contracts, as well as the retail marketing of electricity. Comparative operating income reflects losses incurred during 2002, resulting from the non-renewal of appliance service contracts due to the warm first quarter 2002 weather, as well as from an increase in the provision for bad debts.

Comparative operating income results for 2002 compared to 2001 were significantly impacted by losses incurred by one of our subsidiaries. In 2001, we discontinued the general contracting activities related to the former Roy Kay companies, with the exception of completion of work on then existing contracts. (See Note 10 to the Consolidated Financial Statements "Roy Kay Operations" for a more detailed discussion.) For the year ended December 31, 2001, we incurred an operating loss of $137.8 million associated with the operations of the former Roy Kay companies. The Roy Kay results reflect costs related to the discontinuation of the general contracting activities of these companies, costs to complete work on certain loss construction projects, as well as operating losses. During 2002, in completing the contracts entered into by the former Roy Kay companies we incurred operating losses of $10.8 million reflecting increases in costs to complete construction contracts, and general and administrative expenses. It should be noted that in 2003 we incurred $11.4 million in operating losses which reflected provisions made for the resolution of outstanding claims and change orders, as well as additional costs incurred in connection with the collection of outstanding contract balances.

Excluding the results of the former Roy Kay companies, the Energy Services segment reflected an increase in operating income of $8.7 million in 2002 compared to 2001. Revenues, excluding the Roy Kay companies, decreased by $180.4 million in 2002, while the cost of fuel decreased by $201.0 million. These declines, which for the most part offset each other, reflect the operations of our gas and electric marketing subsidiary. In 2002, this subsidiary substantially decreased its customer base by focusing its marketing efforts on higher net margin customers and in 2003 assigned the majority of its retail natural gas customers to ECONnergy, as previously discussed.

Operating income for the Business Solutions group of companies improved by $22.0 million in 2002 compared to 2001. This increase reflected additional work being performed on the backlog of projects existing at the end of 2001 and the absence of $6 million in losses incurred on four major projects in 2001. A backlog of approximately $514 million existed at December 31, 2002, which was 20% below the December 31, 2001 level.

Offsetting the positive contribution to operating income in 2002 by the Business Solutions group of companies was a decrease of $13.3 million associated with the Home Energy Services group of companies. Contributing to the decrease in operating income from Home Energy Services were the following factors: (i) the adverse impact of the downturn in the economy in 2002; (ii) the non-renewal of appliance service contracts due to the warm first quarter weather; (iii) costs associated with the closing of a service center; and (iv) an increase in the reserve for bad debts. Comparative operating income in 2002 also benefited from the elimination of goodwill amortization, which for 2001 amounted to $8.2 million.

Other Matters

During the third quarter of 2003, KeySpan Services, Inc., and its wholly-owned subsidiary, Paulus, Sokolowski and Sartor, LLC., acquired Bard, Rao + Athanas Consulting Engineers, Inc. (BR+A), a company engaged in the business of providing engineering services relating to mechanical, electrical and plumbing systems. The purchase price was $35 million, plus up to $14.7 million in contingent consideration depending on the financial performance of BR+A over the five-year period after the closing of the acquisition. We have recorded goodwill of $26 million and intangible assets of $2 million associated with this transaction. The intangible assets, which relate primarily to a portion of the backlog purchased, as well as to non-compete agreements with all of the former owners of BR+A, will be amortized over two and three years, respectively.

Energy Investments

The Energy Investment segment consists of our gas exploration and production operations, certain other domestic and international energy-related investments, as well as certain technology-related investments. Our gas exploration and production subsidiaries, Houston Exploration and KeySpan Exploration and Production, LLC ("KES E&P") are engaged in gas and oil exploration and production, and the development and acquisition of domestic natural gas and oil properties. In line with our strategy of monetizing or divesting certain non-core assets, in 2002 we sold a portion of our assets in the joint venture drilling program with

...ploration that was initiated in 1999. In 2003 we reduced ur ownership interest in Houston Exploration to approximately 55% rom the previous level of 66%) through the repurchase, by Houston xploration, of three million shares of common stock owned by eySpan. The net proceeds of approximately $79 million received in onnection with this repurchase were used to pay down short-term ebt. We realized a $19.0 million gain on this transaction that was ecorded in other income and (deductions) in the Consolidated tatement of Income. Income taxes were not provided on this transaction, since the transaction was structured as a return of capital.

In 2003, Houston Exploration acquired the entire Gulf of Mexico hallow-water asset base of Transworld Exploration and Production, Inc. r $149 million. The properties, which are 75% natural gas, have oven reserves of approximately 92 billion cubic feet of natural as equivalent. Current production from 11 fields is approximately 5 million cubic feet of natural gas equivalent per day. Houston ploration funded the transaction from its bank revolver and from sh on hand at the time of closing.

Selected financial data and operating statistics for our gas ploration and production activities is set forth in the following table r the periods indicated.

			(In Thousands of Dollars)
ar Ended December 31,	2003	2002	2001
venues	$501,255	$357,451	$400,031
pletion and amortization expense	204,102	176,925	142,728
l cost ceiling test write-down	—	—	41,989
her operating expenses	99,944	70,267	55,653
erating Income	$197,209	$110,259	$159,661
ural gas and oil roduction (Mmcf)	109,211	106,044	93,968
ral gas (per Mcf) realized	$ 4.55	$ 3.32	$ 4.24
al gas (per Mcf) unhedged	$ 5.23	$ 3.16	$ 4.09

ting income above represents 100% of our gas exploration and production ries' results for the periods indicated. Gas reserves and production are stated in d Mmcfe, which includes equivalent oil reserves

ting Income

ease in operating income of $87.0 million or 79% for the year ecember 31, 2003, compared to the same period of 2002, significant increase in revenues. The higher revenues were some extent, by an increase in operating expenses associated her depletion rate, as well as higher lease operating expenses nce taxes, as discussed below. Revenues for the year 3 benefited from the combination of a 37% increase in lized gas prices (average wellhead price received for ncluding hedging gains and losses) and a 3% increase in olumes.

e financial hedging instruments are employed by Houston provide more predictable cash flow, as well as to reduce fluctuations in natural gas prices. The average realized e year ended 2003 was 87% of the average unhedged natural gas price, resulting in revenues that were approximat $67 million lower than revenues that would have been achie derivative financial instruments had not been in place during 2 Houston Exploration hedged slightly less than 70% of its 2003 tion, principally through the use of costless collars, and has he similar amount of its estimated 2004 production. Further, at De 31, 2003, Houston Exploration has derivative financial instrume in place for approximately 44% of its estimated 2005 productio Note 8 to the Consolidated Financial Statements, "Hedging, Deri Financial Instruments, and Fair Values" for further information.)

The depletion rate experienced in 2003 was $1.85 per Mcf, compared to $1.68 per Mcf experienced in 2002. The increase in t depletion rate reflects downward revisions related to performance, addition of more costs to Houston Exploration's depreciation base v fewer additions for reserves, as well as an increase in estimated futu development costs at year-end.

The increase in other operating expenses for the year ended December 31, 2003, compared to the same period of 2002 was primarily due to increased lease operating costs and severance taxes. Lease operating expenses increased $13.1 million in 2003 compared tc 2002, as a result of the continued expansion of operations both onsho and offshore. Severance tax, which is a function of volume and revenue generated from onshore production, increased $6.5 million in 2003 compared to 2002 as a result of the increase in average wellhead prices for natural gas. Overall operating expenses are increasing as new wells and facilities are added and production from existing wells is maintained.

Operating income decreased $49.4 million or 31% in 2002 compared to 2001 primarily due to a 22% reduction in average realized gas prices, which lowered comparative revenues. Further, operating expenses increased as a result of higher levels of production and a higher depletion rate, as well as from an increase in lease operating expenses. The adverse effect on revenues resulting from the decline in average realized gas prices was partially offset by an increase of 13% in production volumes.

The average realized gas price for 2002 was 105% of the average unhedged natural gas price, resulting in revenues that were approximately $16 million higher than revenues that would have been achieved if derivative financial instruments had not been in place during 2002. Houston Exploration hedged approximately 64% of its 2002 production, principally through the use of costless collars.

The depletion rate was $1.68 per Mcf for the year ended December 31, 2002, compared to $1.49 per Mcf for the same period in 2001, reflecting higher finding and development costs together with the addition of fewer new reserves.

In 2001, our gas exploration and production subsidiaries recorded a non-cash impairment charge of $42.0 million to recognize the effect

prices on their valuation of proved gas reserves. Our
e, which includes our joint venture ownership interest
est, was $26.2 million after-tax. (See Note 1 to the
ıncial Statements "Summary of Significant Accounting
for more information on this charge.)

, prices continue to be volatile and the risk that we may
ecord an impairment charge on our full cost pool again
creases when natural gas prices are depressed or if we
t downward revisions in our estimated proved reserves.
: below indicates the net proved reserves of our gas
ıd production subsidiaries for the periods indicated.

:ember 31,	2003		2002		2001	
	BCFe	%	BCFe	%	BCFe	%
oration	755	99.1%	650	96.7%	608	94.0%
	7	0.9%	22	3.3%	39	6.0%
	762	100.0%	672	100.0%	647	100.0%

ent also consists of KeySpan Canada; our 20% interest in
Gas Transmission System LP ("Iroquois"); our wholly owned
barrel liquefied natural gas ("LNG") storage and receiving
ocated in Rhode Island ("KeySpan LNG"); and our 50% interest
ier Transmission Limited, and until December 2003, our 24.5%
in Phoenix Natural Gas Limited, both located in Northern

elected financial data for our other energy-related investments
forth in the following table for the periods indicated.

(In Thousands of Dollars)

nded December 31,	2003	2002	2001
ues	$113,124	$90,778	$98,287
Operation and			
Maintenance expense	68,568	57,161	71,411
Other operating expenses	22,317	17,622	20,883
Equity earnings	19,106	13,992	13,129
Gain on sale of property	—	2,348	—
ating Income	$ 41,345	$32,335	$19,122

ating income above reflects 100% of KeySpan Canada's results.

increase in operating income in 2003 compared to last year reflects,
art, higher operating income associated with our Canadian invest-
ts, primarily KeySpan Canada, as well as higher earnings from our
hern Ireland investments. KeySpan Canada experienced higher unit
s, as well as higher quantities of sales of natural gas liquids in 2003,
result of increasing oil prices. The pricing of natural gas liquids is
ctly related to oil prices. The Northern Ireland investments realized
ıer gas sales quantities, as well as favorable exchange rates during
3. Operating income for 2003 also reflects our investment in
Span LNG storage facility located in Rhode Island, which we
uired in December 2002.

The increase in operating income in 2002 compared to 2001
ects lower comparative losses associated with certain technology-
ated investments. Further, higher operating income from our Northern
unit sales prices, as well as lower quantities of sales oı ... liquids in 2002, as a result of generally lower oil prices.

KeySpan has announced an initiative to upgrade the storage and receiving terminal and enhance the vaporization capacity at the KeySpan LNG facility located in Providence, Rhode Island. Pending approvals, the facility could be ready to accept marine deliveries by 2005. We anticipate making an investment of approximately $50 million to upgrade the facility.

We do not consider certain businesses contained in the Energy Investments segment to be part of our core asset group. We have statec in the past that we may sell or otherwise dispose of all or a portion of our non-core assets. As previously indicated, in 2003 we monetized 39.09% of our interest in KeySpan Canada, a company with natural gas processing plants and gathering facilities in Western Canada. These assets include 14 processing plants and associated gathering systems that can process approximately 1.5 BCFe of natural gas daily and provide associated natural gas liquids fractionation. We sold a portion of our interest in KeySpan Canada through the establishment of an open-ended income fund trust (the "Fund") organized under the laws of Alberta, Canada. The Fund acquired the 39.09% ownership interest of KeySpan Canada through an indirect subsidiary, and then issued 17. million trust units to the public through an initial public offering. Each trust unit represents a beneficial interest in the Fund and is registered on the Toronto Stock Exchange (KEY.UN). Additionally, we sold our 20% interest in Taylor NGL LP that owns and operates two extraction plants in Canada to AltaGas Services, Inc. We received cash proceeds of $119.4 million associated with these transactions and recorded a pre-tax loss of $30.3 million ($34.1 million after-tax). In February 2004 KeySpan entered into an agreement to sell an additional 36% of its interest in KeySpan Canada. (See Note 15 to the Consolidated Financ Statements "Subsequent Events.")

Further, in the fourth quarter of 2003, we completed the sale (our 24.5% interest in Phoenix Natural Gas Limited. We received cas proceeds of $96 million and recorded a pre-tax gain of $24.7 millic $16.0 million after-tax, or $0.10 per share.

Based on current market conditions we cannot predict when any other sales or dispositions of our non-core assets may take pl or the effect that any such sale or disposition may have on our fi position, results of operations or cash flows.

Allocated Costs

As previously mentioned, we are subject to the jurisdiction of t under PUHCA. As part of the regulatory provisions of PUHCA, regulates various transactions among affiliates within a holdir system. In accordance with the regulations of PUHCA and th State Public Service Commission requirements, we have non- service companies that provide: (i) traditional corporate and tive services; (ii) gas and electric transmission and distributic planning, marketing, and gas supply planning and procure (iii) engineering and surveying services to subsidiaries. Revi

methodologies, approved by the SEC, have been in use since 2001, to allocate certain service company costs to affiliates.

The variation in operating income reflected in "eliminations and other" for KeySpan's non-operating subsidiaries between 2003 and 2002 primarily reflects an adjustment recorded in 2003 for environmental reserves associated with non-utility environmental sites based on a recently concluded site investigation study. (See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies – Environmental Matters" for additional information on environmental issues.) In 2001, these non-operating subsidiaries realized operating income of $31.4 million, primarily related to the $22.0 million benefit associated with the favorable appellate court decision regarding the RICO class action settlement, previously mentioned.

Liquidity

Cash flow from operations for the year ended December 31, 2003 increased $453.2 million, or 62%, compared to the same period last year. During 2003, KeySpan performed an analysis of costs capitalized for self-constructed property and inventory for income tax purposes. KeySpan filed a change of accounting method for income tax purposes resulting in a cumulative deduction for costs previously capitalized. As a result of this tax method change, along with accelerated deductions resulting from bonus depreciation, Keyspan received in October 2003, a $192.3 million refund from the Internal Revenue Service associated with the refund of prior year taxes, as well as an additional $85 million for tax payments made in 2002. On a comparative basis, tax refunds received in 2003 coupled with tax payments made in 2002, resulted in a cash flow benefit in 2003, compared to 2002, of approximately $310 million.

Comparative operating cash flow also reflects the collection of gas accounts receivable associated with higher winter gas heating sales. As a result of load additions, colder than normal winter weather during the first quarter, higher natural gas prices, and higher accounts receivable at the end of 2002, cash receipts from gas heating customers were higher in 2003 than in 2002. Further, the higher natural gas prices resulted in an increase in operating cash flow associated with the operations of Houston Exploration. These benefits to cash flow were partially offset by significantly higher cash expenditures to re-fill natural gas storage levels as a result of the higher natural gas prices.

Cash flow from operations decreased by $158.7 million, or 18%, in 2002 compared to 2001. Operating cash flow from gas exploration and production activities was adversely impacted by significantly lower realized gas prices in 2002. Further, cash flow from operations in 2002 reflects the funding of the pension obligations related to our New England subsidiaries of $80 million. These adverse effects on cash flow were partially offset by the termination of two interest rate swap agreements that resulted in a favorable operating cash flow benefit of approximately $23.4 million, as well as lower income tax payments. State and federal tax payments were lower in 2002, compared to 2001, as KeySpan was in a refund position with regard to such taxes. (See Note 8 to the Consolidated Financial Statements, "Hedging, Derivative Financial Instruments, and Fair Values" for an explanation of the interest rate hedges.)

At December 31, 2003, we had cash and temporary cash investments of $205.8 million. During 2003, we repaid $433.8 million of commercial paper and, at December 31, 2003, $481.9 million of commercial paper was outstanding at a weighted-average annualized interest rate of 1.2%. We had the ability to borrow up to an additional $818.1 million at December 31, 2003, under the terms of our credit facility.

In 2003, KeySpan renewed its $1.3 billion revolving credit facility, which was syndicated among sixteen banks. The facility is used to support KeySpan's commercial paper program, and consists of two separate credit facilities with different maturities but substantially similar terms and conditions: a $450 million facility that extends for 364 days, and a $850 million facility that is committed for three years. The fees for the facilities are subject to a ratings-based grid, with an annual fee that ranges from eight to twenty five basis points on the 364-day facility and ten to twenty basis points on the three-year facility. Both credit agreements allow for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin. ABR loans are based on the highest of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%, plus a margin. Competitive bid loans are based on bid results requested by KeySpan from the lenders. The margins on both facilities are ratings based and range from zero basis points to 112.5 basis points. The margins are increased if outstanding loans are in excess of 33% of the total facility. In addition, the 364-day facility has a one-year term out option, which would cost an additional 0.25% if utilized. We do not anticipate borrowing against this facility; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The credit facility contains certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its property to any lien, as well as certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 64%. Violation of this covenant could result in the termination of the credit facility and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements.

Under the terms of the credit facility, KeySpan's debt-to-total capitalization ratio reflects 80% equity treatment for the MEDS Equity Units issued in 2002. At December 31, 2003, consolidated indebtedness, as calculated under the terms of the credit facility was 58.2% of consolidated capitalization. The leasing arrangement associated with the Ravenswood facility ("Master Lease") has always been treated as debt for the calculation of debt-to-total capitalization under KeySpan's credit facility. Beginning on December 31, 2003, KeySpan was required to

consolidate the Master Lease Agreement as required by FIN 46 and as a result the Master Lease Agreement is reflected as debt on the Consolidated Balance Sheet. See the discussion under "Off-Balance Sheet Arrangements" for an explanation of the Master Lease Agreement.

The credit facility also requires that net cash proceeds from the sale of significant subsidiaries be applied to reduce consolidated indebtedness. Further, an acceleration of indebtedness of KeySpan or one of its subsidiaries for borrowed money in excess of $25 million in the aggregate, if not annulled within 30 days after written notice, would create an event of default under the Indenture dated November 1, 2000, between KeySpan Corporation and the JPMorganChase Bank as Trustee. At December 31, 2003, KeySpan was in compliance with all covenants.

Houston Exploration has a revolving credit facility with a commercial banking syndicate that provides Houston Exploration with a commitment of $300 million, which can be increased at its option to a maximum of $350 million with prior approval from the banking syndicate. The credit facility is subject to borrowing base limitations, currently set at $300 million and is re-determined semi-annually. Up to $25 million of the borrowing base is available for the issuance of letters of credit. The credit facility matures on July 15, 2005, is unsecured and, with the exception of trade payables, ranks senior to all existing debt of Houston Exploration.

Under the Houston Exploration credit facility, interest on base rate loans is payable at a fluctuating rate, or base rate, equal to the sum of (a) the greater of the federal funds rate plus 0.50% or the bank's prime rate plus (b) a variable margin between 0% and 0.50%, depending on the amount of borrowings outstanding under the credit facility. Interest on fixed rate loans is payable at a fixed rate equal to the sum of (a) a quoted reserve adjusted LIBOR rate, plus (b) a variable margin between 1.25% and 2.00%, depending on the amount of borrowings outstanding under the credit facility.

Financial covenants require Houston Exploration to, among other things, (i) maintain an interest coverage ratio of at least 3.00 to 1.00 of earnings before interest, taxes and depreciation ("EBITDA") to cash interest; (ii) maintain a total debt to EBITDA ratio of not more than 3.50 to 1.00; and (iii) generally prohibits the hedging of more than 70% of natural gas and oil production during any 12-month period. At December 31, 2003, Houston Exploration was in compliance with all financial covenants.

During 2003, Houston Exploration borrowed $239 million under its credit facility and repaid $264 million. At December 31, 2003, Houston Exploration had $127 million of borrowings outstanding under its credit facility at an average rate of 3.42%. In addition, $0.4 million was committed under outstanding letters of credit obligations and $172.6 million of borrowing capacity was available.

In 2003, KeySpan Canada replaced its two outstanding credit facilities with one new facility with three tranches that combined allowed KeySpan Canada to borrow up to approximately $125 million. At the time of the partial sale of KeySpan Canada, net proceeds from the sale of $119.4 million plus an additional $45.7 million drawn under the new credit facilities were used to pay down existing outstanding debt of $160.4 million. During the third quarter of 2003, KeySpan Canada issued Cdn$125 million, or approximately US$93 million, in long-term secured notes in a private placement. The proceeds of the offering were used to pay-down, in its entirety, outstanding borrowings under the credit facility. Further, one tranch of the credit facility was discontinued. (See "Capital Expenditures and Financing – Financing" below for further information regarding the long-term debt issuance.) At December 31, 2003, KeySpan Canada's credit facility had the following two tranches with the following maturities: (i) $37.5 million matures in 364 days: and (ii) $37.5 million matures in two years. During 2003, KeySpan Canada borrowed $71.5 million from its prior credit facilities and repaid $240.3 million. During the fourth quarter of 2003, KeySpan Canada borrowed $18.1 million under the new facility and at December 31, 2003, $56.9 million was available for future borrowing.

In 2003, the Boston Gas Company redeemed all 562,700 shares of its outstanding Variable Term Cumulative Preferred Stock, 6.42% Series A at its par value of $25 per share. The total payment was $14.3 million that included $0.2 million of accumulated dividends. This preferred stock series had been reflected as minority interest on KeySpan's Consolidated Balance Sheet.

On January 17, 2003, KeySpan sold 13.9 million shares of common stock on the open market and realized net proceeds of approximately $473 million. All shares were offered by KeySpan pursuant to the effective shelf registration statement filed with the SEC. Net proceeds from the equity sale were used to call $447 million of outstanding promissory notes to LIPA as is further explained in "Capital Expenditures and Financing" below. In addition, as previously noted, we used the net proceeds of approximately $79 million received in connection with the partial monetization of Houston Exploration to repay short-term debt.

A substantial portion of consolidated revenues are derived from the operations of businesses within the Electric Services segment, that are largely dependent upon two large customers – LIPA and the NYISO. Accordingly, our cash flows are dependent upon the timely payment of amounts owed to us by these customers.

We satisfy our seasonal working capital requirements primarily through internally generated funds and the issuance of commercial paper. We believe that these sources of funds are sufficient to meet our seasonal working capital needs.

Capital Expenditures and Financing

Construction Expenditures

The table below sets forth our construction expenditures by operating segment for the periods indicated:

	(In Thousands of Dollars)	
Year Ended December 31,	2003	2002
Gas Distribution	$ 419,549	$ 412,433
Electric Services	256,498	348,147
Energy Investments	314,097	272,720
Energy Services and other	21,572	27,722
	$1,011,716	$1,061,022

... related to the Gas Distribution segment are ...marily for the renewal and replacement of mains and services and for ...e expansion of the gas distribution system. Construction expenditures ...r the Electric Services segment reflect costs to: (i) maintain our gener-...ting facilities; (ii) expand the Ravenswood facility; and (iii) construct ...ew Long Island generating facilities as previously noted. The decrease ... Electric Services construction expenditures in 2003, compared to ...st year reflects the fact that construction of the Glenwood and ...ort Jefferson peaking facilities was substantially completed by June 30, ...002. Construction expenditures related to the Energy Investments ...gment primarily reflect costs associated with gas exploration and ...roduction activities. These costs are related to the exploration ...nd development of properties primarily in Southern Louisiana and ... the Gulf of Mexico. Expenditures also include development costs ...sociated with the joint venture with Houston Exploration, as well ... costs related to KeySpan Canada's gas processing facilities.

Construction expenditures for 2004 are estimated to be approxi-...ately the same as 2003 at $1 billion. The amount of future construc-...on expenditures is reviewed on an ongoing basis and can be affected ... timing, scope and changes in investment opportunities.

...nancing

... November 2003, KeySpan closed on a financing transaction pursuant ... which $128 million tax-exempt bonds with a 5.25% coupon ...aturing in June 2027 were issued on its behalf. Fifty-three million ...llars of these Industrial Development Revenue Bonds were issued ...rough the Nassau County Industrial Development Authority for ...e construction of the Glenwood electric-generation peaking plant and ... balance of $75 million was issued by the Suffolk County Industrial ...velopment Authority for the Port Jefferson electric-generation ...king plant. Proceeds from the transaction were used to pay down ...mercial paper used for the construction, installation and equipping ...e two facilities.

...n 2003, KeySpan Canada, issued Cdn$125 million, or approxi-... US$93 million, long-term secured notes in a private placement to ...rs in Canada and the United States. The notes were issued in the ...ng three series: (i) Cdn$20 million 5.42% senior secured notes ...08; (ii) Cdn$52.5 million 5.79% senior secured notes due 2010; ... Cdn$52.5 million 6.16% senior secured notes due 2013. ...eeds of the offering were used to repay KeySpan Canada's ...ility.

...ldition, Houston Exploration closed on a private placement ...75 million 7.0%, senior subordinated notes due 2013. ...ments began on December 15, 2003, and will be paid ...lly thereafter. The notes will mature on June 15, 2013. ...loration has the right to redeem the notes as of June 15, ...rice equal to the issue price plus a specified redemption ...til June 15, 2006, Houston Exploration may also redeem ... the notes at a redemption price of 107% with proceeds ... offering. Houston Exploration incurred approximately ... debt issuance costs on this private placement. Houston Exploration used a portion of the net proceeds from the iss... redeem all of its outstanding $100 million principal amount ... senior subordinated notes due 2008 at a price of 104.313% plus interest accrued to the redemption date. Debt redemptio... totaled approximately $5.9 million. The remaining net procee... the offering were used to reduce debt amounts associated wit... Exploration's bank revolving credit facility.

We also issued $300 million of medium-term and long-ter... debt in 2003. The debt was issued in the following two series: (... million 4.65% Notes due 2013; and (ii) $150 million 5.875% No... 2033. The proceeds of this issuance were used to pay down outs... commercial paper.

In connection with the KeySpan/LILCO business combination, KeySpan and certain of its subsidiaries issued promissory notes to L... to support certain debt obligations assumed by LIPA. At December ... 2002, the remaining principal amount of promissory notes issued to ... was approximately $600 million. Under these promissory notes, KeyS... is required to obtain letters of credit to secure its payment obligation... if its long-term debt is not rated at least in the "A" range by at least two nationally recognized statistical rating agencies. In an effort to mitigate the dilutive effect of the equity issuance previously mentione... in March 2003, we called approximately $447 million aggregate principal amount of such promissory notes at the applicable redemptio... prices plus accrued and unpaid interest through the dates of redemp-tion. Interest savings associated with this redemption were $15.6 million after-tax, or $0.10 per share, in 2003.

In the fourth quarter of 2003, KeySpan received authorization from the SEC, under PUHCA, to issue up to an additional $3 billion of securities through December 31, 2006. This authorization provides KeySpan with the necessary flexibility to finance our future capital requirements over the next three years. See the discussion under the caption "Regulation and Rate Matters – Securities and Exchange Commission Regulation" for a further discussion of this approval.

We anticipate replacing outstanding commercial paper related to the construction of a new 250 MW combined cycle generating facility at the Ravenswood facility site with the proceeds from a proposed sale/leaseback transaction anticipated to be completed in the second quarter of 2004. (See Note 15 to the Consolidated Financial Statements "Subsequent Events" for further details on this proposed transaction). We will continue to evaluate our capital structure and financing strategy for 2004 and beyond. We believe that our current sources of funding (i.e., internally generated funds, the issuance of additional securities as noted above, and the availability of commercial paper) are sufficient to meet our anticipated capital needs for the foreseeable future.

The following table represents the ratings of our long-term debt at December 31, 2003. Currently, Standard & Poor's and Moody's Investor Services ratings on KeySpan's and its subsidiaries' long-term debt are on negative outlook.

	Moody's Investor Services	Standard & Poor's	Fitch Ratings
KeySpan Corporation	A3	A	A-
KEDNY	N/A	A+	A+
KEDLI	A2	A+	A-
Boston Gas	A2	A	N/A
Colonial Gas	A2	A+	N/A
Electric Generation	A3	A	N/A

Off-Balance Sheet Arrangements

Variable Interest Entity

We have an arrangement with a variable interest entity through which we lease a portion of the Ravenswood facility. We acquired the Ravenswood facility, in part, through the variable interest entity from Consolidated Edison on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into a lease agreement (the "Master Lease") with a variable interest unaffiliated financing entity that acquired a portion of the facility, three steam generating units, directly from Consolidated Edison and leased it to a KeySpan subsidiary. The variable interest unaffiliated financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). Monthly lease payments generally equal the monthly interest expense on the debt securities.

In December 2003, KeySpan implemented FIN 46 that required us to consolidate this variable interest entity and classify the Master Lease as $412.3 million long-term debt on the Consolidated Balance Sheet. Further, we recorded an asset on the Consolidated Balance Sheet for an amount substantially equal to the estimated fair market value of the leased assets at inception of the lease, less depreciation since that time. As previously mentioned, under the terms of our credit facility the Master Lease has been considered debt in the ratio of debt-to-total capitalization since the inception of the lease and therefore, implementation of FIN 46 had no impact on our credit facility. The Interpretation also requires us to continue to depreciate the leased assets over their remaining economic lives. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding the leasing arrangement associated with the Master Lease Agreement and FIN 46 implementation issues.)

Guarantees

KeySpan had a number of financial guarantees for its subsidiaries at December 31, 2003. KeySpan has fully and unconditionally guaranteed: (i) $525 million of medium-term notes issued by KEDLI; (ii) the obligations of KeySpan Ravenswood LLC, the lessee under the $425 million Master Lease Agreement associated with the Ravenswood facility; and (iii) the payment obligations of our subsidiaries related to $128 million of tax-exempt bonds issued through the Nassau County and Suffolk County Industrial Development Authority for the construction of the Glenwood and Port Jefferson electric-generation peaking facilities. The medium-term notes, the Master Lease Agreement and the tax-exempt bonds are reflected on the Consolidated Balance Sheet. Further, KeySpan has guaranteed: (i) up to $168 million of surety bonds associated with certain construction projects currently being performed by subsidiaries within the Energy Services segment; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of $43 million; and (iii) $67 million of subsidiary letters of credit. The guarantee of the KEDLI medium-term notes expires in 2010, while the Master Lease Agreement can be extended to 2009. The guarantee of the payment obligations of our subsidiaries related to the tax-exempt financing extends to 2027. The other guarantees have terms that do not extend beyond 2005 and are not recorded on the Consolidated Balance Sheet. At this time, we have no reason to believe that our subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact such defaults may have on our consolidated results of operations, financial condition or cash flows. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees.)

In addition, KeySpan intends to guarantee approximately $360 million in connection with a proposed sale/leaseback transaction for the financing of a new 250 MW electric generating facility located on the Ravenswood site. (See Note 15 to the Consolidated Financial Statements "Subsequent Events" for further details regarding this transaction.)

Contractual Obligations

KeySpan has certain contractual obligations related to its outstanding long-term debt, outstanding credit facility borrowings, outstanding commercial paper borrowings, operating and capital leases, and demand charges associated with certain commodity purchases. KeySpan's outstanding short-term and long-term debt issuances are explained in more detail in Note 6 to the Consolidated Financial Statements "Long-Term Debt." KeySpan's operating and capital leases, as well as its demand charges are more fully detailed in Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies." The table below reflects maturity schedules for KeySpan's contractual obligations at December 31, 2003:

(In Thousands of Dollars)

Contractual Obligations	Total	1 – 3 Years	4 – 5 Years	After 5 Years
Long-term Debt	$ 5,625,706	$1,814,999	$161,094	$3,649,613
Capital Leases	12,981	3,237	2,192	7,552
Operating Leases	417,124	179,316	115,597	122,211
Master Lease	169,532	92,472	61,648	15,412
Interest Payments	3,387,891	910,937	458,547	2,018,407
Demand Charges	452,045	452,045	—	—
Total Contractual Obligations	$10,065,279	$3,453,006	$799,078	$5,813,195
Commercial Paper	$ 481,900	Revolving		

Discussion of Critical Accounting Policies and Assumptions

In preparing our financial statements, the application of certain accounting policies requires difficult, subjective and/or complex judgments. The circumstances that make these judgments difficult, subjective and/or complex have to do with the need to make estimates about the impact of matters that are inherently uncertain. Actual effects on our financial position and results of operations may vary significantly from expected results if the judgments and assumptions underlying the estimates prove to be inaccurate. The critical accounting policies requiring such subjectivity are discussed below.

Percentage-of-Completion

Percentage-of-completion accounting is a method of accounting for long-term construction type contracts in accordance with Generally Accepted Accounting Principles and, accordingly, the method used for engineering and mechanical contracting revenue recognition by the Energy Services segment. Percentage-of-completion is measured principally by comparing the percentage of costs incurred to date for each contract to the estimated total costs for each contract at completion. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are known. Application of percentage-of-completion accounting, results in the recognition of costs and estimated earnings in excess of billings on uncompleted contracts (recorded within the Consolidated Balance Sheet) which arise when revenues have been recognized but the amounts cannot be billed under the terms of the contracts. Such amounts are recoverable from customers based on various measures of performance, including achievement of certain milestones, completion of specified units or completion of the contract. Due to uncertainties inherent within estimates employed to apply percentage-of-completion accounting, it is possible that estimates will be revised as project work progresses. Changes in estimates resulting in additional future costs to complete projects can result in reduced margins or loss contracts. Unapproved change orders and claims also involve the use of estimates, and it is reasonably possible that revisions to the estimated recoverable amounts of recorded change orders and claims may be made in the near-term. Application of percentage-of-completion accounting requires that the impact of those revised estimates be reported in the consolidated financial statements prospectively.

Valuation of Goodwill

KeySpan records goodwill on purchase transactions, representing the excess of acquisition cost over the fair value of net assets acquired. In testing for goodwill impairment under Statement of Financial Accounting Standards ("SFAS") 142 "Goodwill and Other Intangible Assets", significant reliance is placed upon a number of estimates regarding future performance that require broad assumptions and significant judgment by management. A change in the fair value of our investments could cause a significant change in the carrying value of goodwill. The assumptions used to measure the fair value of our investments are the same as those used by us to prepare yearly operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set yearly budgetary guidelines.

KeySpan currently has $1.8 billion of recorded goodwill, the majority of which is recorded in the Gas Distribution and Energy Investments segment, with approximately $171 million recorded in the Energy Services segment. As permitted under SFAS 142, we can rely on our previous valuations for the annual impairment testing provided that the following criteria for each reporting unit are met: (a) the assets and liabilities that make up the reporting unit have not changed significantly since the most recent fair value determination; and (b) the most recent fair value determination resulted in an amount that exceeded the carrying amount of the reporting unit by a substantial margin and there is no economic indication that the carrying value of goodwill may be impaired. In the case of the Gas Distribution and the Energy Investments segments, the above criteria have been met and therefore, there was no impairment to goodwill in 2003. In regard to the Energy Services segment, adverse economic conditions experienced in the construction industry in the Northeastern United States during 2003 and its related impact on the operating results of this segment, prompted management to conduct an impairment test during the fourth quarter.

KeySpan employed a combination of two methodologies in determining the fair value for its investment in the Energy Services segment, a market valuation approach and an income valuation approach. A third party specialist was engaged to assist with the valuation and evaluate the reasonableness of key assumptions employed.

Since the companies included in the Energy Services segment are not publicly traded, the market valuation approach was used to estimate their total enterprise value or aggregate potential market value. Under the market valuation approach, KeySpan compared relevant financial information relating to the companies included in the Energy Services segment to the corresponding financial information for a peer group of companies in the specialty trade-contracting sector of the construction industry. The market valuation approach derived enterprise value to earnings before interest and taxes ("EV/EBIT") multiples and enterprise value to earnings before interest, taxes, depreciation and amortization ("EV/EBITDA") multiples. Though there are numerous multiples that can be used to value an individual firm, these multiples were selected since they offer the closest parallels to discounted cash flow valuation and are most appropriate for the Energy Services segment's market sector.

In addition to the market valuation approach, we also used an income valuation approach or discounted cash flow ("DCF") valuation approach to estimate the fair market value for the companies included in the Energy Services segment. Under the income valuation approach, the fair value of a firm is obtained by discounting the sum of (i) the expected future cash flows to a firm; and (ii) the terminal value of a firm. The discount factor used in the calculation is basically a firm's weighted-average cost of capital. KeySpan was required to make certain significant assumptions in the income approach, specifically the weighted-average cost of capital, short and long-term growth rates and expected future cash flows. The cash flow model is based on relevant

industry forecasts projecting improved market conditions over the next five years, continued increases in business activity that are likely to result in backlog growth, and short and long-term revenue and operating margin growth projections that management believes are reasonable given historical performance.

As a result of our valuation, management has determined that the fair value of the assets adequately exceeds their carrying value and no impairment charge is necessary. Management will continue to review and focus on our overall strategy for this business unit and accordingly will continue to evaluate the related carrying value of the goodwill. While we believe that our assumptions are reasonable, actual results, however, may differ from our projections.

Accounting for the Effects of Rate Regulation on Gas Distribution Operations

The financial statements of the Gas Distribution segment reflect the ratemaking policies and orders of the New York Public Service Commission ("NYPSC"), the New Hampshire Public Utilities Commission ("NHPUC"), and the Massachusetts Department of Telecommunications and Energy ("DTE").

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas Company and EnergyNorth Natural Gas, Inc.) are subject to the provisions of SFAS 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the actions of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies.

In separate merger-related orders issued by the DTE, the base rates charged by Colonial Gas Company and Essex Gas Company have been frozen at their current levels for ten-year periods ending 2009 and 2008, respectively. Due to the length of these base rate freezes, the Colonial and Essex Gas Companies had previously discontinued the application of SFAS 71.

SFAS 71 allows for the deferral of expenses and income on the consolidated balance sheet as regulatory assets and liabilities when it is probable that those expenses and income will be allowed in the rate setting process in a period different from the period in which they would have been reflected in the consolidated statements of income of an unregulated company. These deferred regulatory assets and liabilities are then recognized in the consolidated statement of income in the period in which the amounts are reflected in rates.

Rate regulation is undergoing significant change as regulators and customers seek lower prices for utility service and greater competition among energy service providers. In the event that regulation significantly changes the opportunity for us to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101 "Regulated Enterprises - Accounting for the Discontinuation of Application of FASB Statement No. 71." We estimate that the write-off of our net regulatory assets at December 31, 2003 could result in a charge to net income of approximately $300 million or $1.89 per share, which would be classified as an extraordinary item. In management's opinion, our regulated subsidiaries that currently are subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

As is further discussed under the caption "Regulation and Rate Matters," in October 2003 the DTE rendered its decision on the Boston Gas Company's base rate case and Performance Based Rate Plan proposal submitted to the DTE in April 2003. The DTE approved a $27 million increase in base revenues, as well as an allowed rate of return on equity of 10.2%. The DTE also approved a Performance Based Rate Plan for up to ten years. The rate plans previously in effect for KEDNY and KEDLI have expired. The continued application of SFAS 71 to record the activities of these subsidiaries is contingent upon the actions of regulators with regard to future rate plans. We are currently evaluating various options that may be available to us including, but not limited to, proposing new plans for KEDNY and KEDLI. The ultimate resolution of any future rate plans could have a significant impact on the application of SFAS 71 to these entities and, accordingly, on our financial position, results of operations and cash flows. However, management believes that currently available facts support the continued application of SFAS 71 and that all regulatory assets and liabilities are recoverable or refundable through the regulatory environment.

Pension and Other Postretirement Benefits

As discussed in Note 4 to the Consolidated Financial Statements, "Postretirement Benefits," KeySpan participates in both non-contributory defined benefit pension plans, as well as other post-retirement benefit ("OPEB") plans (collectively "postretirement plans"). KeySpan's reported costs of providing pension and OPEB benefits are dependent upon numerous factors resulting from actual plan experience and assumptions of future experience. Pension and OPEB costs (collectively "postretirement costs") are impacted by actual employee demographics, the level of contributions made to the plans, earnings on plan assets, and health care cost trends. Changes made to the provisions of these plans may also impact current and future postretirement costs. Postretirement costs may also be significantly affected by changes in key actuarial assumptions, including, anticipated rates of return on plan assets and the discount rates used in determining the postretirement costs and benefit obligations. Actual results that differ from our assumptions are accumulated and amortized over ten years.

Certain gas distribution subsidiaries are subject to SFAS 71, and, as a result, changes in postretirement expenses are deferred for future recovery from or refund to gas sales customers. (However, KEDNY, although subject to SFAS 71, does not have a recovery mechanism in place for increases in postretirement costs.) Further, changes in postretirement expenses associated with subsidiaries that service the LIPA Agreements are also deferred for future recovery from or refund to LIPA.

For 2003, the assumed long-term rate of return on our postretirement plans' assets was 8.5% (pre-tax), net of expenses. This is an appropriate long-term expected rate of return on assets based on

KeySpan's investment strategy, asset allocation and the historical outperformance of equity investments over long periods of time. The actual 10 year compound annual rate of return for the KeySpan Plans is greater than 8.5%.

KeySpan's master trust investment allocation policy target is 70% equity and 30% fixed income. At December 31, 2003, the actual investment allocation was 67% equities, 33% fixed income and cash. In an effort to maximize plan performance, actual asset allocation will fluctuate from year to year depending on the then current economic environment.

During 2003, KeySpan conducted an asset and liability study projecting asset returns and expected benefit payments over a 10-year period. Based on the results, KeySpan has developed a multiyear funding strategy for its postretirement plans. KeySpan believes that it is reasonable to assume assets can achieve or outperform the assumed long-term rate of return with the target allocation as a result of historical outperformance of equity investments over long-term periods.

A 25 basis point increase or decrease in the assumed long-term rate of return on plan assets would have impacted 2003 expense by approximately $4 million, before deferrals.

The year-end December 31, 2003 assumed discount rate used to determine postretirement obligations was 6.25%. Our discount rate assumption is based upon the current investment yield associated with rating agency indices that have high quality long-term corporate bonds. A 25 basis point increase or decrease in the assumed year-end discount rate would have had no impact on 2003 expense. However, a 25 basis point decrease in the assumed year-end discount rate would result in the recording of an additional minimum pension liability. A year-end discount rate of 6.00% would have required an additional $11 million debit to other comprehensive income ("OCI"), net of tax and deferrals.

At January 1, 2003, the assumed discount rate used to determine postretirement obligations was 6.75%. A 25 basis point increase or decrease in the assumed discount rate at the beginning of the year would have impacted 2003 expense by approximately $14 million, before deferrals.

Our health care cost trend assumptions are developed based on historical cost data, the near-term outlook and an assessment of likely long-term trends. The salary growth assumptions reflect our long-term outlook.

Historically, we have funded our qualified pension plans in excess ɔf the amount required to satisfy minimum ERISA funding requirements. \t December 31, 2003, we had a funding credit balance in excess of he ERISA minimum funding requirements and as a result KeySpan was ot required to make any contributions to its qualified pension plans in)03. However, although we have presently exceeded ERISA funding quirements, our pension plans, on an actuarial basis, are currently derfunded. Therefore, during 2003 KeySpan contributed $137 million its postretirement plans.

For 2004, KeySpan expects to contribute a total of $147 million ts funded and unfunded post-retirement plans. Future funding uirements are heavily dependent on actual return on plan assets prevailing interest rates.

Full Cost Accounting

Our gas exploration and production subsidiaries use the full cost method to account for their natural gas and oil properties. Under full cost accounting, all costs incurred in the acquisition, exploration, and development of natural gas and oil reserves are capitalized into a "full cost pool." Capitalized costs include costs of all unproved properties, internal costs directly related to natural gas and oil activities, and capitalized interest.

Under full cost accounting rules, total capitalized costs are limited to a ceiling equal to the present value of future net revenues, discounted at 10%, plus the lower of cost or fair value of unproved properties less income tax effects (the "ceiling limitation"). A quarterly ceiling test is performed to evaluate whether the net book value of the full cost pool exceeds the ceiling limitation. If capitalized costs (net of accumulated depreciation, depletion and amortization) less deferred taxes are greater than the discounted future net revenues or ceiling limitation, a write-down or impairment of the full cost pool is required. A write-down of the carrying value of the full cost pool is a non-cash charge that reduces earnings and impacts stockholders' equity in the period of occurrence and typically results in lower depreciation, depletion and amortization expense in future periods. Once incurred, a write-down is not reversible at a later date.

The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, held constant over the life of the reserves. Our gas exploration and production subsidiaries use derivative financial instruments that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" to hedge against the volatility of natural gas prices. In accordance with current SEC guidelines, these derivatives are included in the estimated future cash flows in the ceiling test calculation. In calculating the ceiling test at December 31, 2003, our subsidiaries estimated that a full cost ceiling "cushion" existed, whereby the carrying value of the full cost pool was less that the ceiling limitation. No write-down is required when a cushion exists. Natural gas prices continue to be volatile and the risk that a write-down to the full cost pool will be required increases when natural gas prices are depressed or if there are significant downward revisions in estimated proved reserves.

Natural gas and oil reserve quantities represent estimates only. Under full cost accounting, reserve estimates are used to determine the full cost ceiling limitation, as well as the depletion rate. Houston Exploration estimates its proved reserves and future net revenues using sales prices estimated to be in effect as of the date it makes the reserve estimates. Natural gas prices, which have fluctuated widely in recent years, affect estimated quantities of proved reserves and future net revenues. Any estimates of natural gas and oil reserves and their values are inherently uncertain, including many factors beyond our control. The accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. In addition, estimates of reserves may be revised based upon actual production, results of future development and exploration activities, prevailing natural gas and oil prices, operating costs and other factors,

which revision may be material. Reserve estimates are highly dependent upon the accuracy of the underlying assumptions. Actual future production may be materially different from estimated reserve quantities and the differences could materially affect future amortization of natural gas and oil properties.

Valuation of Derivative Instruments

We employ derivative instruments to manage commodity and financial market risk. All of our derivative instruments, except for certain weather derivatives, are reported on the Consolidated Balance Sheet at fair value in accordance with SFAS 133; weather derivatives are accounted for in accordance with Emerging Issues Task Force ("EITF") 99-2. None of KeySpan's derivative instruments qualify as "energy trading contracts" as defined by current accounting literature.

For those derivative instruments designated as cash flow hedges under SFAS 133, which are the majority of KeySpan's derivative instruments, changes in the market value are recorded in other comprehensive income on the Consolidated Balance Sheet, (in line with effectiveness measurements) and are recorded through earnings at the time of settlement. Hedge effectiveness is dependent upon various factors such as the use of hedge contracts with market points that are different from the underlying transaction, and to the extent hedge contracts are deemed ineffective, that portion will impact earnings.

Additionally, we use derivative financial instruments to reduce cash flow variability associated with the purchase price for a portion of future natural gas purchases for our regulated gas distribution activities; the accounting for such derivative instruments is subject to SFAS 71. Changes in the market value of these derivative instruments are recorded as regulatory assets and liabilities, as appropriate, on the Consolidated Balance Sheet. KeySpan's non-regulated subsidiaries employ a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133, and, therefore, changes in the market value of these derivative instruments are recorded through earnings.

When available, quoted market prices are used to record a derivative contract's fair value. However market values for certain derivative contracts may not be readily available or determinable. If no active market exists for a commodity, a specific contract type, or for the entire term of a contract's duration, fair values are based on pricing models. Such models employ matrix pricing based on contracts with similar terms and risks, including pricing based on broker quotes and industry publications. KeySpan validates its internally developed fair values by using forecasted market information and mathematical extrapolation techniques. In addition, for hedges of forecasted transactions, KeySpan estimates the expected future cash flows of the forecasted transactions, as well as evaluates the probability of occurrence and timing of such transactions. Changes in market conditions or the occurrence of unforeseen events could affect the timing of recognition of changes in fair value of certain hedging derivatives.

See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" and Item 7A, "Quantitative and Qualitative Disclosures About Market Risk" for a further description of all our derivative instruments.

Dividends

We are currently paying a dividend at an annual rate of $1.78 per common share. Our dividend policy is reviewed annually by the Board of Directors. The amount and timing of all dividend payments is subject to the discretion of the Board of Directors and will depend upon business conditions, results of operations, financial conditions and other factors. Based on currently foreseeable market conditions, we intend to maintain the annual dividend at the $1.78 level.

Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to KeySpan is conditioned upon maintenance of a utility capital structure with debt not exceeding 55% and 58%, respectively, of total utility capitalization. In addition, the level of dividends paid by both utilities may not be increased from current levels if a 40 basis point penalty is incurred under the customer service performance program. At the end of KEDNY's and KEDLI's most recent rate years (September 30, 2003 and November 30, 2003, respectively), the ratio of debt to total utility capitalization was 41% and 49%, respectively. Additionally, we have met the requisite customer service performance standards. Our corporate and financial activities and those of each of our subsidiaries (including their ability to pay dividends to us) are also subject to regulation by the SEC. (For additional information, see the discussion under the heading "Regulation and Rate Matters – Securities and Exchange Commission Regulation").

Regulation and Rate Matters

Gas Distribution

By orders dated February 5, 1998 and April 14, 1998, the NYPSC approved the KeySpan/LILCO business combination and established gas rates for both KEDNY and KEDLI. Pursuant to the orders, $1 billion of efficiency savings, excluding gas costs, attributable to operating synergies that are expected to be realized over the ten-year period following the combination, were allocated to customers, net of transaction costs.

Effective May 29, 1998, KEDNY's base rates to core customers were reduced by $23.9 million annually. In addition, KEDNY is subject to an earnings sharing provision pursuant to which it is required to credit core customers with 60% of any utility earnings up to 100 basis points above certain threshold return on equity levels over the term of the rate plan (other than any earnings associated with discrete incentives) and 50% of any utility earnings in excess of 100 basis points above such threshold level. The threshold level for the rate year ended September 30, 2003 was 13.25%. KEDNY did not earn above its threshold return level in its rate year ended September 30, 2003. On September 30, 2002, KEDNY's rate agreement with the NYPSC expired. Under the terms of the agreement, the then current gas distribution rates and all other provisions, including the earnings sharing provision (at the 13.25% threshold level), remain in effect until changed by the NYPSC. At this time, we are currently evaluating various options that may be available to us regarding KEDNY's rates, including but not limited to, proposing a new rate plan.

The 1998 orders also required KEDLI to reduce base rates to its customers by $12.2 million annually effective February 5, 1998 and by an additional $6.3 million annually effective May 29, 1998. KEDLI is subject to an earnings sharing provision pursuant to which it is required to credit to firm customers 60% of any utility earnings in any rate year up to 100 basis points above a return on equity of 11.10% and 50% of any utility earnings in excess of a return on equity of 12.10%. KEDLI did not earn above its threshold return level in its rate year ended November 30, 2003. On November 30, 2000, KEDLI's rate agreement with the NYPSC expired. Under the terms of the agreement, the gas distribution rates and all other provisions, including the earnings sharing provision, will remain in effect until changed by the NYPSC. At this time, we are currently evaluating various options that may be available to us regarding KEDLI's rate plan, including but not limited to, proposing a new rate plan.

Boston Gas Company, Colonial Gas Company and Essex Gas Company operations are subject to Massachusetts's statutes applicable to gas utilities. Rates for gas sales and transportation service, distribution safety practices, issuance of securities and affiliate transactions are regulated by the DTE.

Regarding the Boston Gas Company, we filed a base rate case and Performance Based Rate Plan on April 16, 2003, to be effective in the fourth quarter of 2003. On October 31, 2003, the DTE rendered its decision on the Boston Gas Company's proposal and approved a $25.9 million increase in base revenues with an allowed return on equity of 10.2% assuming an equal balance of debt and equity. On January 27, 2004 the DTE issued orders on Boston Gas Company's Motions for Recalculation, Reconsideration and Clarification that granted an additional $1.1 million in base revenues, for a total of $27 million. The DTE also approved a true-up mechanism for pension and other postretirement benefit costs under which variations between actual pension and other postretirement benefit costs and amounts used to establish rates are deferred and collected from or refunded to customers in subsequent periods through an adjustment clause. This true-up mechanism allows for carrying charges on deferred assets and liabilities at Boston Gas Company's weighted-average cost of capital.

The DTE also approved a Performance Based Rate Plan (the "Plan") for up to ten years. The Plan allows for an annual revenue adjustment based on inflation, less a 0.41 percent productivity factor. Further, the plan contained a margin sharing mechanism, whereby 25% of earnings in excess of a 15% return on equity will be passed back to customers. Similarly, ratepayers would absorb 25% of any shortfall below a 7% return on equity.

Prior to the change in base rates and the new Plan noted above, Boston Gas Company's gas rates for local distribution service were governed by a five-year Performance-Based Rate Plan approved by the DTE in 1996 (the "Plan"). Under this Plan, Boston Gas Company's rates for local distribution were recalculated annually to reflect inflation for the previous 12 months, and reduced by a productivity factor of 1%. The productivity factor had been the subject of a remand proceeding at the DTE. With respect to this appeal, on March 7, 2002, the Massachusetts Supreme Judicial Court ruled in favor of Boston Gas Company and reduced the productivity factor from 1.0% to .5%.

In connection with the Eastern Enterprises acquisition of Colonial Gas Company in 1999, the DTE approved a merger and rate plan that resulted in a ten year freeze of base rates to Colonial Gas Company's firm customers. The base rate freeze is subject only to certain exogenous factors, such as changes in tax laws, accounting changes, or regulatory, judicial, or legislative changes. The Office of the Attorney General appealed the DTE's order to the Supreme Judicial Court, which appeal is still pending. Due to the length of the base rate freeze, Colonial Gas Company discontinued its application of SFAS 71. Essex Gas Company is also under a ten-year base rate freeze and has also discontinued its application of SFAS 71.

EnergyNorth Natural Gas, Inc.'s base rates continue as set by the NHPUC in 1993.

Electric Rate Matters

KeySpan sells to LIPA all of the capacity and, to the extent requested, energy conversion services from our existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC in accordance with the Power Supply Agreement ("PSA") entered into between KeySpan and LIPA in 1998. The current FERC approved rates, which have been in effect since May 1998, expired on December 31, 2003. KeySpan filed with the FERC an updated cost of service for the Long Island based oil and gas-fired generating plants in October 2003. The rate filing included, among other things, an annual revenue increase of 2.1% or approximately $6.4 million, a return on equity of 11%, updated operating and maintenance expense levels and recovery of certain other costs. FERC approved implementation of new rates starting January 1, 2004, subject to refund. Settlement negotiations are currently ongoing.

Securities and Exchange Commission Regulation

KeySpan and its subsidiaries are subject to the jurisdiction of the SEC under PUHCA. The rules and regulations under PUHCA generally limit the operations of a registered holding company to a single integrated public utility system, plus additional energy-related businesses. In addition, the principal regulatory provisions of PUHCA: (i) regulate certain transactions among affiliates within a holding company system including the payment of dividends by such subsidiaries to a holding company; (ii) govern the issuance, acquisition and disposition of securities and assets by a holding company and its subsidiaries; (iii) limit the entry by registered holding companies and their subsidiaries into businesses other than electric and/or gas utility businesses; and (iv) require SEC approval for certain utility mergers and acquisitions.

The SEC's order issued on December 18, 2003, provides us with, among other things, authorization to do the following through December 31, 2006 (the "Authorization Period"): (a) to issue and sell up to an additional amount of $3.0 billion of common stock, preferred stock, preferred and equity-linked securities, and long-term debt securities (the "Long-Term Financing Limit") in accordance with certain defined parameters; (b) in addition to the Long-Term Financing Limit, to issue and sell up to an aggregate amount of $1.3 billion of short-term debt (the "Short-Term Financing Limit"); (c) to issue up to 13 million shares of common stock under dividend reinvestment and stock-based management incentive and employee benefit plans; (d) to maintain existing and enter into additional hedging transactions with respect to outstanding indebtedness in order to manage and minimize interest rate costs; (e) to issue guarantees and other forms of credit support in an aggregate principal amount not to exceed $4.0 billion outstanding at any one time; (f) to refund, repurchase (through open market purchases, tender offers or private transactions), replace or refinance debt or equity securities outstanding during the Authorization Period through the issuance of similar or any other type of authorized securities; (g) to pay dividends out of capital and unearned surplus as well as paid-in-capital with respect to certain subsidiaries, subject to certain limitations; (h) to engage in preliminary development activities and administrative and management activities in connection with anticipated investments in exempt wholesale generators, foreign utility companies and other energy-related companies; (i) to organize and/or acquire the equity securities of entities that will serve the purpose of facilitating authorized financings; (j) to invest up to $3.0 billion in exempt wholesale generators and foreign utility companies; (k) to create and/or acquire the securities of entities organized for the purpose of facilitating investments in other non-utility subsidiaries; and (l) to enter into certain types of affiliate transactions between certain non-utility subsidiaries involving cost structures above the typical "at-cost" limit.

In addition, we have committed that during the Authorization Period, our common equity will be at least 30% of our consolidated capitalization and each of our utility subsidiaries' common equity will be at least 30% of such entity's capitalization. As of December 31, 2003 our consolidated common equity was 38% of our consolidated capitalization, including commercial paper, and each of our utility subsidiaries common equity was at least 35% of its respective capitalization.

Electric Services – Revenue Mechanisms

LIPA Agreements

KeySpan, through certain of its subsidiaries, provides services to LIPA under the following agreements:

- *Management Services Agreement ("MSA")*

KeySpan manages the day-to-day operations, maintenance and capital improvements of the transmission and distribution ("T&D") system. LIPA exercises control over the performance of the T&D system through specific standards for performance and incentives. In exchange for providing the services, we earn a $10 million annual management fee and are operating under a contract, which provides certain incentives and imposes certain penalties based upon performance. We have reached an agreement with LIPA to extend the MSA for 31 months through 2008, as discussed under the heading "Generation Purchase Right Agreement" below. Annual service incentives or penalties exist under the MSA if certain targets are achieved or not achieved. In addition, we can earn certain incentives for budget underruns associated with the day-to-day operations, maintenance and capital improvements of LIPA's T&D system. These incentives provide for us to (i) retain 100% on the first $5 million in annual budget underruns, and (ii) retain 50% of additional annual underruns up to 15% of the total cost budget, thereafter all savings accrue to LIPA. With respect to cost overruns, we will absorb the first $15 million of overruns, with a sharing of overruns above $15 million. There are certain limitations on the amount of cost sharing of overruns. To date, we have performed our obligations under the MSA within the agreed upon budget guidelines and we are committed to providing on-going services to LIPA within the established cost structure. However, no assurances can be given as to future operating results under this agreement.

Power Supply Agreement ("PSA")

KeySpan sells to LIPA all of the capacity and, to the extent requested, energy conversion services from our existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC. As noted previously, rates under the PSA have been reestablished for the contract year commencing January 1, 2004. Rates charged to LIPA include a fixed and variable component. The variable component is billed to LIPA on a monthly per megawatt hour basis and is dependent on the number of megawatt hours dispatched. LIPA has no obligation to purchase energy conversion services from us and is able to purchase energy or energy conversion services on a least-cost basis from all available sources consistent with existing interconnection limitations of the T&D system. The PSA provides incentives and penalties that can total $4 million annually for the maintenance of the output capability and the efficiency of the generating facilities. 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.

Energy Management Agreement ("EMA")

The EMA provides for KeySpan to procure and manage fuel supplies on behalf of LIPA to fuel the generating facilities under contract to it and perform off-system capacity and energy purchases on a least-cost basis to meet LIPA's needs. In exchange for these services we earn an annual fee of $1.5 million. In addition, we arrange for off-system sales on behalf of LIPA of excess output from the generating facilities and other power supplies either owned or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales. In addition, the EMA provides incentives and penalties that can total

ion annually for performance related to fuel purchases and tem power purchases. The EMA is expected to be in effect jh 2013 for the procurement of fuel supplies and through 2006 i-system management services.

Jnder these agreements, we are required to obtain a letter of in the aggregate amount of $60 million supporting our obliga- to provide the various services if our long-term debt is not rated e "A" range by a nationally recognized rating agency.

ieration Purchase Right Agreement ("GPRA")

er the GPRA, LIPA originally had the right for a one-year period inning on May 28, 2001, to acquire all of our Long Island based ierating assets formerly owned by LILCO at fair market value at time of the exercise of such right.

By agreement dated March 29, 2002, LIPA and KeySpan amended e GPRA to provide for a new six month option period ending on ay 28, 2005. The other terms of the option reflected in the GPRA mained unchanged. In return for providing LIPA an extension of the PRA, KeySpan has been provided with a corresponding extension f 31 months for the MSA to the end of 2008.

The extension is the result of an initiative established by LIPA to vork with KeySpan and others to review Long Island's long-term energy ieeds. LIPA and KeySpan will jointly analyze new energy supply options ncluding re-powering existing plants, renewable energy technologies, distributed generation, conservation initiatives and retail competition. The extension allows both LIPA and KeySpan to explore alternatives to the GPRA including re-powering existing facilities, the sale of some or all of KeySpan's plants to LIPA, or the sale of some or all of these plants to other investor-owned entities.

KeySpan Glenwood and Port Jefferson Energy Centers

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC have entered into 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 guarantees full 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.

Ravenswood Facility

We currently sell capacity, energy and ancillary services associated with the Ravenswood facility through a bidding process into the NYISO energy markets on both a day-ahead and a real-time basis. We also have the ability to enter into bilateral transactions to sell all or a portion of the energy produced by the Ravenswood facility to load serving entities, i.e. entities that sell to end-users or to brokers and marketers.

Environmental Matters

KeySpan is subject to various federal, state and local laws and regulatory programs related to the environment. During 2003, we undertook an extensive review of all our current and former properties that are or may be subject to environmental cleanup activities. As a result of this study, we adjusted reserve balances for estimated manufactured gas plant ("MGP") related environmental cleanup activities, as well as estimated environmental cleanup costs related to three non-utility sites. Through various rate orders issued by the NYPSC, DTE and NHPUC, costs related to MGP environmental cleanup activities are recovered in rates charged to gas distribution customers and, as a result, adjustments to these reserve balances do not impact earnings. However, environmental cleanup activities related to the three non-utility sites are not subject to rate recovery. Based on the recently concluded environmental study we reduced our reserve balance for future cleanup costs related to these sites and realized a pre-tax operating income benefit of $10 million.

We estimate that the remaining cost of our MGP related environmental cleanup activities, including costs associated with the Ravenswood facility, will be approximately $269.1 million and we have recorded a related liability for such amount. We have also recorded an additional $25.6 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of December 31, 2003, we have expended a total of $101.1 million on environmental investigation and remediation activities. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Guarantees and Contingencies" for a further explanation of these matters.)

Market and Credit Risk Management Activities

Market Risk: KeySpan is exposed to market risk arising from potential changes in one or more market variables, such as energy commodity price risk, interest rate risk, foreign currency exchange rate risk, volumetric risk due to weather or other variables. Such risk includes any or all changes in value whether caused by commodity positions, asset ownership, business or contractual obligations, debt covenants, exposure concentration, currency, weather, and other factors regardless of accounting method. We manage our exposure to changes in market prices using various risk management techniques for non-trading purposes, including hedging through the use of derivative instruments, both exchange-traded and over-the-counter contracts, purchase of insurance and execution of other contractual arrangements.

Credit Risk: KeySpan is exposed to credit risk arising from the potentia that our counterparties fail to perform on their contractual obligations. Our credit exposures are created primarily through the sale of gas and transportation services to residential, commercial, electric generation,

and industrial customers and the provision of retail access services to gas marketers, by our regulated gas businesses; the sale of commodities and services to LIPA and the NYISO; the sale of gas, power and services to our retail customers by our unregulated energy service businesses; entering into financial and energy derivative contracts with energy marketing companies and financial institutions; and the sale of gas, natural gas liquids, oil and processing services to energy marketing and oil and gas production companies.

We have regional concentration of credit risk due to receivables from residential, commercial and industrial customers in New York, New Hampshire and Massachusetts, although this credit risk is spread over a diversified base of residential, commercial and industrial customers. Customers' payment records are monitored and action is taken, when appropriate. Companies within the Energy Services segment have a concentration of credit risk to large customers and to the governmental and healthcare industries.

We also have concentrations of credit risk from LIPA, our largest customer, and from other energy companies. Concentration of energy company counterparties may impact overall exposure to credit risk in that our counterparties may be similarly impacted by changes in economic, regulatory or other considerations. We actively monitor the credit profile of our wholesale counterparties in derivative and other contractual arrangements, and manage our level of exposure accordingly. Over the past year, the credit quality of certain energy companies has declined. In instances where counterparties' credit quality has declined, we may limit our credit exposure by restricting new transactions with the counterparty, requiring additional collateral or credit support and negotiating the early termination of certain agreements.

Equity and Debt Securities Risk: KeySpan is exposed to price risk due to investments in equity and debt securities held to fund benefit payments for various employee pension and other postretirement benefit plans. To the extent that the values of investments held decline, the effect will be reflected in KeySpan's recognition of periodic cost of such employee benefit plans and the determination of the amount of cash to be contributed to the employee benefit plans.

Regulatory Issues and Competitive Environment

We are subject to various other risk exposures and uncertainties associated with our gas and electric operations. The most significant contingency involves the evolution of the gas distribution and electric industries towards more competitive and deregulated environments. Set forth below is a description of these exposures.

The Gas Industry

Long Island and New York

The NYPSC continues to conduct collaborative proceedings on ways to develop the competitive energy market in New York. On July 13, 2001, the presiding officers in the case issued their recommended decision ("RD"). The RD recommends that the NYPSC adopt an end state vision that includes removing the utilities from the provision of the energy (gas and electric) commodity. The RD also recommends that utilities exit the commodity function only where there is a workably competitive market. The RD states that the only market that is currently workably competitive is the commodity market for non-residential large- use gas customers. Parties filed briefs on and opposing exceptions to the RD. On January 27, 2004, the NYPSC issued a notice seeking further comments on the matters addressed in the RD, in light of the current state of the retail market and the experience of the past few years.

On May 23, 2002, the NYPSC issued an Order Adopting Terms of Gas Restructuring Joint Proposal Petition of KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island for a Multi-Year Restructuring Agreement ("Joint Proposal"). The Joint Proposal did not alter base rate levels, but established a merchant function backout credit of $.21/dth and $.19/dth for KEDNY and KEDLI, respectively. These credits are designed to lower transportation rates charged to transportation only customers. These credits were based on established levels of projected avoided costs and levels of customer migration to non-utility commodity service. Lost revenues resulting from application of these credits will be recovered from firm gas sales customers. The Joint Proposal expired on November 30, 2003. However, by Order dated November 25, 2003 the NYPSC approved tariff amendments that allow KEDNY and KEDLI to continue the merchant function backout credit and the lost revenue recovery mechanism through May 31, 2005.

As a result of circumstances in 2001, including the California energy crisis and the bankruptcy of Enron Corp., state regulators around the country are reassessing the pace of movement toward deregulation. We are unable to predict the outcome or pace of this trend or its ultimate effect on our results of operation, financial condition or cash flows.

On December 20, 2002, New York State Governor George Pataki signed into law the "Energy Consumer Protection Act of 2002" ("Act"). The Act defines energy services companies that provide gas or electric commodity service to customers as utilities subject to the Home Energy Fair Practices Act provisions ("HEFPA") of the New York Public Service Law. Under the Act, in certain circumstances utilities such as KEDNY and KEDLI will be required to suspend distribution service to customers whose commodity service has been terminated by an energy services company. Generally, those energy services companies are required under the Act to provide these customers with the same consumer protections prescribed under HEFPA as are prescribed for full service sales customers of gas distribution companies. Those consumer protections include a series of notices warning of potential service termination, offering

deferred payment agreements, and special protections for elderly, blind and disabled customers. Pursuant to the Act, the NYPSC proposed regulations implementing the Act through a notice of Proposed Rulemaking dated January 27, 2004. The Act became effective on June 18, 2003. We cannot predict the impact of the Act on KeySpan's regulated or unregulated operations at this time.

New England

In July 1997, the DTE directed Massachusetts gas distribution companies to undertake a collaborative process with other stakeholders to develop common principles under which comprehensive gas service unbundling might proceed. A settlement agreement by the local distribution companies ("LDCs") and the marketer group regarding model terms and conditions for unbundled transportation service was approved by the DTE in November 1998. In February 1999, the DTE issued its order on how unbundling of natural gas service will proceed. For a five year transition period, the DTE determined that LDC contractual commitments to upstream capacity will be assigned on a mandatory, pro-rata basis to marketers selling gas supply to the LDCs' customers. The approved mandatory assignment method eliminates the possibility that the costs of upstream capacity purchased by the LDCs to serve firm customers will be absorbed by the LDC or other customers through the transition period. The DTE also found that, through the transition period, LDCs will retain primary responsibility for upstream capacity planning and procurement to assure that adequate capacity is available to support customer requirements and growth. The DTE approved the LDCs' Terms and Conditions of Distribution Service that conform to the settled upon model terms and conditions. Since November 1, 2000, all Massachusetts gas customers have the option to purchase their gas supplies from third party sources other than the LDCs. Further, the New Hampshire Public Utility Commission required gas utilities to offer transportation services to all commercial and residential customers starting November 1, 2001. In January 2004, the DTE began a proceeding to re-examine whether the upstream capacity market has been sufficiently competitive to allow voluntary capacity assignment.

We believe that the actions described above strike a balance among competing stakeholder interests in order to most effectively make available the benefits of the unbundled gas supply market to all customers.

Electric Industry

The Ravenswood Facility and our New York City Operations

The NYISO's New York City local reliability rules currently require that 80% of the electric capacity needs of New York City be provided by "in-City" generators. As additional, more efficient electric power plants are built in New York City and the surrounding areas, the requirement that 80% of in-City load be served by in-City generators could be modified. Construction of new transmission facilities could also cause significant changes to the market. If generation and/or transmission facilities are constructed, and/or the availability of our Ravenswood facility deteriorates, then the capacity and energy sales volumes could be adversely affected. We cannot predict, however, when or if new power plants or transmission facilities will be built or the nature of future New York City energy requirements or market design.

Regional Transmission Organizations and Standard Market Design

During 2001, the FERC issued several orders and began several proceedings related to the development of Regional Transmission Organizations ("RTO") and the design of the wholesale energy markets. On September 16, 2004, FERC terminated various RTO proceedings, including the NYISO/ISONE proceeding, because it determined their continuation is no longer necessary to achieve the Commission's objective of establishing RTOs. Nevertheless, the Commission continues to guide the evolution of competitive markets in other proceedings including the development of a Standard Market Design.

On July 31, 2002, FERC issued a Notice of Proposed Rulemaking ("NOPR") intended to establish a standardized national market design and rules for competitive wholesale electric markets ("Standard Market Design" or "SMD"). These rules would apply to transmission owners ("TOs"), independent system operators ("ISOs"), and RTOs. The SMD is intended to create: (i) genuine wholesale competition; (ii) efficient transmission systems; (iii) the right pricing signals for investment in transmission and generation facilities; and (iv) more customer options. How the SMD will be implemented will be based on FERC's final rules in this regard, as well as the subject of various compliance filings by TOs, ISOs, and RTOs. We do not know how the markets will develop nor how these proposed changes will impact the operations of the NYISO or its market rules. Furthermore, we are unable to determine to what extent, if any, this process will impact the Ravenswood facility's financial condition, results of operations or cash flows.

New York Independent System Operator Matters

On May 31, 2002, FERC approved the NYISO's mitigation plan ("the Plan"). The Plan retains existing mitigation measures such as $1,000/MWhr energy price caps, non-spinning reserve bid caps, in-City capacity and energy mitigation measures, the day ahead Automated Mitigation Procedure ("AMP"), and the NYISO's general mitigation authority. In addition, the Plan implemented a new in-City real time automated mitigation procedure. On November 26, 2003, the NYISO filed with FERC a request for tariff revisions reflecting the implementation of enhanced real-time scheduling software. Among other things,

the new software included changes to the in-City day-ahead energy mitigation measures. The in-City day-ahead energy mitigation will no longer use the Indian Point 2 price as a proxy for determining whether an energy offer should be mitigated. The NYISO is going to apply its conduct and impact mitigation scheme to in-City offers. This will be applied on an hour by hour basis rather than on a 24-hour basis. Overall the changes are intended to address longstanding issues in the NYISO market and help the NYISO markets reach their full potential. The revisions are expected to lead to prices that reflect actual market and system conditions, including scarcity conditions. FERC approved the tariff revisions on February 11, 2004 and the NYISO will implement the revisions when they complete testing of the software revisions in the fall of 2004. However, the NYISO will implement the revisions associated with the in-City mitigation measures in its existing systems before the summer of 2004. Although prices for various energy products in the NYISO markets have softened, it is not known to what extent each of these proceedings and revised rules may impact the Ravenswood facility's financial condition, results of operations or cash flows.

NYISO Demand Curve Capacity Market Implementation
On March 21, 2003 the NYISO made a filing at FERC seeking approval of a Demand Curve to be used in place of its current deficiency auction for capacity procurement. On May 20, 2003, FERC approved, with some modifications, the Demand Curve to become effective May 21, 2003. On October 23, 2003, FERC denied various requests for rehearing of its order approving the Demand Curve and approved the NYISO's compliance filing. On December 9, 2003, the NYISO filed its first status report with FERC with respect to how the Demand Curve was working. The NYISO report found that there was no evidence of inappropriate withholding of capacity resources and that the Demand Curve was working as intended. On December 22, 2003, the Electric Consumers Resource Council filed an appeal with the DC Circuit Court of Appeals of FERC's May 20, 2003 order approving the Demand Curve and its October 23, 2003 order denying rehearing. This case is still pending and we are unable to determine to what extent, if any, this proceeding will impact the Ravenswood facility's financial condition, results of operations or cash flows.

10-Minute Non-Spinning Reserves – DC Court of Appeals
Due to volatility in the market clearing price of 10-minute spinning and non-spinning reserves during the first quarter of 2000, the NYISO requested that FERC approve a bid cap on reserves as well as requiring a refunding of so called alleged "excess payments" received by sellers, including Ravenswood. On May 31, 2000, FERC issued an order that granted approval of a $2.52 per MWh bid cap for 10 minute non-spinning reserves, plus payments for the opportunity cost of not making energy sales. The other requests, such as a bid cap for spinning reserves, retroactive refunds, recalculation of reserve prices for March 2000, and convening a technical conference and settlement proceeding, were rejected.

The NYISO, Con Edison, Niagara Mohawk Power Corporation and Rochester Gas and Electric (joint petitioners) each individually appealed FERC's order to Federal court. The appeals were consolidated into one case by the court. On November 7, 2003 the United States Court of Appeals for the District of Columbia (the "Court") issued its decision in the case of *Consolidated Edison Company of New York, Inc., v. Federal Energy Regulatory Commission* ("Decision"). Essentially, the Court found errors in the Commission's decision and remanded some issues in the case back to the Commission for further explanation and action. The Commission has not acted on the remand. At this time we cannot predict the outcome of the remand proceeding.

Foreign Currency Fluctuations
We follow the principles of SFAS 52, "Foreign Currency Translation" for recording our investments in foreign affiliates. At December 31, 2003, the net assets of these affiliates was approximately $323 million and at December 31, 2003, the accumulated after-tax foreign currency translation included in Other Comprehensive Income was a credit of $26.5 million. (See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies.")

Quantitative and Qualitative Disclosures About Market Risk

Financially-Settled Commodity Derivative Instruments – Non-Regulated Hedging Activities: From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas exploration and production activities and its electric generating facilities. Derivative financial instruments are employed by Houston Exploration to hedge cash flow variability associated with forecasted sales of natural gas. The Ravenswood facility uses derivative financial instruments to hedge the cash flow variability associated with the purchase of natural gas and oil that will be consumed during the generation of electricity. The Ravenswood facility also hedges the cash flow variability associated with a portion of peak electric energy sales.

For derivative instruments associated with gas exploration and production activities, KeySpan uses standard New York Mercantile Exchange ("NYMEX") future price quotes to value swap positions and published volatility in its Black-Scholes calculation for outstanding options. Further, KeySpan uses standard NYMEX futures prices to value gas futures contracts and market quoted forward prices to value oil swap and natural gas basis swap contracts associated with its Ravenswood facility. We also use market quoted forward prices to value electric derivatives associated with the Ravenswood facility.

The following tables set forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2003.

Type of Contract **Gas**	Year of Maturity	Volumes (mmcf)	Floor $	Ceiling $	Fixed Price $	Current Price $	Fair Value ($000)
Collars	2004	64,100	3.75 – 4.13	5.05 – 6.02	—	5.11 – 6.19	(29,449)
	2005	36,500	4.50	5.50	—	4.65 – 5.61	(1,534)
Put Options – Short Natural Gas	2004	9,100	—	—	5.00	5.11 – 5.26	4,228
Swaps/Futures – Short Natural Gas	2004	14,640	—	—	4.96	5.11 – 6.19	(6,912)
	2005	18,250	—	—	4.77	4.65 – 5.61	(3,194)
Swaps/Futures – Long Natural Gas	2005	10	—	—	4.95	4.65	(6)
		142,600					(36,867)

Type of Contract **Oil**	Year of Maturity	Volumes (Barrels)	Fixed Price $	Current Price $	Fair Value ($000)
Swaps – Long Fuel Oil	2004	100,548	20.55 – 29.60	28.28 – 32.42	361
	2005	28,000	24.65 – 27.25	27.35	24
		128,548			385

Type of Contract **Electricity**	Year of Maturity	MWh	Fixed Price $	Current Price $	Fair Value ($000)
Swaps – Energy	2004	580,000	14.00 – 28.00	14.10 – 39.33	259

The following tables detail the changes in and sources of fair value for the above derivatives:

(In Thousands of Dollars)	2003 ($000)
Change in Fair Value of Derivative Hedging Instruments	
Fair value of contracts at January 1,	$(32,628)
Net losses on contracts realized	35,449
(Decrease) in fair value of all open contracts	(39,045)
Fair value of contracts outstanding at December 31,	$(36,224)

(In Thousands of Dollars)	Fair Value of Contracts		
Sources of Fair Value	Maturity In 12 Months	Maturity in 2005	Total Fair Value
Prices actively quoted	$(23,142)	$(3,677)	$ (26,819)
Prices provided by external sources	(3)	—	(3)
Prices based on models and other valuation methods	(8,992)	(1,054)	(10,046)
Local published indicies	620	24	644
	$(31,517)	$(4,707)	$ (36,224)

Firm Gas Sales Derivative Instruments – Regulated Utilities:
We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. The accounting for these derivative instruments is subject to SFAS 71 "Accounting for the Effects of Certain Types of Regulation." Therefore, changes in the fair value of these derivatives have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements.

The following table sets forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2003.

Type of Contract	Year of Maturity	Volumes (mmcf)	Floor $	Ceiling $	Fixed Price $	Current Price $	Fair Value ($000)
Options	2004	6,460	3.75 – 4.13	4.75 – 6.00	—	5.11 – 6.19	3,008
Swaps	2004	17,122	—	—	4.42 – 6.23	5.11 – 6.19	6,501
	2005	3,310	—	—	4.61 – 5.65	4.65 – 5.61	352
		26,892					9,861

See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" for a further description of all our derivative instruments.

of Management's Responsibility ial Statements

nt has prepared and is responsible for the consolidated itements and related information in the Annual Report. al statements, which include amounts based on judgments tes, have been prepared in conformity with generally ccounting principles consistently applied.

gement has developed and continues to maintain a system accounting and other controls for KeySpan and its s. Management believes these controls provide reasonable that assets are safeguarded from loss or unauthorized use and oan's financial records are a reliable basis for preparing ial statements. KeySpan's system of internal controls is l by written policies, including a code of conduct, a program l audits, and by a program of selecting and training qualified lerlying the concept of reasonable assurance is the premise cost of control should not exceed the benefit derived.

nagement also has in place a system of disclosure controls and rocedures which provide reasonable assurance that KeySpan olied with the required reporting and timely filings of all reports e Securities Exchange Act of 1934.

oitte & Touche LLP, independent accountants, have audited the ated financial statements as described in their report. Their hich was conducted in accordance with auditing standards gen-cepted in the United States of America, included consideration nternal control structure. Their report expresses an independent on the fairness of presentation of the financial statements.

e Board of Directors, through its audit committee consisting f outside directors, is responsible for reviewing and monitoring n's financial reporting, accounting practices and the n of the independent accountants. The audit committee meets y with management, internal auditors and independent tants, both separately and together. The internal auditors and ependent accountants have free access to the audit committee to the results of their audits, the adequacy of internal accounting s and the quality of financial reporting.

Cautionary Statement Regarding Forward-Looking Statements

Certain statements contained herein are forward-looking statements, which reflect numerous assumptions and estimates and involve a number of risks and uncertainties. For these statements, we claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

There are possible developments that could cause our actual results to differ materially from those forecast or implied in the forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which are current only as of the date of this filing. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Among the factors that could cause actual results to differ materially are: volatility of energy prices of fuel used to generate electricity; fluctuations in weather and in gas and electric prices; general economic conditions, especially in the Northeast United States; our ability to successfully reduce our cost structure and operate efficiently; our ability to successfully contract for natural gas supplies required to meet the needs of our firm customers; implementation of new accounting standards; inflationary trends and interest rates; the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of recent and future acquisitions; available sources and cost of fuel; creditworthiness of counter-parties to derivative instruments and commodity contracts; retention of key personnel; federal and state regulatory initiatives that increase competition, threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses; the impact of federal and state utility regulatory policies and orders on our regulated and unregulated businesses; potential write-down of our investment in natural gas properties when natural gas prices are depressed or if we have significant downward revisions in our estimated proved gas reserves; competition in general facing our unregulated Energy Services businesses, including but not limited to competition from other mechanical, plumbing, heating, ventilation and air conditioning, and engineering companies, as well as, other utilities and utility holding companies that are permitted to engage in such activities; the degree to which we develop unregulated business ventures, as well as federal and state regulatory policies affecting our ability to retain and operate such business ventures profitably; and other risks detailed from time to time in other reports and other documents filed by KeySpan with the Securities and Exchange Commission.

Independent Auditors' Report

To the Shareholders and Board of Directors of
KeySpan Corporation:

We have audited the accompanying Consolidated Balance Sheets of KeySpan Corporation and subsidiaries (the Company) as of December 31, 2003 and 2002, and the related Consolidated Statements of Income, Retained Earnings, Comprehensive Income, Capitalization, and Cash Flows for each of the two years in the period ended December 31, 2003. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. The consolidated financial statements of KeySpan Corporation for the year ended December 31, 2001 were audited by other auditors who have ceased operations. Their report, dated February 4, 2002, expressed an unqualified opinion on those statements.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the KeySpan Corporation and subsidiaries as of December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1(G) to the consolidated financial statements, on January 1, 2002, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," (SFAS No. 142) to change its method of accounting for goodwill and other intangibles. As discussed in Note 1(N) and Note 1(P), on January 1, 2003, the Company adopted SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosure" and SFAS No. 143 "Accounting for Asset Retirement Obligations" (SFAS No. 143), respectively. Also, as discussed in Note 1(P), on December 31, 2003, the Company adopted FASB Interpretation No. 46, "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" (FIN 46).

As discussed above, the consolidated financial statements of the Company as of December 31, 2001 were audited by other auditors who have ceased operations. The notes related to these consolidated financial statements have been revised from those originally issued to include the transitional disclosures required by SFAS No. 142, SFAS No. 143 and FIN 46, which were adopted by the Company as of January 1, 2002, January 1, 2003 and December 31, 2003, respectively. Our audit procedures with respect to the disclosures in Note 1(G) for 2001 included (i) agreeing the previously reported earnings for common shareholders to the previously issued consolidated financial statements and the adjustments to earnings for common shareholders representing amortization expense recognized in those periods related to goodwill to the Company's underlying records obtained from management, and (ii) testing the mathematical accuracy of the reconciliation of adjusted net income to reported earnings for common shareholders, and the related earnings-per-share amounts. Our audit procedures with respect to the disclosures in Note 1(P) for 2001 included (i) agreeing the previously reported earnings for common stock to the previously issued consolidated financial statements and the adjustments to earnings for common stock representing accretion, cost of removal and amortization expense to the Company's underlying records obtained from management, and (ii) testing the mathematical accuracy of the reconciliation of Earnings for Common Stock to reported pro forma earnings, and the related earnings-per-share amounts.

In addition, the 2001 consolidated financial statements have also been revised from those originally issued to reflect certain reclassifications as discussed in Note 1(B). These reclassifications have been made to the Consolidated Statement of Income and the Consolidated Statement of Cash Flows. On the Consolidated Statement of Income, "Income from Equity Investments" has been reclassified from a component of "Other Income and (Deductions)" to a component of "Operating Income". On the Consolidated Statement of Cash Flows, "Net Income","Minority Interest", "Changes in Assets and Liabilities – Other", and "(Gain) Loss on Disposal of Subsidiary Stock" amounts have been reclassified. Our audit procedures with respect to such reclassifications for 2001 included (i) agreeing the amount to the previously issued consolidated financial statements, and (ii) testing the mathematical accuracy of the consolidated financial statements.

In our opinion, the adjustments in Note 1(G), Note 1(P), and the reclassifications reflected in the Consolidated Statements of Income and Cash Flows are appropriate and have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 2001 financial statements of the Company other than with respect to such adjustments and reclassifications and, accordingly, we do not express an opinion or any other form of assurance on the 2001 financial statements taken as a whole.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
February 18, 2004
New York, New York

Independent Auditors' Report

To the Shareholders and Board of Directors of KeySpan Corporation:

We have audited the accompanying Consolidated Balance Sheet and Consolidated Statement of Capitalization of KeySpan Corporation (a New York corporation) and subsidiaries as of December 31, 2001 and December 31, 2000 and the related Consolidated Statements of Income, Retained Earnings, Comprehensive Income and Cash Flows for the three years ended December 31, 2001. These financial statements are the responsibility of KeySpan Corporation's management.

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position and capitalization of KeySpan Corporation and subsidiaries as of December 31, 2001 and December 31, 2000 and the results of their operations and their cash flows for the three years ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

Arthur Andersen LLP

ARTHUR ANDERSEN LLP

February 4, 2002
New York, New York

Readers of these consolidated financial statements should be aware that this report is a copy of a previously issued Arthur Andersen LLP report and that this report has not been reissued by Arthur Andersen LLP. Furthermore, this report has not been updated since February 4, 2002 and Arthur Andersen LLP completed its last post-audit review of December 31, 2001 consolidated financial information on April 29, 2002.

Consolidated Statement of Income

Year Ended December 31,	2003	2002	2001
	(In Thousands of Dollars, Except Per Share Amounts)		
Revenues			
Gas Distribution	**$4,161,272**	$3,163,761	$3,613,551
Electric Services	**1,503,086**	1,421,043	1,421,079
Energy Services	**641,432**	938,761	1,100,167
Gas Exploration and Production	**501,255**	357,451	400,031
Energy Investments	**108,116**	89,650	98,287
Total Revenues	**6,915,161**	5,970,666	6,633,115
Operating Expenses			
Purchased gas for resale	**2,495,102**	1,653,273	2,171,113
Fuel and purchased power	**414,633**	395,860	538,532
Operations and maintenance	**2,005,796**	2,101,897	2,114,759
Depreciation, depletion and amortization	**574,074**	514,613	559,138
Operating taxes	**418,236**	381,767	448,924
Total Operating Expenses	**5,907,841**	5,047,410	5,832,466
Gain on sale of property	**15,123**	4,730	—
Income from equity investments	**19,214**	14,096	13,129
Operating Income	**1,041,657**	942,082	813,778
Other Income and (Deductions)			
Interest charges	**(307,694)**	(301,504)	(353,470)
Sale of subsidiary stock	**13,356**	—	—
Cost of debt redemption	**(24,094)**	—	—
Minority interest	**(63,852)**	(24,918)	(40,847)
Other	**42,119**	25,169	34,924
Total Other Income and (Deductions)	**(340,165)**	(301,253)	(359,393)
Income Taxes			
Current	**(104,355)**	(24,212)	101,738
Deferred	**381,666**	267,691	108,955
Total Income Taxes	**277,311**	243,479	210,693
Earnings from Continuing Operations	**424,181**	397,350	243,692
Discontinued Operations			
Income (loss) from operations, net of tax	—	(3,356)	10,918
Loss on disposal, net of tax	—	(16,306)	(30,356)
Loss from Discontinued Operations	—	(19,662)	(19,438)
Cumulative Change in Accounting Principles, net of tax	**(37,451)**	—	—
Net Income	**386,730**	377,688	224,254
Preferred stock dividend requirements	**5,844**	5,753	5,904
Earnings for Common Stock	**$ 380,886**	$ 371,935	$ 218,350
Basic Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 2.64**	$ 2.77	$ 1.72
Discontinued Operations	—	(0.14)	(0.14)
Change in Accounting Principles	**(0.23)**	—	—
Basic Earnings Per Share	**$ 2.41**	$ 2.63	$ 1.58
Diluted Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 2.62**	$ 2.75	$ 1.70
Discontinued Operations	—	(0.14)	(0.14)
Change in Accounting Principles	**(0.23)**	—	—
Diluted Earnings Per Share	**$ 2.39**	$ 2.61	$ 1.56
Average Common Shares Outstanding (000)	**158,256**	141,263	138,214
Average Common Shares Outstanding – Diluted (000)	**159,232**	142,300	139,221

See accompanying Notes to the Consolidated Financial Statements

Consolidated Balance Sheet

		(In Thousands of Dollars)
Year Ended December 31,	2003	2002
ASSETS		
Current Assets		
Cash and temporary cash investments	$ 205,751	$ 170,617
Accounts receivable	1,029,459	1,122,022
Unbilled revenue	505,633	473,060
Allowance for uncollectible accounts	(79,184)	(63,029)
Gas in storage, at average cost	488,521	297,060
Material and supplies, at average cost	121,415	113,519
Other	115,304	93,980
	2,386,899	2,207,229
Investments and Other	248,565	264,729
Property		
Gas	6,522,251	6,125,529
Electric	2,636,537	1,974,352
Other	425,576	394,374
Accumulated depreciation	(2,610,876)	(2,374,772)
Gas exploration and production, at cost	3,088,242	2,438,998
Accumulated depletion	(1,167,427)	(973,889)
	8,894,303	7,584,592
Deferred Charges		
Regulatory assets	564,985	438,516
Goodwill and other intangible assets, net of amortization	1,809,712	1,796,225
Other	722,320	688,759
	3,097,017	2,923,500
Total Assets	$14,626,784	$12,980,050

See accompanying Notes to the Consolidated Financial Statements

Consolidated Balance Sheet

Year Ended December 31,	2003	(In Thousands of Dollars) 2002
LIABILITIES AND CAPITALIZATION		
Current Liabilities		
Current redemption of long-term debt	**$ 1,471**	$ 11,413
Accounts payable and other liabilities	**1,141,597**	1,096,654
Commercial paper	**481,900**	915,697
Dividends payable	**72,289**	64,714
Taxes accrued	**46,580**	51,276
Customer deposits	**40,370**	38,387
Interest accrued	**64,609**	77,092
	1,848,816	2,255,233
Deferred Credits and Other Liabilities		
Regulatory liabilities:		
Miscellaneous liabilities	**104,034**	84,479
Removal costs recovered	**450,034**	—
Removal costs recovered	**—**	365,744
Deferred income tax	**1,273,651**	877,013
Postretirement benefits and other reserves	**961,962**	759,731
Other	**121,790**	154,907
	2,911,471	2,241,874
Commitments and Contingencies (See Note 7)	**—**	—
Capitalization		
Common stock	**3,487,645**	3,005,354
Retained earnings	**621,430**	522,835
Accumulated other comprehensive income	**(68,640)**	(108,423)
Treasury stock	**(378,487)**	(475,174)
Total common shareholders' equity	**3,661,948**	2,944,592
Preferred stock	**83,568**	83,849
Long-term debt	**5,611,432**	5,224,081
Total Capitalization	**9,356,948**	8,252,522
Minority Interest in Subsidiary Companies	**509.549**	230.421
Total Liabilities and Capitalization	**$14,626,784**	$12,980,050

See accompanying Notes to the Consolidated Financial Statements

Consolidated Statement of Cash Flows

(In Thousands of Dollars)

Year Ended December 31,	2003	2002	2001
Operating Activities			
Net income	**$ 386,730**	$ 377,688	$ 224,254
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation, depletion and amortization	**574,074**	514,613	559,138
Deferred income tax	**189,275**	90,724	108,955
Income from equity investments	**(18,038)**	(14,096)	(13,129)
Dividends from equity investments	**2,807**	3,905	7,570
Amortization of interest rate swap	**(9,861)**	—	—
(Gain) loss on disposal of subsidiary stock	**(13,356)**	—	19,438
Gain on sale of property	**(15,123)**	(4,730)	—
Gain from class action settlement	—	—	(33,510)
Provision for losses on contracting business	—	—	63,682
Change in accounting principle	**37,451**	—	—
Environmental reserve adjustment	**(10,459)**	—	—
Minority interest	**63,852**	24,918	40,847
Changes in assets and liabilities			
Accounts receivable	**77,750**	(259,454)	401,976
Materials and supplies, fuel oil and gas in storage	**(199,357)**	42,508	(43,856)
Accounts payable and accrued expenses	**199,980**	18,179	(400,636)
Reserve payments	**(36,486)**	(23,369)	—
Other	**(44,596)**	(39,394)	(44,548)
Net Cash Provided by Operating Activities	**1,184,643**	731,492	890,181
Investing Activities			
Construction expenditures	**(1,011,716)**	(1,061,022)	(1,059,759)
Other Investments	**(211,370)**	(27,579)	—
Proceeds from sale of property and subsidiary stock	**309,696**	179,840	18,458
Issuance of long-term note	**(55,000)**	—	—
Other	—	—	(6)
Net Cash (Used in) Investing Activities	**(968,390)**	(908,761)	(1,041,307)
Financing Activities			
Treasury stock issued	**96,687**	86,710	88,786
Common stock issuance	**473,573**	—	—
Issuance of long-term debt	**1,024,912**	549,280	812,116
Payment of long-term debt	**(605,625)**	(124,991)	(183,410)
Payment of commercial paper	**(433,797)**	(132,753)	(251,787)
Redemption of promissory notes	**(447,005)**	—	—
Redemption of preferred stock	**(14,293)**	—	—
Common and preferred stock dividends paid	**(280,560)**	(256,656)	(251,502)
Termination of interest rate swaps	—	57,415	—
Other	**4,989**	9,629	12,846
Net Cash (Used in) Provided by Financing Activities	**(181,119)**	188,634	227,049
Net Increase in Cash and Cash Equivalents	**$ 35,134**	$ 11,365	$ 75,923
Cash and Cash Equivalents at Beginning of Period	**170,617**	159,252	83,329
Cash and Cash Equivalents at End of Period	**$ 205,751**	$ 170,617	$ 159,252
Interest Paid	**$ 355,136**	$ 343,933	$ 328,910
Income Tax Paid	**$ 65,495**	$ 98,344	$ 128,558

See accompanying Notes to the Consolidated Financial Statements.

Consolidated Statement of Retained Earnings

(In Thousands of Dollars)

Year Ended December 31,	2003	2002	2001
Balance at Beginning of Period	**$522,835**	$ 452,206	$480,639
Net Income for Period	**386,730**	377,688	224,254
	909,565	829,894	704,893
Deductions:			
Cash dividends declared on common stock	**282,291**	252,175	246,783
Cash dividends declared on preferred stock	**5,844**	5,753	5,904
MEDS Equity Units	—	49,131	—
Balance at End of Period	**$621,430**	$ 522,835	$452,206

Consolidated Statement of Comprehensive Income

(In Thousands of Dollars)

Year Ended December 31,	2003	2002	2001
Net Income	**$386,730**	$ 377,688	$224,254
Other comprehensive income, net of tax			
Net losses (gains) on derivative instruments	**23,042**	(17,033)	(27,690)
Reclassification adjustment for other gains reclassified to net income	—	—	(3,242)
Foreign currency translation adjustments	**28,696**	9,759	(9,627)
Unrealized gains (losses) on marketable securities	**8,480**	(10,019)	(5,464)
Premium on derivative instrument	**(3,437)**	—	—
Accrued unfunded pension obligation	**8,380**	(55,768)	(13,262)
Unrealized (losses) gains on derivative financial instruments	**(25,379)**	(39,845)	62,943
Other comprehensive income (loss), net of tax	**39,782**	(112,906)	3,658
Comprehensive Income	**$426,512**	$ 264,782	$227,912
Related tax (benefit) expense			
Net losses (gains) on derivative instruments	**12,407**	(9,172)	$ (14,910)
Reclassification adjustment for other gains reclassified to net income	—	—	(1,746)
Foreign currency translation adjustments	**15,451**	5,255	(5,184)
Unrealized gains (losses) on marketable securities	**4,568**	(5,395)	(2,942)
Accrued unfunded pension obligation	**4,513**	(30,029)	(7,140)
Premium on derivative instrument	**(1,851)**	—	—
Unrealized (losses) gains on derivative financial instruments	**(13,666)**	(21,454)	33,892
Total Tax (Benefit) Expense	**$ 21,422**	$ (60,795)	$ 1,970

See accompanying Notes to the Consolidated Financial Statements.

Consolidated Statement of Capitalization

Year Ended December 31,	Shares Issued 2003	Shares Issued 2002	(In Thousands of Dollars) 2003	(In Thousands of Dollars) 2002
Common Shareholders' Equity				
Common stock, $0.01 par value	**172,737,654**	158,837,654	**$ 1,727**	$ 1,588
Premium on capital stock			**3,485,918**	3,003,766
Retained earnings			**621,430**	522,835
Other comprehensive income			**(68,640)**	(108,423)
Treasury stock	**13,073,219**	16,412,880	**(378,487)**	(475,174)
Total Common Shareholders' Equity	**159,664,435**	142,424,774	**3,661,948**	2,944,592
Preferred Stock – No Redemption Required				
Par Value $100 per share				
7.07% Series B – private placement	**553,000**	553,000	**55,300**	55,300
7.17% Series C – private placement	**197,000**	197,000	**19,700**	19,700
6.00% Series A – private placement	**85,676**	88,486	**8,568**	8,849
Total Preferred Stock – No Redemption Required			**83,568**	83,849
Long-Term Debt	**Interest Rate**	**Maturity**		
Notes				
Medium and long term notes	4.65% – 9.75%	2005 – 2033	**3,185,000**	2,885,000
Senior secured notes	5.42% – 6.16%	2008 – 2013	**96,425**	—
Senior subordinated notes	7.0%	2013	**175,000**	100,000
Total Notes			**3,456,425**	2,985,000
Gas Facilities Revenue Bonds	Variable	2020	**125,000**	125,000
	5.50% – 6.95%	2020 – 2026	**523,500**	523,500
Total Gas Facilities Revenue Bonds			**648,500**	648,500
Promissory Notes to LIPA				
Debentures	8.20%	2023	—	270,000
Pollution control revenue bonds	5.15%	2016	**108,022**	108,022
Electric facilities revenue bonds	5.30%	2023 – 2025	**47,400**	224,405
Total Promissory Notes to LIPA			**155,422**	602,427
MEDS Equity Units	8.75%	2005	**460,000**	460,000
Industrial Development Bonds	5.25%	2027	**128,275**	—
First Mortgage Bonds	5.50% – 10.10%	2003 – 2028	**153,186**	163,625
Authority Financing Notes	Variable	2027 – 2028	**66,005**	66,005
Other Subsidiary Debt			**145,612**	304,298
Ravenswood Master Lease & Capital Leases		2005 – 2022	**425,262**	13,884
Subtotal			**5,638,687**	5,243,739
Unamortized interest rate hedge and debt discount			**(69,243)**	(75,265)
Derivative impact on debt			**43,459**	67,020
Less: current maturities			**1,471**	11,413
Total Long-Term Debt			**5,611,432**	5,224,081
Total Capitalization			**$9,356,948**	$8,252,522

See accompanying Notes to the Consolidated Financial Statements.

ſE 1. Summary of Significant Accounting Policies

Ɔrganization of the Company

Span Corporation, a New York corporation, was formed in May ꞓ98, as a result of the business combination of KeySpan Energy rporation, the parent of The Brooklyn Union Gas Company, and :tain businesses of the Long Island Lighting Company ("LILCO"). ı November 8, 2000, KeySpan acquired Eastern Enterprises Eastern"), a Massachusetts business trust, and the parent of several ɜs utilities operating in Massachusetts. Also on November 8, 2000, astern acquired EnergyNorth, Inc. ("ENI"), the parent of a gas utility ıperating in central New Hampshire. KeySpan Corporation will be eferred to in these notes to the Consolidated Financial Statements as 'KeySpan", "we", "us" and "our."

Our core business is gas distribution, conducted by our six regulated gas utility subsidiaries: The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York ("KEDNY") and KeySpan Gas East Corporation d/b/a KeySpan Energy Delivery Long Island ("KEDLI") distribute gas to customers in the Boroughs of Brooklyn, Staten Island and a portion of the Borough of Queens in New York City, and the counties of Nassau and Suffolk on Long Island and the Rockaway Peninsula in Queens, respectively; Boston Gas Company, Colonial Gas Company and Essex Gas Company, each doing business as KeySpan Energy Delivery New England ("KEDNE"), distribute gas to customers in southern, eastern and central Massachusetts; and EnergyNorth Natural Gas, Inc., d/b/a KeySpan Energy Delivery New England distributes gas to customers in central New Hampshire. Together, these companies distribute gas to approximately 2.5 million customers throughout the Northeast.

We also own, lease and operate electric generating plants on Long Island and in New York City. Under contractual arrangements, we provide power, electric transmission and distribution services, billing and other customer services for approximately 1.0 million electric customers of the Long Island Power Authority ("LIPA").

Our other subsidiaries are involved in gas and oil exploration and production; gas storage; liquefied natural gas storage; wholesale and retail electric marketing; appliance service; plumbing; heating, ventilation, air conditioning and other mechanical services; large energy-system ownership, installation and management; fiber optic services; and engineering and consulting services. We also invest in, and participate in the development of natural gas pipelines; natural gas processing plants; electric generation, and other energy-related projects, domestically and internationally. (See Note 2, "Business Segments" for additional information on each operating segment.)

We are a registered holding company under the Public Utility Holding Company Act of 1935 ("PUHCA"), as amended. Therefore, our corporate and financial activities and those of our subsidiaries, including their ability to pay dividends to us, are subject to regulation by the Securities and Exchange Commission ("SEC"). Under our holding company structure, we have no independent operations or source of income of our own and conduct all of our operations through our subsidiaries and, as a result, we depend on the earnings and cash flow of, and dividends or distributions from, our subsidiaries to provide the funds necessary to meet our debt and contractual obligations. Furthermore, a substantial portion of our consolidated assets, earnings and cash flow is derived from the operations of our regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation by state regulatory authorities.

B. Basis of Presentation

The Consolidated Financial Statements presented herein reflect the accounts of KeySpan and its subsidiaries. Most of our subsidiaries are fully consolidated in the financial information presented, except for certain subsidiary investments in the Energy Investments segment which are accounted for on the equity method as we do not have a controlling voting interest or otherwise have control over the management of such companies. All significant intercompany transactions have been eliminated. Certain reclassifications were made to conform prior period financial statements to current period financial statement presentation. For December 31, 2003, 2002 and 2001, we reclassified income from equity investments and property sales from other income and (deductions) to operating income on the Consolidated Statement of Income. On the 2001 Consolidated Statement of Cash Flows, "minority interest," "changes in assets and liabilities – other," and "(gain) loss on disposal of subsidiary stock" amounts have been reclassified. The amount related to the loss from discontinued operations has been separately identified as "(gain) loss of disposal of subsidiary stock". In addition, "minority interest" was previously disclosed as a component of "changes in assets and liabilities – other"; it has now been reclassified as a separate line item for all periods presented.

The preparation of financial statements in conformity with generally accepted accounting principles ("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.

C. Accounting for the Effects of Rate Regulation

The accounting records for our six regulated gas utilities are maintained in accordance with the Uniform System of Accounts prescribed by the Public Service Commission of the State of New York ("NYPSC"), the New Hampshire Public Utility Commission ("NHPUC"), and the Massachusetts Department of Telecommunications and Energy ("DTE"). Our electric generation subsidiaries are not subject to state rate regulation, but they are subject to Federal Energy Regulatory Commission ("FERC") regulation. Our financial statements reflect the ratemaking policies and actions of these regulators in conformity with GAAP for rate-regulated enterprises.

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas Company and EnergyNorth Natural Gas, Inc.) and our Long Island basec electric generation subsidiaries are subject to the provisions of Statement of Financial Accounting Standards ("SFAS") 71, "Accountinc for the Effects of Certain Types of Regulation." This statement recognizes the ability of regulators, through the ratemaking process, to crea future economic benefits and obligations affecting rate-regulated

companies. Accordingly, we record these future economic benefits and obligations as regulatory assets and regulatory liabilities on the Consolidated Balance Sheet, respectively.

In separate merger related orders issued by the DTE, the base rates charged by Colonial Gas Company and Essex Gas Company have been frozen at their current levels for ten-year periods, ending 2009 and 2008, respectively. Due to the length of these base rate freezes, the Colonial and Essex Gas Companies had previously discontinued the application of SFAS 71.

The following table presents our net regulatory assets at December 31, 2003 and December 31, 2002.

		(In Thousands of Dollars)
December 31,	2003	2002
Regulatory Assets		
Regulatory tax asset	$ 47,236	$ 53,401
Property taxes	64,854	58,400
Environmental costs	296,888	182,163
Postretirement benefits	93,284	82,563
Costs associated with the KeySpan/LILCO transaction	50,585	61,989
Derivative financial instruments	6,909	—
Other	5,229	—
Total Regulatory Assets	$564,985	$438,516
Miscellaneous Regulatory Liabilities	(104,034)	(84,479)
Net Regulatory Assets	460,951	354,037
Removal Costs Recovered	(450,034)	—
	$ 10,917	$354,037

The regulatory assets above are not included in rate base. However, we record carrying charges on the property tax and costs associated with the KeySpan/LILCO transaction cost deferrals. We also record carrying charges on our regulatory liabilities. The remaining regulatory assets represent, primarily, costs for which expenditures have not yet been made, and therefore, carrying charges are not recorded. We anticipate recovering these costs in our gas rates concurrently with future cash expenditures. If recovery is not concurrent with the cash expenditures, we will record the appropriate level of carrying charges. Deferred gas costs of $53.4 million and $61.8 million at December 31, 2003 and December 31, 2002, respectively are reflected in accounts receivable on the Consolidated Balance Sheet. Deferred gas costs are subject to current recovery from customers.

We estimate that full recovery of our regulatory assets will not exceed 10 years, except for the regulatory tax asset, which will be recovered over the estimated lives of certain utility property.

Rate regulation is undergoing significant change as regulators and customers seek lower prices for utility service and greater competition among energy service providers. In the event that regulation significantly changes the opportunity to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of all or a portion of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101, "Regulated Enterprises - Accounting for the Discontinuation of Application of FASB Statement 71." We estimate that the write-off of all net regulatory assets at December 31, 2003, before consideration of removal costs recovered, could result in a charge to net income of $300 million or $1.89 per share, which would be classified as an extraordinary item. In 2003, KeySpan implemented SFAS 143 "Accounting for Asset Retirement Obligations" and reclassified cost of removal accruals from accumulated depreciation to regulatory liabilities. For the 2002 Consolidated Balance Sheet presentation, these accruals are reflected as a separate line item in deferred credits and other liabilities. In management's opinion, our regulated subsidiaries that are currently subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

D. Revenues

Gas Distribution: Utility gas customers are billed monthly or bi-monthly on a cycle basis. Revenues include unbilled amounts related to the estimated gas usage that occurred from the most recent meter reading to the end of each month.

The cost of gas used is recovered when billed to firm customers through the operation of gas adjustment clauses ("GAC") included in utility tariffs. The GAC provision requires periodic reconciliation of recoverable gas costs and GAC revenues. Any difference is deferred pending recovery from or refund to firm customers. Further, net revenues from tariff gas balancing services, off-system sales and certain on-system interruptible sales are refunded, for the most part, to firm customers subject to certain sharing provisions.

The New York and Long Island gas utility tariffs contain weather normalization adjustments that largely offset shortfalls or excesses of firm net revenues (revenues less gas costs and revenue taxes) during a heating season due to variations from normal weather. Revenues are adjusted each month the clause is in effect and are generally included in rates in the following month. The New England gas utility rate structures contain no weather normalization feature, therefore their net revenues are subject to weather related demand fluctuations.

Electric Services: Electric revenues are derived from billings to LIPA for management of LIPA's transmission and distribution ("T&D") system, electric generation, and procurement of fuel.

KeySpan manages the day-to-day operations, maintenance and capital improvements of the T&D system under a Management Service Agreement ("MSA"). In exchange for providing the services, KeySpan earns a $10 million annual management fee. Annual service incentives or penalties exist under the MSA if certain targets are achieved or not achieved. In addition, we can earn certain incentives for budget underruns, associated with the day-to-day operations, maintenance and capital improvements of LIPA's T&D system. These incentives provide for us to (i) retain 100% on the first $5 million in annual budget underruns, and (ii) retain 50% of additional annual underruns up to 15% of the total cost budget, thereafter all savings accrue to LIPA. With respect to cost overruns, we will absorb the first $15 million of overruns, with a

sharing of overruns above $15 million. There are certain limitations on the amount of cost sharing of overruns.

In addition, KeySpan sells to LIPA under a Power Supply Agreement ("PSA") all of the capacity and, to the extent requested, energy conversion services from our existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC. Rates charged to LIPA include a fixed and variable component. The variable component is billed to LIPA on a monthly per megawatt hour basis and is dependent on the number of megawatt hours dispatched. The PSA provides incentives and penalties that can total $4 million annually for the maintenance of the output capability and the efficiency of the generating facilities.

KeySpan also procures and manages fuel supplies on behalf of LIPA, under an Energy Management Agreement ("EMA"), to fuel the generating facilities under contract to it and perform off-system capacity and energy purchases on a least-cost basis to meet LIPA's needs. In exchange for these services we earn an annual fee of $1.5 million. In addition, we arrange for off-system sales on behalf of LIPA of excess output from the generating facilities and other power supplies either owned or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales. In addition, the EMA provides incentives and penalties that can total $7 million annually for performance related to fuel purchases and off-system power purchases.

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC have entered into 25 year Power Purchase Agreements with LIPA (the "PPAs"). Under the terms of the PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Each plant is designed to produce 79.9 megawatts ("MW"). Under the PPAs, LIPA pays a monthly capacity fee, which guarantees full 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.

In addition, electric revenues are derived from our investment in the 2,200 megawatt Ravenswood electric generation facility ("Ravenswood facility"), which we acquired in June 1999. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for a description of the Ravenswood transaction.) We realize revenues from our investment in the Ravenswood facility through the sale, at wholesale, of energy, capacity, and ancillary services to the New York Independent System Operator ("NYISO"). Energy and ancillary services are sold through a bidding process into the NYISO energy markets on a day ahead or real time basis.

Energy Services: Revenues earned by our Energy Services segment for mechanical and other contracting services are derived from service rendered under fixed price, cost-plus, guaranteed maximum price, and time and materials-type contracts and generally recognized on the percentage-of-completion method. Percentage-of-completion is measured principally by the percentage of costs incurred to date for each contract to the estimated total costs for each contract at completion. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. In the case of customer change orders, estimated recoveries are included for work performed in forecasting ultimate profitability on certain contracts. Due to uncertainties inherent in the estimation process, changes in job performance, job conditions, estimated profitability and final contract settlements may result in revisions to estimated costs and, therefore, revenues. Such revisions to costs and income are recognized in the period in which the revisions are determined.

Costs and estimated earnings in excess of billings on uncompleted contracts arise when revenues have been recorded but the amounts cannot be billed under the terms of the contracts. Such amounts are recoverable from customers upon various measures of performance, including achievement of certain milestones, completion of specified units or completion of the contract.

Also included in costs and estimated earnings on uncompleted contracts are amounts to be collected from customers for changes in contract specifications or design, contract change orders in dispute or unapproved as to scope or price, or other customer-related causes of unanticipated additional contract costs. These amounts are recorded at their estimated net realizable value when realization is probable and can be reasonably estimated. Claims and unapproved change orders involve negotiation and, in certain cases, litigation. Unapproved change orders and claims also involve the use of estimates, and it is reasonably possible that revisions to the estimated recoverable amounts of recorded change orders and claims may be made in the near-term. If KeySpan does not successfully resolve these matters, an expense may be required, in addition to amounts that have been previously provided for. Claims against KeySpan are recognized when a loss is considered probable and amounts are reasonably determinable.

Energy service and maintenance revenues are recognized as earned or over the life of the service contract, as appropriate. Energy sales made by our electric marketing subsidiary are recorded upon delivery of the related commodity. Fiber optic service revenue is recognized upon delivery of service access. We have unearned revenue recorded in deferred credits and other liabilities - other on the Consolidated Balance Sheet totaling $23.8 million and $19.2 million for the years ended December 31, 2003, and December 31, 2002, respectively. These balances represent primarily unearned revenues for service contracts and leases on fiber optic cables. The unearned revenues from the service contracts are generally amortized to income within one year, while the lease related unearned revenues are amortized over periods ranging from five to 30 years.

Gas Exploration and Production: Natural gas and oil revenues earned by our gas exploration and production activities are recognized using the entitlements method of accounting. Under this method of accounting, income is recorded based on the net revenue interest in production or nominated deliveries. Production gas volume imbalances are incurred in the ordinary course of business. Net deliveries in excess of entitled amounts are recorded as liabilities, while net under deliveries are recorded as assets. Imbalances are reduced either by subsequent recoupment

leliveries or by cash settlement, as required by
s. Production imbalances are marked-to-market at the
ı using the market price at the end of each period.

ther Property – Depreciation and Maintenance
lly utility gas property is stated at original cost of
ich includes allocations of overheads, including taxes,
e for funds used during construction. The rates at which
aries capitalized interest for the years ended December
gh 2003 ranged from 2.95% to 10.67%. Capitalized
)3, 2002 and 2001 was $13.5 million, $19.7 million
on, respectively.
tion is provided on a straight-line basis in amounts
composite rates on average depreciable property. The
rty retired is charged to accumulated depreciation.
n recovers certain asset retirement costs through rates
ustomers as a portion of depreciation expense. At
1, 2003 and 2002, KeySpan had costs recovered in excess
urred totaling $450 million and $366 million, respectively.
unts are reflected as a regulatory liability for 2003 and in
edits and other liabilities for 2002 on the Consolidated
heet.
cost of repair and minor replacement and renewal of property
d to maintenance expense. The composite rates on average
ble property were as follows:

l December 31,	2003	2002	2001
	3.81%	3.88%	3.78%
	3.37%	3.44%	3.40%

also had $425.6 million of other property at December 31,
hich is not reflected in "rate base" for utility rate making
s. This property consists of assets held primarily by our
te Service subsidiary of $320.3 million and $105.3 million in
Services assets. The Corporate Service assets consist largely of
ildings, office equipment and furniture, vehicles, computer
communications equipment and systems. These assets have
able lives ranging from three to 40 years. We allocate the
cost of these assets to our operating subsidiaries through our
allocation methodology. Energy Services assets consist largely
truction equipment and fiber optic cable and related electronics
ve service lives ranging from seven to 40 years.
eySpan's repair and maintenance costs, including planned major
nance in the Electric Services segment for turbine and generator
uls, are expensed as incurred unless they represent replacement
erty to be capitalized. Planned major maintenance cycles
ly range from seven to eight years. Smaller periodic overhauls
formed approximately every 18 months.

Exploration and Production Property – Depletion
ember 31, 2003, we had exploration and production property in
of accounting. Under the full cost method, costs of acquisition, exploration and development of natural gas and oil reserves are capitalized into a "full cost pool" as incurred. Unproved properties and related costs are excluded from the depletion and amortization base until a determination as to the existence of proved reserves. Properties are depleted and charged to operations using the unit of production method using proved reserve quantities.

These investments consist of our 55% ownership interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company, as well as KeySpan Exploration and Production, LLC ("KeySpan Exploration"), our wholly-owned subsidiary engaged in a joint venture with Houston Exploration. To the extent that such capitalized costs (net of accumulated depletion) less deferred taxes exceed the present value (using a 10% discount rate) of estimated future net cash flows from proved natural gas and oil reserves and the lower of cost or fair value of unproved properties, less deferred taxes, such excess costs are charged to operations, but would not have an impact on cash flows. Once incurred, such impairment of gas properties is not reversible at a later date even if gas prices increase.

The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, held flat over the life of the reserves. We use derivative financial instruments that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," to hedge the volatility of natural gas prices. In accordance with current SEC guidelines, we have included estimated future cash flows from our hedging program in the ceiling test calculation. As of December 31, 2003, we estimated, using a wellhead price of $5.79 per MCF, that our capitalized costs did not exceed the ceiling test limitation. At December 31, 2002, we estimated, using a wellhead price of $4.35 per MCF, that our capitalized costs did not exceed the ceiling test limitation.

In calculating the ceiling test at December 31, 2001, we estimated, using a wellhead price of $2.38 per MCF, that our capitalized costs exceeded the ceiling limitation. As a result, in the fourth quarter of 2001, a $42.0 million impairment charge to write down our gas exploration and production assets was recorded. This charge was recorded in depreciation, depletion and amortization on the Consolidated Statement of Income. KeySpan's share of the impairment charge was $26.2 million after-tax, or $0.19 per share.

Natural gas prices continue to be volatile and the risk that a wri
down to the full cost pool increases when, among other things, natu
gas prices are depressed, there are significant downward revisions ir
our estimated proved reserves or we have unsuccessful drilling resu

Houston Exploration capitalizes interest related to its unevalua
natural gas and oil properties, as well as some properties under development which are not currently being amortized. For years ended December 31, 2003, 2002 and 2001, capitalized interest w
$7.3 million, $8.0 million and $12.0 million, respectively.

G. Goodwill and Other Intangible Assets

The balance of goodwill and other intangible assets was $1.8 billion at December 31, 2003 and 2002, representing primarily the excess of acquisition cost over the fair value of net assets acquired. Goodwill and other intangible assets reflect the Eastern and ENI acquisitions, the KeySpan/LILCO transaction, as well as acquisitions of energy-related service companies and also relates to certain ownership interests of 50% or less in energy-related investments in Northern Ireland which are accounted for under the equity method.

The table below summarizes the goodwill and other intangible assets balance for each segment at December 31, 2003 and 2002:

	(In Thousands of Dollars)	
Year Ended December 31,	2003	2002
Operating Segment		
Gas Distribution	$1,436,917	$1,436,917
Energy Services	172,874	148,596
Energy Investments and other	199,921	210,712
	$1,809,712	$1,796,225

The increase in goodwill related to the Energy Services segment primarily reflects the acquisition of Bard, Rao + Athanas Consulting Engineers, LLC. ("BR+A"), a Boston, Massachusetts company engaged in the business of providing engineering services relating to heating, ventilation, and air conditioning systems. The purchase price was approximately $35 million, plus up to $14.7 million in contingent consideration depending on the financial performance of BR+A over the five-year period following the closing of the acquisition. We have recorded goodwill of approximately $26 million and intangible assets of approximately $2 million associated with this transaction. The intangible assets, which relate primarily to a portion of the backlog purchased, as well as to non-compete agreements entered into with all of the former owners of BR+A, will be amortized over two and three years, respectively.

The decrease in goodwill related to Energy Investments and other primarily reflects the sale of our 24.5% interest in Phoenix Natural Gas-Limited, located in Northern Ireland, and the related write-off of the goodwill associated with this investment.

On January 1, 2002, KeySpan adopted SFAS 142 "Goodwill and Other Intangible Assets". Under SFAS 142, among other things, goodwill is no longer required to be amortized and is to be tested for impairment at least annually. The initial impairment test was to be performed within six months of adopting SFAS 142 using a discounted cash flow method, compared to a undiscounted cash flow method allowed under a previous standard. Any amounts impaired using data as of January 1, 2002, was to be recorded as a "Cumulative Effect of an Accounting Change." Any amounts impaired using data after the initial adoption date will be recorded as an operating expense. During the second quarter of 2002, we completed our initial impairment analysis for all the reporting units and determined that no consolidated impairment existed. In the fourth quarter of 2002, KeySpan updated its review of the carrying value of goodwill compared to the fair value of the assets by reporting unit and determined that no impairment existed.

In the fourth quarter of 2003, KeySpan updated its review of the carrying value of goodwill associated with the Energy Services segment. KeySpan employed a combination of two methodologies in determining the fair value for its investment in the Energy Services segment, a market valuation approach and an income valuation approach. A third party specialist was engaged to assist with the valuation and evaluate the reasonableness of key assumptions employed. Under the market valuation approach, KeySpan compared relevant financial information relating to the companies included in the Energy Services segment to the corresponding financial information for a peer group of companies in the specialty trade-contracting sector of the construction industry. Under the income valuation approach, the fair value of a firm is obtained by discounting the sum of (i) the expected future cash flows to a firm; and (ii) the terminal value of a firm. As a result of our valuation, management has determined that the fair value of the assets adequately exceeds their carrying value and no impairment charge was necessary.

As required by SFAS 142, below is a reconciliation of reported earnings available for common stockholders for the years ended December 31, 2003, 2002 and 2001 and pro-forma net income, for the same periods, adjusted for the discontinuance of goodwill amortization.

	(In Thousands of Dollars, Except for Per Share Amounts)		
Year Ended December 31,	2003	2002	2001
Earnings for common stockholders	$380,886	$371,935	$218,350
Add back: goodwill amortization*	—	—	49,550
Adjusted net income	$380,886	$371,935	$267,900
Basic earnings per share	$ 2.41	$ 2.63	$ 1.58
Add back: goodwill amortization	—	—	0.36
Adjusted basic earnings per share	$ 2.41	$ 2.63	$ 1.94
Diluted earnings per share	$ 2.39	$ 2.61	$ 1.56
Add back: goodwill amortization	—	—	0.36
Adjusted diluted earnings per share	$ 2.39	$ 2.61	$ 1.92

* *Excludes the write-off of $12.4 million of goodwill in 2001 associated with the Roy Kay Operations.*

For the twelve months ended December 31, 2001, goodwill amortization was recorded in each segment as follows: Gas Distribution $35.6 million; Energy Services $8.2 million; and Energy Investments and other $5.8 million.

Prior to implementation of SFAS 142, goodwill was reviewed for impairment under SFAS 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." Under SFAS 121, the carrying value of goodwill was reviewed if the facts and circumstances, such as significant declines in sales, earnings or cash flows, or material adverse changes in the business climate, suggested it might be impaired. If this review indicated that goodwill was not recoverable, as determined based upon the estimated undiscounted cash flows of the entity acquired, impairment was measured by comparing the carrying value of the investment in such entity to its fair value.

G. Goodwill and Other Intangible Assets

The balance of goodwill and other intangible assets was $1.8 billion at December 31, 2003 and 2002, representing primarily the excess of acquisition cost over the fair value of net assets acquired. Goodwill and other intangible assets reflect the Eastern and ENI acquisitions, the KeySpan/LILCO transaction, as well as acquisitions of energy-related service companies and also relates to certain ownership interests of 50% or less in energy-related investments in Northern Ireland which are accounted for under the equity method.

The table below summarizes the goodwill and other intangible assets balance for each segment at December 31, 2003 and 2002:

	(In Thousands of Dollars)	
Year Ended December 31,	2003	2002
Operating Segment		
Gas Distribution	$1,436,917	$1,436,917
Energy Services	172,874	148,596
Energy Investments and other	199,921	210,712
	$1,809,712	$1,796,225

The increase in goodwill related to the Energy Services segment primarily reflects the acquisition of Bard, Rao + Athanas Consulting Engineers, LLC. ("BR+A"), a Boston, Massachusetts company engaged in the business of providing engineering services relating to heating, ventilation, and air conditioning systems. The purchase price was approximately $35 million, plus up to $14.7 million in contingent consideration depending on the financial performance of BR+A over the five-year period following the closing of the acquisition. We have recorded goodwill of approximately $26 million and intangible assets of approximately $2 million associated with this transaction. The intangible assets, which relate primarily to a portion of the backlog purchased, as well as to non-compete agreements entered into with all of the former owners of BR+A, will be amortized over two and three years, respectively.

The decrease in goodwill related to Energy Investments and other primarily reflects the sale of our 24.5% interest in Phoenix Natural Gas-Limited, located in Northern Ireland, and the related write-off of the goodwill associated with this investment.

On January 1, 2002, KeySpan adopted SFAS 142 "Goodwill and Other Intangible Assets". Under SFAS 142, among other things, goodwill is no longer required to be amortized and is to be tested for impairment at least annually. The initial impairment test was to be performed within six months of adopting SFAS 142 using a discounted cash flow method, compared to a undiscounted cash flow method allowed under a previous standard. Any amounts impaired using data as of January 1, 2002, was to be recorded as a "Cumulative Effect of an Accounting Change." Any amounts impaired using data after the initial adoption date will be recorded as an operating expense. During the second quarter of 2002, we completed our initial impairment analysis for all the reporting units and determined that no consolidated impairment existed. In the fourth quarter of 2002, KeySpan updated its review of the carrying value of goodwill compared to the fair value of the assets by reporting unit and determined that no impairment existed.

In the fourth quarter of 2003, KeySpan updated its review of the carrying value of goodwill associated with the Energy Services segment. KeySpan employed a combination of two methodologies in determining the fair value for its investment in the Energy Services segment, a market valuation approach and an income valuation approach. A third party specialist was engaged to assist with the valuation and evaluate the reasonableness of key assumptions employed. Under the market valuation approach, KeySpan compared relevant financial information relating to the companies included in the Energy Services segment to the corresponding financial information for a peer group of companies in the specialty trade-contracting sector of the construction industry. Under the income valuation approach, the fair value of a firm is obtained by discounting the sum of (i) the expected future cash flows to a firm; and (ii) the terminal value of a firm. As a result of our valuation, management has determined that the fair value of the assets adequately exceeds their carrying value and no impairment charge was necessary.

As required by SFAS 142, below is a reconciliation of reported earnings available for common stockholders for the years ended December 31, 2003, 2002 and 2001 and pro-forma net income, for the same periods, adjusted for the discontinuance of goodwill amortization.

	(In Thousands of Dollars, Except for Per Share Amounts)		
Year Ended December 31,	2003	2002	2001
Earnings for common stockholders	$380,886	$371,935	$218,350
Add back: goodwill amortization*	—	—	49,550
Adjusted net income	$380,886	$371,935	$267,900
Basic earnings per share	$ 2.41	$ 2.63	$ 1.58
Add back: goodwill amortization	—	—	0.36
Adjusted basic earnings per share	$ 2.41	$ 2.63	$ 1.94
Diluted earnings per share	$ 2.39	$ 2.61	$ 1.56
Add back: goodwill amortization	—	—	0.36
Adjusted diluted earnings per share	$ 2.39	$ 2.61	$ 1.92

* *Excludes the write-off of $12.4 million of goodwill in 2001 associated with the Roy Kay Operations.*

For the twelve months ended December 31, 2001, goodwill amortization was recorded in each segment as follows: Gas Distribution $35.6 million; Energy Services $8.2 million; and Energy Investments and other $5.8 million.

Prior to implementation of SFAS 142, goodwill was reviewed for impairment under SFAS 121 "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of." Under SFAS 121, the carrying value of goodwill was reviewed if the facts and circumstances, such as significant declines in sales, earnings or cash flows, or material adverse changes in the business climate, suggested it might be impaired. If this review indicated that goodwill was not recoverable, as determined based upon the estimated undiscounted cash flows of the entity acquired, impairment was measured by comparing the carrying value of the investment in such entity to its fair value.

Fair value was determined based on quoted market values, appraisals, or discounted cash flows. For the year ended December 31, 2001, we reviewed the facts and circumstances for the entities carrying goodwill and as a result of the above procedures, wrote off $12.4 million associated with the Roy Kay Companies upon determination that the asset was not recoverable. (See Note 10, "Roy Kay Operations" for additional information.)

H. Hedging and Derivative Financial Instruments

From time to time, we employ derivative instruments to hedge a portion of our exposure to commodity price risk and interest rate risk, as well as to hedge cash flow variability associated with a portion of our peak electric energy sales. Whenever hedge positions are in effect, we are exposed to credit risk in the event of nonperformance by counter-parties to derivative contracts, as well as nonperformance by the counter-parties of the transactions against which they are hedged. We believe that the credit risk related to the futures, options and swap instruments is no greater than that associated with the primary commodity contracts which they hedge. Our derivative instruments do not qualify as energy trading contracts as defined by current accounting literature.

Financially-Settled Commodity Derivative Instruments: We employ derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with forecasted purchases and sales of various energy-related commodities. All such derivative instruments are accounted for pursuant to the requirements of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS 149, "Amendment of Statement 133 Derivative Instruments and Hedging Activities" (collectively, "SFAS 133"). With respect to those commodity derivative instruments that are designated and accounted for as cash flow hedges, the effective portion of periodic changes in the fair market value of cash flow hedges is recorded as other comprehensive income on the Consolidated Balance Sheet, while the ineffective portion of such changes in fair value is recognized in earnings. Unrealized gains and losses (on such cash flow hedges) that are recorded as other comprehensive income are subsequently reclassified into earnings concurrent when hedged transactions impact earnings. With respect to those commodity derivative instruments that are not designated as hedging instruments, such derivatives are accounted for on the Consolidated Balance Sheet at fair value, with all changes in fair value reported in earnings.

Firm Gas Sales Derivatives Instruments - Regulated Utilities: We utilize derivative financial instruments to reduce cash flow variability associated with the purchase price for a portion of our future natural gas purchases. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. Since these derivative instruments are being employed to support our gas sales prices to regulated firm gas sales customers, the accounting for these derivative instruments is subject to SFAS 71. Therefore, changes in the market value of these derivatives are recorded as regulatory assets or regulatory liabilities on our Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers during the appropriate winter heating season consistent with regulatory requirements.

Physically-Settled Commodity Derivative Instruments: Upon implementation of Derivative Implementation Group ("DIG") Issue C16 on April 1, 2002, certain of our contracts for the physical purchase of natural gas were assessed as no longer being exempt from the requirements of SFAS 133 as normal purchases. As such, these contracts are recorded on the Consolidated Balance Sheet at fair market value. However, since such contracts were executed for the purchases of natural gas that is sold to regulated firm gas sales customers, and pursuant to the requirements of SFAS 71, changes in the fair market value of these contracts are recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet.

Weather Derivatives: The utility tariffs associated with our New England gas distribution operations do not contain a weather normalization adjustment. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate the effect of fluctuations from normal weather on our financial position and cash flows, we may enter into derivative instruments from time to time. Based on the terms of the contracts, we account for these instruments pursuant to the requirements of Emerging Issues Task Force ("EITF") 99-2 "Accounting for Weather Derivatives." In this regard, we account for weather derivatives using the "intrinsic value method" as set forth in such guidance.

Interest Rate Derivative Instruments: We continually assess the cost relationship between fixed and variable rate debt. Consistent with our objective to minimize our cost of capital, we periodically enter into hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable or variable to fixed. Payments made or received on these derivative contracts are recognized as an adjustment to interest expense as incurred. Hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable are designated and accounted for as fair-value hedges pursuant to the requirements of SFAS 133. Hedging transactions that effectively convert the terms of underlying debt obligations from variable to fixed are considered cash flow hedges.

I. Equity Investments

Certain subsidiaries own as their principal assets, investments (including goodwill), representing ownership interests of 50% or less in energy-related businesses that are accounted for under the equity method. None of these investments are publicly traded.

J. Income and Excise Tax

In accordance with SFAS 109, "Accounting for Income Taxes" and applicable rate regulation, certain of our regulated subsidiaries record a regulatory asset for the net cumulative effect of providing deferred income taxes on all differences between the financial statement carrying amounts of existing assets and liabilities, and their respective tax basis. Investment tax credits, which were available prior to the Tax Reform Act of 1986, were deferred and generally amortized as a reduction of income tax over the estimated lives of the related property.

We report our collections and payments of excise taxes on a gross basis. Gas distribution revenues include the collection of excise taxes, while operating taxes include the related expense. For the years ended December 31, 2003, 2002 and 2001, excise taxes collected and paid were $90.5 million, $83.1 million, $119.1 million, respectively.

K. Subsidiary Common Stock Issuances to Third Parties

We follow an accounting policy of income statement recognition for parent company gains or losses from issuances of common stock by subsidiaries to unaffiliated third parties.

L. Foreign Currency Translation

We follow the principles of SFAS 52, "Foreign Currency Translation," for recording our investments in foreign affiliates. Under this statement, all elements of the financial statements are translated by using a current exchange rate. Translation adjustments result from changes in exchange rates from one reporting period to another. At December 31, 2003 and 2002, the foreign currency translation adjustment was included on the Consolidated Balance Sheet. The functional currency for our foreign affiliates is their local currency.

M. Earnings Per Share

Basic earnings per share ("EPS") is calculated by dividing earnings for common stock by the weighted average number of shares of common stock outstanding during the period. No dilution for any potentially dilutive securities is included. Diluted EPS assumes the conversion of all potentially dilutive securities and is calculated by dividing earnings for common stock, as adjusted, by the sum of the weighted average number of shares of common stock outstanding plus all potentially dilutive securities.

At December 31, 2003 we have approximately 2 million options outstanding to purchase KeySpan common stock that were not used in the calculation of diluted EPS since the exercise price associated with these options was greater than the average per share market price of KeySpan's common stock. Further, we have 85,676 shares of convertible preferred stock outstanding that can be converted into 221,153 shares of common stock. These shares were not included in the calculation of diluted EPS for the year ending December 31, 2001 since to do so would have been anti-dilutive.

Under the requirements of SFAS 128, "Earnings Per Share" our basic and diluted EPS are as follows:

			(In Thousands of Dollars, Except Per Share Amounts)
Year Ended December 31,	2003	2002	2001
Earnings for common stock	$380,886	$371,935	$218,350
Houston Exploration dilution	(269)	(471)	(1,116)
Preferred stock dividend	514	531	—
Earnings for common stock - adjusted	$381,131	$371,995	$217,234
Weighted average shares outstanding (000)	158,256	141,263	138,214
Add dilutive securities:			
Options	755	809	1,007
Convertible preferred stock	221	228	—
Total weighted average shares outstanding - assuming dilution	159,232	142,300	139,221
Basic earnings per share	$ 2.41	$ 2.63	$ 1.58
Diluted earnings per share	$ 2.39	$ 2.61	$ 1.56

N. Stock Options and Other Stock Based Compensation

We issue stock options to all KeySpan officers and certain other management employees as approved by the Board of Directors. These options generally vest over a three-to-five year period and have exercise periods between 5-10 years. Up to approximately 21 million shares have been authorized for the issuance of options and approximately 7.0 million of these shares were remaining at December 31, 2003. Moreover, under a separate plan, Houston Exploration has issued and outstanding approximately 2.5 million stock options to key Houston Exploration employees. KeySpan and Houston Exploration have adopted the prospective method of transition in accordance with SFAS 148 "Accounting for Stock-Based Compensation - Transition and Disclosure." Accordingly, compensation expense has been recognized by employing the fair value recognition provisions of SFAS 123 "Accounting for Stock-Based Compensation" for grants awarded after January 1, 2003.

KeySpan and Houston Exploration continue to apply APB Opinion 25, "Accounting for Stock Issued to Employees," and related Interpretations in accounting for grants awarded prior to January 1, 2003. Accordingly, no compensation cost has been recognized for these fixed stock option plans in the Consolidated Financial Statements since the exercise prices and market values were equal on the grant dates. Had compensation cost for these plans been determined based on the fair value at the grant dates for awards under the plans consistent with SFAS 123, our net income and earnings per share would have decreased to the pro-forma amounts indicated below:

(In Thousands of Dollars, Except Per Share Amounts)

Year Ended December 31,	2003	2002	2001
Earnings available for common stock:			
As reported	$380,886	$371,935	$218,350
Add: recorded stock-based compensation expense, net of tax	3,650	221	261
Deduct: total stock-based compensation expense, net of tax	(9,358)	(7,547)	(8,459)
Pro-forma earnings	$375,178	$364,609	$210,152
Earnings per share:			
Basic - as reported	$ 2.41	$ 2.63	$ 1.58
Basic - pro-forma	$ 2.37	$ 2.58	$ 1.52
Diluted - as reported	$ 2.39	$ 2.61	$ 1.56
Diluted - pro-forma	$ 2.36	$ 2.56	$ 1.50

All grants are estimated on the date of the grant using the Black-Scholes option-pricing model. The following table presents the weighted average fair value, exercise price and assumptions used for the periods indicated:

Year Ended December 31,	2003	2002	2001
Fair value of grants issued	$ 4.26	$ 3.42	$ 5.29
Dividend yield	5.49%	5.36%	4.91%
Expected volatility	24.26%	22.47%	29.04%
Risk free rate	3.16%	4.94%	5.13%
Expected lives	6 years	10 years	10 years
Exercise price	$ 32.40	$ 32.66	$ 39.50

A summary of the status of our fixed stock option plans and changes is presented below for the periods indicated:

Year Ended December 31,	2003		2002		2001	
	Weighted Average		Weighted Average		Weighted Average	
Fixed Options	Shares	Exercise Price	Shares	Exercise Price	Shares	Exercise Price
Outstanding at beginning of period	9,524,900	$30.74	7,796,162	$29.67	6,456,627	$25.61
Granted during the year	1,650,450	$32.40	2,796,310	$32.66	2,285,350	$39.50
Exercised	(664,902)	$23.64	(506,794)	$24.42	(809,983)	$25.15
Forfeited	(189,705)	$34.63	(560,778)	$30.99	(135,832)	$29.19
Outstanding at end of period	10,320,743	$31.39	9,524,900	$30.74	7,796,162	$29.67
Exercisable at end of period	5,365,545	$28.76	4,105,999	$27.69	2,996,771	$24.86

Remaining Contractual Life	Options Outstanding at December 31, 2003	Weighted Average Exercise Price	Range of Exercise Price	Options Exercisable at December 31, 2003	Weighted Average Exercise Price	Range of Exercise Price
2 years	30,138	$25.98	$14.86 - 27.00	30,138	$25.98	$14.86 - 27.00
3 years	221,086	$30.43	$20.57 - 30.50	221,086	$30.43	$20.57 - 30.50
4 years	301,410	$32.56	$19.15 - 32.63	301,410	$32.56	$19.15 - 32.63
5 years	1,359,727	$27.86	$24.73 - 29.38	1,359,727	$27.86	$24.73 - 29.38
6 years	652,344	$26.97	$21.99 - 27.06	652,344	$26.97	$21.99 - 27.06
7 years	1,567,924	$22.79	$22.50 - 32.76	1,546,262	$22.64	$22.50 - 32.76
8 years	2,012,038	$39.50	$39.50	805,553	$39.50	$39.50
9 years	2,565,404	$32.66	$32.66	449,025	$32.66	$32.66
10 years	1,610,672	$32.40	$32.40	–	$32.40	$32.40
	10,320,743			5,365,545		

In early 2003, KeySpan's Board of Directors approved a modification to the Long-Term Incentive Compensation Plan design and its application to officers of KeySpan. Long-term incentive compensation for officers consist of 50% stock options and 50% performance shares. Performance shares will be awarded based upon the attainment of overall corporate performance goals and will better align incentive compensation with overall corporate performance. During 2002, and in prior years, the majority of long-term incentive compensation awards were stock option grants with a limited amount of restricted stock award grants.

O. Recent Accounting Pronouncements

In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46 ("FIN 46,") "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" which was revised in December 2003. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 was effective for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the original provisions of FIN 46 were to be applied for the first interim or annual period beginning after June 15, 2003. In October, the FASB delayed implementation of FIN 46 until the fourth quarter 2003 for certain variable interest entities. We currently have an arrangement with a variable interest entity through which we lease a portion of the Ravenswood facility. As required by FIN 46, this variable entity was consolidated at December 31, 2003. (See Note 7, "Contractual Obligations, Financial Guarantees and Contingencies - Variable Interest Entity" for a detailed description of this leasing arrangement.)

In April 2003, the FASB issued SFAS 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain instruments embedded in other

contracts and for hedging activities under Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities." This Statement: (i) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative; (ii) clarifies when a derivative contains a financing component; (iii) amends the definition of an underlying; and (iv) amends certain other existing pronouncements. The implementation of this Statement will not have a significant impact on our results of operations, financial condition or cash flows since our derivative instruments that meet the definition of a derivative and qualify for hedge accounting treatment will continue to do so. The Statement was effective for contracts entered into or modified after June 30, 2003.

In May 2003, the FASB issued SFAS 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify certain financial instruments as a liability (or an asset in some circumstances) when there is an obligation to redeem the issuer's shares and either requires or may require satisfaction of the obligation by transferring assets, or satisfy the obligation by issuing additional equity shares subject to certain criteria. This Statement was effective for financial instruments entered into or modified after May 31, 2003, and otherwise was effective at the beginning of the first interim period beginning after June 15, 2003. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. The implementation of this Statement did not have an impact on our results of operations, financial condition or cash flows.

In July 2003, the FASB concluded its discussions on EITF 03-11 "Reporting Realized Gains and Losses on Derivative Instruments That Are Subject to FASB Statement No. 133 *Accounting for Derivative Instruments and Hedging Activities and Not Held for Trading Purposes as Defined in EITF Issue No. 02-3 Issues Involved in Accounting for Derivative Contracts held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities.*" The Task Force reached a consensus that determining whether realized gains or losses on physically settled derivative contracts not "held for trading purposes" should be reported in the income statement on a gross or net basis is a matter of judgment that depends on the relevant facts and circumstances. KeySpan reports realized gains or losses on its derivative instruments that hedge the cash flow variability associated with the forecasted sales of natural gas and electricity in its reported revenues at time of their settlement. Realized gains or losses on derivative instruments that hedge the cash flow variability associated with the forecasted purchase of natural gas or fuel oil are reported in operating expense. We believe that this EITF does not have a significant impact on our results of operations, financial condition or cash flows. This Statement was effective October 1, 2003.

In December 2003, the FASB issued SFAS 132 (revised 2003) "Employers' Disclosures about Pensions and Other Postretirement Benefits." This Statement revises employers' disclosures about pension and other postretirement benefit plans. This Statement retains the disclosure requirements contained in FASB Statement 132 "Employers' Disclosures about Pensions and Other Postretirement Benefits", which it replaces. It requires additional disclosures to those in the original Statement 132 about assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit postretirement plans. KeySpan has implemented all the requirements of this Statement in Footnote 4 "Postretirement Benefits."

P. Impact of Change in Accounting Principles

KeySpan has an arrangement with a variable interest entity through which it leases a portion of the 2,200-megawatt Ravenswood electric generation facility. On December 31, 2003, KeySpan adopted FIN 46. This pronouncement required KeySpan to consolidate its variable interest entity, which had a fair market value of a $425 million at the inception of the lease, June 1999. As a result, KeySpan recorded a $37.6 million after-tax charge, or $0.23 per share, change in accounting principle on the Consolidated Statement of Income, representing approximately four and a half years of depreciation. (See Note 7, "Contractual Obligations, Financial Guarantees and Contingencies - Variable Interest Entity" for a detailed description of the impact of the adoption of this standard.)

On January 1, 2003, KeySpan adopted SFAS 143, "Accounting for Asset Retirement Obligations." SFAS 143 requires an entity to record a liability and corresponding asset representing the present value of legal obligations associated with the retirement of tangible, long-lived assets. The cumulative effect of SFAS 143 and the change in accounting principle was a benefit to net income of $0.2 million, after-tax. (See Note 7, "Contractual Obligations, Financial Guarantees and Contingencies - Asset Retirement Obligation" for further details.)

Under Accounting Principle Board Opinion No. 20 ("APB 20"), the pro-forma impact of the retroactive application resulting from the adoption of a change in accounting principle is to be disclosed as follows:

Year Ended December 31,	2003	2002	2001
			(In Thousands of Dollars, Except Per Share Amounts)
Earnings for common stock	$380,886	$371,935	$218,350
Add back: Cumulative effect of a change in accounting principle	37,451	—	—
Earnings for common stock before cumulative effect of a change in accounting principle:			
As reported	418,337	371,935	218,350
Less: SFAS 143 Accretion expense, net of taxes	—	(1,135)	(1,067)
Less: FIN 46 Depreciation expense, net of taxes	(9,538)	(8,024)	(8,024)
Add: SFAS 143 Costs of removal expense, net of taxes	—	471	471
Pro-forma earnings	$408,799	$363,247	$209,730
Earnings per share before cumulative change in accounting principle:			
Basic – as reported	$ 2.64	$ 2.63	$ 1.58
Basic – pro-forma	$ 2.58	$ 2.57	$ 1.52
Diluted – as reported	$ 2.62	$ 2.61	$ 1.56
Diluted – pro-forma	$ 2.57	$ 2.55	$ 1.51
Earnings per share for common stock:			
Basic – as reported	$ 2.41	$ 2.63	$ 1.58
Basic – pro-forma	$ 2.58	$ 2.57	$ 1.52
Diluted – as reported	$ 2.39	$ 2.61	$ 1.56
Diluted – pro-forma	$ 2.57	$ 2.55	$ 1.51

Q. Accumulated Other Comprehensive Income

As required by SFAS 130, "Reporting Comprehensive Income", the components of accumulated other comprehensive income are as follows:

Year Ended December 31,	2003	2002
		(In Thousands of Dollars)
Foreign currency translation adjustments	$ 26,523	$ (2,173)
Unrealized (losses) on marketable securities	(7,530)	(16,012)
Premium on derivative instrument	(3,437)	–
Accrued unfunded pension obligation	(60,650)	(69,031)
Unrealized (losses) on derivative financial instruments	(23,546)	(21,207)
Accumulated other comprehensive income	$(68,640)	$(108,423)

Note 2. Business Segments

We have four reportable segments: Gas Distribution, Electric Services, Energy Services and Energy Investments.

The Gas Distribution segment consists of our six gas distribution subsidiaries. KEDNY provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Staten Island and a portion of the Borough of Queens. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. The remaining gas distribution subsidiaries, collectively doing business as KEDNE, provide gas distribution service to customers in Massachusetts and New Hampshire.

The Electric Services segment consists of subsidiaries that: operate the electric transmission and distribution system owned by LIPA; own and provide capacity to and produce energy for LIPA from our generating facilities located on Long Island; and manage fuel supplies for LIPA to fuel our Long Island generating facilities. These services are provided in accordance with long-term service contracts having remaining terms that range from three to eleven years and power purchase agreements for 25 years. The Electric Services segment also includes subsidiaries that own, lease and operate the 2,200 megawatt Ravenswood electric generation facility located in Queens, New York. All of the energy, capacity and ancillary services related to the Ravenswood facility is sold to the NYISO energy markets. KeySpan is currently analyzing proposals from interested investors to participate in a leveraged lease financing of a new 250 MW combined cycle electric generating facility located at the existing Ravenswood facility site. (See Note 15, "Subsequent Events" for further details.)

The Energy Services segment includes companies that provide energy-related and a minimal amount of fiber optic services to customers primarily located within the Northeastern United States, with concentrations in the New York City metropolitan area, including New Jersey and Connecticut, as well as Rhode Island, Pennsylvania, Massachusetts and New Hampshire, through the following lines of business: (i) Home Energy Services, which provides residential customers with service and maintenance of energy systems and appliances, as well as the retail marketing of electricity to commercial customers; and (ii) Business Solutions, which provides plumbing, heating, ventilation, air conditioning and mechanical services, as well as operation and maintenance, design, engineering and consulting services to commercial and industrial customers.

In 2003, KeySpan Services, Inc. and its wholly-owned subsidiary Paulus, Sokolowski, and Sartor, LLC. acquired Bard, Rao + Athanas Consulting Engineers, LLC. ("BR+A"), a Boston, Massachusetts company engaged in the business of providing engineering services relating to heating, ventilation, and air conditioning systems. The purchase price was approximately $35 million, plus up to $14.7 million in contingent consideration depending on the financial performance of BR+A over the five-year period following the closing of the acquisition. We have recorded goodwill of $26 million and intangible assets of $2 million associated with this transaction. The intangible assets, which relate primarily to a portion of the backlog purchased, as well as to non-compete agreements entered into with all of the former owners of BR+A, will be amortized over two and three years, respectively. In 2003, KeySpan's gas and electric marketing subsidiary, KeySpan Energy Services Inc., assigned the majority of its retail natural gas customers, consisting mostly of residential and small commercial customers, to ECONnergy Energy Co., Inc. ("ECONnergy"). KeySpan Energy Services will continue its electric marketing activities.

The Energy Investments segment consists of our gas exploration and production investments, as well as certain other domestic and international energy-related investments. Our gas exploration and production subsidiaries are engaged in gas and oil exploration and production, and the development and acquisition of domestic natural gas and oil properties. These investments consist of our 55% equity interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company, as well as our wholly-owned subsidiary KeySpan Exploration and Production, LLC, our wholly owned subsidiary engaged in a joint venture with Houston Exploration. In February 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. We realized net proceeds of $79 million in connection with this repurchase. KeySpan follows an accounting policy of income statement recognition for Parent company gains or losses from common stock transactions initiated by its subsidiaries. As a result, KeySpan realized a gain of $19 million on this transaction, which is reflected in other income and (deductions) on the Consolidated Statement of Income. Income taxes were not provided, since this transaction was structured as a return of capital.

In the fourth quarter of 2003, Houston Exploration acquired the entire Gulf of Mexico shallow-water asset base of Transworld Exploration and Production, Inc. for $149 million. The properties, which are 75% natural gas, have proven reserves of 92 billion cubic feet of natural gas equivalent. Current production from 11 fields is approximately 35 million cubic feet of natural gas equivalent per day. Houston Exploration funded the transaction from its bank revolving credit facility and with cash on hand at the time of closing.

Subsidiaries in this segment also hold a 20% equity interest in the Iroquois Gas Transmission System LP, a pipeline that transports Canadian gas supply to markets in the Northeastern United States; and a 50% interest in the Premier Transmission Pipeline Limited in Northern Ireland. These subsidiaries are accounted for under the equity method. Accordingly, equity income from these investments is reflected as a component of operating income in the Consolidated Statement of Income. In the fourth quarter of 2003, we completed the sale of our 24.5% interest in Phoenix Natural Gas-Limited for $96 million and recorded a pre-tax gain of $24.7 million in other income and (deductions) on the Consolidated Statement of Income.

We also have investments in certain midstream natural gas assets in Western Canada through KeySpan Canada. These assets include 14 processing plants and associated gathering systems that can process approximately 1.5 BCFe of natural gas daily and provide associated natural gas liquids fractionation. In 2003, we sold a portion of our interest in KeySpan Canada through the establishment of an open-ended income fund trust ("KeySpan Facilities Income Fund" or the "Fund") organized under the laws of Alberta, Canada. The Fund acquired a 39.09% ownership interest in KeySpan Canada through an indirect subsidiary, and then issued 17 million trust units to the public through an initial public offering. Each trust unit represents a beneficial interest in the Fund and is registered on the Toronto Stock Exchange under the symbol KEY.UN. Additionally, we sold our 20% interest in Taylor NGL LP that owns and operates two extraction plants also in Canada to AltaGas Services, Inc. Net proceeds of $119.4 million from the two sales, plus proceeds of $45.7 million drawn under a new credit facility made available to KeySpan Canada, were used to pay down existing KeySpan Canada credit facilities of $160.4 million. A pre-tax loss of $30.3 million was recognized on the transactions and is included in other income and (deductions) on the Consolidated Statement of Income. These transactions produced a tax expense of $3.8 million as a result of certain United States partnership tax rules and resulted in an after-tax loss of $34.1 million. In February 2004, KeySpan entered into an agreement to sell an additional 36% of its interest in KeySpan Canada. (See Note 15, to the Consolidated Financial Statements "Subsequent Events.")

The accounting policies of the segments are the same as those used for the preparation of the Consolidated Financial Statements. Our segments are strategic business units that are managed separately because of their different operating and regulatory environments. Operating results of our segments are evaluated by management on an operating income basis. Due to the July 2002 sale of Midland Enterprises LLC, an inland marine barge business, this subsidiary is reported as discontinued operations for 2002 and 2001. (See Note 9 "Discontinued Operations" for more information on the sale of Midland).

The reportable segment information below is shown excluding the operations of Midland:

(In Thousands of Dollars)

	Gas Distribution	Electric Services	Energy Services	Gas Exploration and Production	Other Investments	Eliminations	Consolidated
Year Ended December 31, 2003							
Unaffiliated revenue	4,161,272	1,503,086	641,432	501,255	108,116	—	6,915,161
Intersegment revenue	—	101	8,158	—	5,008	(13,267)	—
Depreciation, depletion and amortization	259,934	66,843	9,869	204,102	19,046	14,280	574,074
Sales of property	15,123	—	—	—	—	—	15,123
Income from equity investments	—	—	—	—	19,106	108	19,214
Operating income	574,254	268,977	(38,066)	197,209	41,345	(2,062)	1,041,657
Interest income	1,194	4,628	1,070	—	1,002	(2,235)	5,659
Interest charges	203,733	43,065	16,863	8,504	7,541	27,988	307,694
Total assets	8,444,071	2,473,076	445,534	1,530,875	915,383	817,845	14,626,784
Equity method investments	—	—	—	—	97,018	—	97,018
Construction expenditures	419,549	256,498	9,305	295,943	18,154	12,267	1,011,716

Eliminating items include intercompany interest income and expense, the elimination of certain intercompany accounts, as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.5 billion for the year ended December 31, 2003, represents approximately 22% of our consolidated revenues during that period.

(In Thousands of Dollars)

	Gas Distribution	Electric Services	Energy Services	Gas Exploration and Production	Other Investments	Eliminations	Consolidated
Year Ended December 31, 2002							
Unaffiliated revenue	3,163,761	1,421,043	938,761	357,451	89,650	—	5,970,666
Intersegment revenue	—	100	—	—	1,128	(1,228)	—
Depreciation, depletion and amortization	237,186	61,377	9,522	176,925	14,573	15,030	514,613
Sales of property	903	1,479	—	—	2,348	—	4,730
Income from equity investments	—	—	—	—	13,992	104	14,096
Operating income	531,134	288,796	(11,935)	110,259	32,335	(8,507)	942,082
Interest income	2,020	1,834	1,248	—	238	(3,768)	1,572
Interest charges	215,140	57,589	19,386	7,303	6,858	(4,772)	301,504
Total assets	7,783,011	1,775,244	497,269	1,187,425	974,409	762,692	12,980,050
Equity method investments					130,815	—	130,815
Construction expenditures	412,433	348,147	11,648	241,477	31,243	16,074	1,061,022

Eliminating items include intercompany interest income and expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.4 billion for the year ended December 31, 2002 represents approximately 24% of our consolidated revenues during that period.

	Gas Distribution	Electric Services	Energy Services	Gas Exploration and Production	Other Investments	Eliminations	Consolidated
							(In Thousands of Dollars)
Year Ended December 31, 2001							
Unaffiliated revenue	3,613,551	1,421,079	1,100,167	400,031	98,287	—	6,633,115
Intersegment revenue	—	100	—	—	—	(100)	—
Depreciation, depletion and amortization	253,523	52,284	33,636	184,717	15,737	19,241	559,138
Income from equity investments	—	—	—	—	13,129	—	13,129
Operating income	481,393	269,721	(147,485)	159,661	19,122	31,366	813,778
Interest income	3,879	433	3,185	—	334	495	8,326
Interest charges	219,307	46,842	21,106	2,993	9,772	53,450	353,470
Total assets	6,994,140	1,677,710	550,891	951,135	797,294	818,436	11,789,606
Equity method investments	—	—	—	—	107,069	—	107,069
Construction expenditures	384,323	211,816	17,134	385,463	52,513	8,510	1,059,759

Eliminating items include intercompany interest income and expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.4 billion for the year ended December 31, 2001 represents approximately 21% of our consolidated revenues during that period

NOTE 3. INCOME TAX

KeySpan files a consolidated federal income tax return. A tax sharing agreement between the holding company and its subsidiaries provides for the allocation of a realized tax liability or benefit based upon separate return contributions of each subsidiary to the consolidated taxable income or loss in the consolidated income tax return. The subsidiaries record income tax payable or receivable from KeySpan resulting from the inclusion of their taxable income or loss in the consolidated return.

Income tax expense is reflected as follows in the Consolidated Statement of Income:

			(In Thousands of Dollars)
Year Ended December 31,	2003	2002	2001
Current income tax	$(104,355)	$ (24,212)	$101,738
Deferred income tax	381,666	267,691	108,955
Total income tax	$ 277,311	$243,479	$210,693

At December 31, the significant components of the KeySpan's deferred tax assets and liabilities calculated under the provisions of SFAS No.109 "Accounting for Income Taxes" were as follows:

		(In Thousands of Dollars)
December 31,	2003	2002
Reserves not currently deductible	$ 34,342	$ 38,275
New York corporation income tax	(56,188)	(13,997)
Property related differences	(1,049,237)	(818,116)
Regulatory tax asset	(16,532)	(18,690)
Property taxes	(98,089)	(52,339)
Other items - net	(87,947)	(12,146)
Net deferred tax liability	$(1,273,651)	$(877,013)

During the year ended December 31, 2002, an adjustment to deferred income taxes of $177.7 million was recorded to reflect a decrease in the tax basis of the assets acquired at the time of the KeySpan/LILCO combination. This adjustment resulted from a revised valuation study. Concurrent with this deferred tax adjustment, KeySpan reduced current income taxes payable by $183.2 million, resulting in a net $5.5 million income tax benefit. Currently, the Internal Revenue Service is auditing KeySpan's tax returns pertaining to the KeySpan/LILCO combination, as well as other return years. At this time, we cannot predict the outcome of the ongoing audit.

The federal income tax amounts included in the Statement of Income differ from the amounts which result from applying the statutory federal income tax rate to income before income tax.

The table below sets forth the reasons for such differences:

			(In Thousands of Dollars)
Year Ended December 31,	2003	2002	2001
Computed at the statutory rate	$245,522	$224,290	$159,035
Adjustments related to:			
Tax credits	—	(1,026)	(1,100)
Removal costs	(6,592)	(4,787)	(1,470)
Accrual to return adjustment	549	(9,539)	2,354
Goodwill amortization	—	—	21,126
Minority interest in Houston Exploration	19,969	9,490	13,862
State income tax	28,462	42,125	26,418
Other items – net	(10,599)	(17,074)	(9,532)
Total income tax	$277,311	$243,479	$210,693
Effective income tax rate (1)	40%	38%	46%

(1) Reflects both federal as well as state income taxes

Note 4. Postretirement Benefits

Pension Plans: The following information represents the consolidated results for our noncontributory defined benefit pension plans which cover substantially all employees. Benefits are based on years of service and compensation. Funding for pensions is in accordance with requirements of federal law and regulations. KEDLI and Boston Gas Company are subject to certain deferral accounting requirements mandated by the NYPSC and DTE, respectively for pension costs and other postretirement benefit costs.

Information pertaining to discontinued operations has been excluded from this presentation.

The calculation of net periodic pension cost is as follows:

			(In Thousands of Dollars)
Year Ended December 31,	2003	2002	2001
Service cost, benefits earned during the period	$ 47,531	$42,423	$ 41,162
Interest cost on projected benefit obligation	138,270	132,424	128,481
Expected return on plan assets	(130,556)	(157,958)	(180,757)
Net amortization and deferral	66,949	(4,247)	(39,772)
Total pension (benefit) cost	$122,194	$12,642	$(50,886)

The following table sets forth the pension plans' funded status at December 31, 2003 and December 31, 2002.

		(In Thousands of Dollars)
Year Ended December 31,	2003	2002
Change in benefit obligation:		
Benefit obligation at beginning of period	$(2,080,193)	$(1,915,154)
;ervice cost	(47,531)	(42,423)
nterest cost	(138,270)	(132,424)
mendments	(3,079)	(2,932)
ctuarial (loss)	(192,617)	(103,988)
enefits paid	118,494	116,728
nefit obligation at end of period	(2,343,196)	(2,080,193)
ange in plan assets:		
value of plan assets at eginning of period	1,544,518	1,899,256
ual return on plan assets	335,757	(347,270)
loyer contribution	93,458	109,260
fits paid	(118,494)	(116,728)
alue of plan assets at end of period	1,855,239	1,544,518
ed status	(487,957)	(535,675)
ognized net loss from past experience erent from that assumed and from nges in assumptions	557,204	627,199
gnized prior service cost	64,925	71,126
gnized transition obligation	—	237
paid pension cost reflected on olidated balance sheet	$ 134,172	$ 162,887

Year Ended December 31,	2003	2002	2001
Assumptions:			
Obligation discount	6.25%	6.75%	7.00%
Asset return	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	4.00%

Unfunded Pension Obligation: At December 31, 2003 the accumulated benefit obligation was in excess of pension assets. As prescribed by SFAS 87 "Employers' Accounting for Pensions," KeySpan had a $244.4 million minimum liability at December 31, 2003, for this unfunded pension obligation. As permitted under current accounting guidelines, these accruals can be offset by a corresponding debit to long-term asset up to the amount of accumulated unrecognized prior service costs. Any remaining amount is to be recorded in other comprehensive income on the Consolidated Balance Sheet.

Therefore, at year-end, we had a long-term asset in deferred charges other of $55.3 million, representing the amount of unrecognized prior service cost and a debit to other comprehensive income of $93.3 million, or $60.6 million after-tax. The remaining amount of $95.8 was recorded as a contractual receivable, representing the amount that would have been recovered from LIPA in accordance with our service agreements if the underlying assumptions giving rise to this minimum liability were realized and recorded as pension expense.

At December 31, 2003 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in excess of plan assets were $1.2 billion, $1.1 billion and $794 million.

At December 31, 2002, the accumulated benefit obligation was also in excess of pension assets. As a result, we had an additional minimum liability of $286.3 million, a long-term asset in deferred charges other of $61.5 million, and a debit to other comprehensive income of $106.2 million, or $69.0 million after-tax. The remaining amount of $118.6 was recorded as a contractual receivable from LIPA.

At December 31, 2002 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in plan assets were $1.1 billion, $948 million and $621 million, respectively.

At the end of the year, we will re-measure the accumulated benefit obligation and pension assets, and adjust the accrual and deferrals as appropriate.

Other Postretirement Benefits: The following information represents the consolidated results for our noncontributory defined benefit plans covering certain health care and life insurance benefits for retired employees. We have 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.

Net periodic other postretirement benefit cost included the following components:

			(In Thousands of Dollars)
Year Ended December 31,	2003	2002	2001
Service cost, benefits earned during the period	$18,825	$16,566	$20,339
Interest cost on accumulated postretirement benefit obligation	69,803	65,486	64,649
Expected return on plan assets	(27,530)	(36,839)	(42,822)
Net amortization and deferral	35,815	17,527	11,664
Other postretirement cost	$96,913	$62,740	$53,830

The following table sets forth the plans' funded status at December 31, 2003 and December 31, 2002.

		(In Thousands of Dollars)
Year Ended December 31,	2003	2002
Change in benefit obligation:		
Benefit obligation at beginning of period	$(1,056,944)	$(969,692)
Service cost	(18,825)	(16,566)
Interest cost	(69,803)	(65,486)
Plan participants' contributions	(1,757)	(1,587)
Amendments	35,458	57,984
Actuarial (loss)	(209,446)	(115,563)
Benefits paid	53,693	53,966
Benefit obligation at end of period	(1,267,624)	(1,056,944)
Change in plan assets:		
Fair value of plan assets at beginning of period	361,166	476,146
Actual return on plan assets	85,625	(82,950)
Employer contribution	43,578	20,349
Plan participants' contributions	1,757	1,587
Benefits paid	(53,693)	(53,966)
Fair value of plan assets at end of period	438,433	361,166
Funded status	(829,191)	(695,778)
Unrecognized net loss from past experience different from that assumed and from changes in assumptions	573,277	464,269
Unrecognized prior service cost	(89,034)	(60,104)
Accrued postretirement cost reflected on consolidated balance sheet	$ (344,948)	$(291,613)

Year Ended December 31,	2003	2002	2001
Assumptions:			
Obligation discount	6.25%	6.75%	7.00%
Asset return	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	4.00%

The measurement of plan liabilities also assumes a health care cost trend rate of 11% grading down to 5% over five years, and 5% thereafter. A 1% increase in the health care cost trend rate would have the effect of increasing the accumulated postretirement benefit obligation as of December 31, 2003 by $149.9 million and the net periodic health care expense by $12.3 million. A 1% decrease in the health care cost trend rate would have the effect of decreasing the accumulated postretirement benefit obligation as of December 31, 2003 by $131.8 million and the net periodic health care expense by $10.5 million.

At December 31, 2003, KeySpan had a contractual receivable from LIPA of $226.3 million representing the postretirement benefits associated with the electric business unit employees recorded in deferred charges other on the Consolidated Balance Sheet. LIPA has been reimbursing us for costs related to the postretirement benefits of the electric business unit employees in accordance with the LIPA Agreements.

KeySpan's retiree health benefit plan currently includes a prescription drug benefit that is provided to retired employees. In December 2003, new Medicare legislation (the Medicare Prescription Drug, Improvement and Modernization Act of 2003 - "the Medicare Act") was enacted that may ultimately affect KeySpan's obligations and expense related to retiree health benefits. Keyspan has elected to defer accounting for the effects of the Medicare Act, as permitted by FASB Staff Position 106-1 "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003". Therefore, any measure of the accumulated postretirement benefit obligation or retiree benefit costs reflected in the accompanying notes do not reflect the effects of this new legislation. In consideration of this new law, KeySpan may need to amend certain benefit plans and, therefore, the impact of the Medicare Act on KeySpan's financial condition and cash flows can not be determined with any degree of certainty at this time. Further, the FASB will be issuing specific guidance on the accounting for the subsidy arising under the Medicare Act and that guidance, when issued, could require KeySpan to change previously reported information.

Pension/Other Post Retirement Benefit Plan Assets: Keyspan's weighted average asset allocations at December 31, 2003 and 2002, by asset category, for both the pension and other postretirement benefit plans are as follows:

	Pension		OPEB	
	2003	2002	2003	2002
Asset Category				
Equity securities	61%	54%	68%	60%
Debt securities	31%	30%	26%	28%
Cash and equivalents	2%	8%	2%	7%
Venture capital	6%	8%	4%	5%
Total	100%	100%	100%	100%

The long-term rate of return on assets (pre-tax) is assumed to be 8.5% which management believes is an appropriate long-term expected rate of return on assets based on our investment strategy, asset allocation mix and the historical performance of equity investments over long periods of time. The actual ten- year compound rate of return for our Plans is greater than 8.5%.

Our master trust investment allocation policy target for the assets of the pension and other postretirement benefit plans is 70% equity and 30% fixed income.

During 2003, KeySpan conducted an asset and liability study projecting asset returns and expected benefit payments over a ten-year period. Based on the results of the study, KeySpan has developed a multi-year funding strategy for its plans. We believe that it is reasonable to assume assets can achieve or outperform the assumed long-term rate of return with the target allocation as a result of historical out-performance of equity investments over long-term periods.

Cash Contributions: In 2004, KeySpan is expected to contribute approximately $89 million to its pension plans and approximately $58 million to its other postretirement benefit plans.

Defined Contribution Plan: KeySpan also offers both its union and management employees a defined contribution plan. Both the KeySpan Energy 401(k) Plan for Management Employees and the KeySpan Energy 401(k) Plan for Union Employees are available to all eligible employees. These Plans are defined contribution plans subject to Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"). All eligible employees contributing to the Plan receive a certain employer matching contribution based on a percentage of the employee contribution, as well as a 10% discount on the KeySpan Common Stock Fund. The matching contributions are in KeySpan's common stock. For the years ended December 31, 2003, 2002 and 2001, we recorded an expense of $11.2 million, $11.2 million, and $11.0 million respectively.

Note 5. Capital Stock

Common Stock: Currently we have 450,000,000 shares of authorized common stock. In 1998, we initiated a program to repurchase a portion of our outstanding common stock on the open market. At December 31, 2003, we had 13.1 million shares, or approximately $378.5 million of treasury stock outstanding. We completed this repurchase plan in 1999 and have since utilized treasury stock to satisfy our common stock benefit plans. During 2003, we issued 3.3 million shares out of treasury for the dividend reinvestment feature of our Investor Program, the Employee Stock Discount Purchase Plan, the 401(k) Plan and Stock Option Plans.

On January 17, 2003, we issued 13.9 million shares of common stock in a public offering that generated net proceeds of approximately $473 million. All shares were offered by KeySpan pursuant to an effective shelf registration statement filed with the SEC.

Preferred Stock: We have the authority to issue 100,000,000 shares of preferred stock with the following classifications: 16,000,000 shares of preferred stock, par value $25 per share; 1,000,000 shares of preferred stock, par value $100 per share; and 83,000,000 shares of preferred stock, par value $.01 per share.

At December 31, 2003 we had 553,000 shares outstanding of 7.07% Preferred Stock Series B par value $100; 197,000 shares outstanding of 7.17% Preferred Stock Series C par value $100; and 85,676 shares outstanding of 6% Preferred Stock Series A par value $100, in the aggregate totaling $83.6 million.

In September 2003, the Boston Gas Company redeemed all 562,700 shares of its outstanding Variable Term Cumulative Preferred Stock, 6.42% Series A at its par value of $25 per share. The total payment was $14.3 million, which included $0.2 million of accumulated dividends. This preferred stock series had been reflected as Minority Interest on KeySpan's Consolidated Balance Sheet.

Note 6. Long-Term Debt

Notes Payable: KEDLI had $125 million of Medium-Term Notes at 6.90% due January 15, 2008, and $400 million of 7.875% Medium-Term Notes due February 1, 2010, outstanding at December 31, 2003, each of which is guaranteed by KeySpan.

Further, KeySpan had $2.36 billion of medium and long-term notes outstanding at December 31, 2003 of which $1.65 billion of these notes are associated with the acquisition of Eastern and ENI. These notes were issued in three series as follows: $700 million, 7.25% Notes due 2005; $700 million, 7.625% Notes due 2010 and $250 million, 8.00% Notes due 2030. The remaining notes of $710 million have interest rates ranging from 6.15% to 9.75% and mature in 2005-2025.

In 2003, we issued $300 million of medium-term and long-term debt. The debt was issued in the following two series: (i) $150 million 4.65% Notes due 2013; and (ii) $150 million 5.875% Notes due 2033. The proceeds of this issuance were used to pay down outstanding commercial paper.

Also during 2003, KeySpan Canada, issued Cdn$125 million, or approximately US$93 million, long-term secured notes in a private placement to investors in Canada and the United States. The notes were issued in the following three series: (i) Cdn$20 million 5.42% senior secured notes due 2008; (ii) Cdn$52.5 million 5.79% senior secured notes due 2010; and (iii) Cdn$52.5 million 6.16% senior secured notes due 2013. The proceeds of the offering have been used to re-pay KeySpan Canada's credit facility.

In 2003 Houston Exploration finalized a private placement issuance of $175 million of 7.0%, senior subordinated notes due 2013. Interest payments began on December 15, 2003, and will be paid semi-annually thereafter. The notes will mature on June 15, 2013. Houston Exploration has the right to redeem the notes as of June 15, 2008, at a price equal to the issue price plus a specified redemption premium. Until June 15, 2006, Houston Exploration may also redeem up to 35% of the notes at a redemption price of 107% with proceeds from an equity offering. Houston Exploration incurred approximately $4.5 million of debt issuance costs on this private placement.

Houston Exploration used a portion of the net proceeds from the issuance to redeem all of its outstanding $100 million principal amount of 8.625% senior subordinated notes due 2008 at a price of 104.313% of par plus interest accrued to the redemption date. Debt redemption costs totaled approximately $5.9 million and is reflected in other income and (deductions) in the Consolidated Statement of Income. The remaining net proceeds from the offering were used to reduce debt amounts associated with Houston Exploration's bank revolving credit facility.

Gas Facilities Revenue Bonds: KEDNY can issue tax-exempt bonds through the New York State Energy Research and Development Authority. Whenever bonds are issued for new gas facilities projects, proceeds are deposited in trust and subsequently withdrawn to finance qualified expenditures. There are no sinking fund requirements on any of our Gas Facilities Revenue Bonds. At December 31, 2003, KEDNY had $648.5 million of Gas Facilities Revenue Bonds outstanding. The interest rate on the variable rate series due December 1, 2020 is reset weekly and ranged from 0.60% to 1.20% during the year ended December 31, 2003, at which time the rate was 1.10%.

Promissory Notes: In connection with the KeySpan/LILCO transaction, KeySpan and certain of its subsidiaries issued promissory notes to LIPA to support certain debt obligations assumed by LIPA. The remaining principal amount of promissory notes issued to LIPA was approximately $600 million at December 31, 2002. In 2003 we called approximately $447 million aggregate principal amount of such promissory notes at the applicable redemption prices plus accrued and unpaid interest through the dates of redemption. Therefore, at December 31, 2003, $155.4 million of these promissory notes remained outstanding. Under these promissory notes, KeySpan is required to obtain letters of credit to secure its payment obligations if its long-term debt is not rated at least in the "A" range by at least two nationally recognized statistical rating agencies. At December 31, 2003, KeySpan was in compliance with this requirement.

Interest savings associated with this redemption were $15.6 million after-tax, or $0.10 per share, in 2003. We applied the provisions of SFAS 145 "Rescission of FASB Statement No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections" and recorded an expense of $18.2 million, reflecting redemption costs, as well as the write-off of previously deferred debt issuance costs. This expense has been recorded in other income and (deductions) in the Consolidated Statement of Income.

MEDS Equity Units: At December 31, 2003, KeySpan had $460 million of MEDS Equity Units outstanding at 8.75% consisting of a three-year forward purchase contract for our common stock and a six-year note. The purchase contract commits us, three years from the date of issuance of the MEDS Equity Units, May 2005, to issue and the investors to purchase, a number of shares of our common stock based on a formula tied to the market price of our common stock at that time. The 8.75% coupon is composed of interest payments on the six-year note of 4.9% and premium payments on the three-year equity forward contract of 3.85%. These instruments have been recorded as long-term debt on the Consolidated Balance Sheet. Further, upon issuance of the MEDS Equity Units, we recorded a direct charge to retained earnings of $49.1 million, which represents the present value of the forward contract's premium payments.

There were eight million MEDS Equity units issued which are subject to conversion upon execution of the three-year forward purchase contract. The number of shares to be issued depends on the average closing price of our common stock over the 20 day trading period ending on the third trading day prior to May 16, 2005. If the average closing price over this time frame is less than or equal to $35.30 of KeySpan's common stock, 11.3 million shares will be issued. If the average closing price over this time frame is greater than or equal to $42.36, 9.4 million shares will be issued. The number of shares issued at a price between $35.30 and $42.36 will be between 9.4 million and 11.3 million based upon a sliding scale.

These securities are currently not considered convertible instruments for purposes of applying SFAS 128 "Earnings Per Share" calculations, unless or until such time as the market value of our common stock reaches a threshold appreciation price ($42.36 per share) that is higher than the current per share market value. Interest payments do, however, reduce net income and earnings per share.

The Emerging Issues Task Force of the FASB is considering proposals related to accounting for certain securities and financial instruments, including securities such as the Equity Units. The current proposals being considered include the method of accounting discussed above. Alternatively, other proposals being considered could result in the common shares issuable pursuant to the purchase contract to be deemed outstanding and included in the calculation of diluted earnings per share, and could result in periodic "mark to market" of the purchase contracts, causing periodic charges or credits to income. If this latter approach were adopted, our basic and diluted earnings per share could increase and decrease from quarter to quarter to reflect the lesser and greater number of shares issuable upon satisfaction of the contract, as well as charges or credits to income.

Industrial Development Revenue Bonds: In the fourth quarter of 2003, KeySpan closed on a financing transaction pursuant to which $128 million tax-exempt bonds with a 5.25% coupon maturing in June 2027 were issued on its behalf. Fifty-three million dollars 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. Proceeds from the transaction were used to repay commercial paper used to finance the construction, installation and equipping of the two facilities. KeySpan has guaranteed all payment obligations of our subsidiaries with regard to these bonds.

First Mortgage Bonds: Colonial Gas Company, Essex Gas Company, ENI and their respective subsidiaries, have issued and outstanding approximately $153.2 million of first mortgage bonds. These bonds are secured by KEDNE gas utility property. The first mortgage bond indentures include, among other provisions, limitations on: (i) the issuance of long-term debt; (ii) engaging in additional lease obligations; and (iii) the payment of dividends from retained earnings.

Authority Financing Notes: Certain of our electric generation subsidiaries can issue tax-exempt bonds through the New York State Energy Research and Development Authority. At December 31, 2003, $41.1 million of Authority Financing Notes 1999 Series A Pollution Control Revenue Bonds due October 1, 2028 were outstanding. The interest rate on these notes is reset based on an auction procedure. The interest rate during 2003 ranged from 0.56% to 1.15%, through December 31, 2003, at which time the rate was 1.10%.

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 ranged from 0.70 % to 1.21% from January 1, 2003 through December 31, 2003 at which time the rate was 1.08%.

Ravenswood Master Lease: We have an arrangement with a variable interest unaffiliated entity through which we lease a portion of the Ravenswood facility. We acquired the Ravenswood facility, in part, through the variable interest entity, from Consolidated Edison on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into a lease agreement (the "Master Lease") with a variable interest financing entity that acquired a portion of the facility, three steam generating units, directly from Consolidated Edison and leased it to a KeySpan subsidiary. The variable interest financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). Monthly lease payments are substantially equal to the monthly interest expense on the debt securities.

In December 2003, KeySpan implemented FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." This Interpretation required us to, among other things, consolidate this variable interest entity and classify the Master Lease as $412.3 million long-term debt on the Consolidated Balance Sheet. Further, we recorded an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date. Under the terms of our credit facility the Master Lease has been considered debt in the ratio of debt-to-total capitalization since the inception of the lease and therefore, implementation of FIN 46 has no impact on our credit facility. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding the leasing arrangement associated with the Master Lease Agreement and FIN 46 implementation issues.)

PUHCA Authorization: In the fourth quarter of 2003 KeySpan received authorization from the SEC, under PUCHA, to issue up to an additional $3 billion of securities through December 31, 2006. This authorization provides KeySpan with the necessary flexibility to finance future capital requirements over the next three years.

Commercial Paper and Revolving Credit Agreements: In June 2003, KeySpan renewed its $1.3 billion revolving credit facility, which was syndicated among sixteen banks. The credit facility supports KeySpan's commercial paper program, and consists of two separate credit facilities with different maturities but substantially similar terms and conditions: a $450 million facility that extends for 364 days, and a $850 million facility that is committed for three years. The fees for the facilities are subject to a ratings-based grid, with an annual fee that ranges from eight to twenty five basis points on the 364-day facility and ten to thirty basis points on the three-year facility. Both credit agreements allow for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin. ABR loans are based on the highest of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%, plus a margin. Competitive bid loans are based on bid results requested by KeySpan from the lenders. The margins on both facilities are ratings based and range from zero basis points to 112.5 basis points. The margins are increased if outstanding loans are in excess of 33% of the total facility. In addition, the 364-day facility has a one-year term out option, which would cost an additional 0.25% if utilized. We do not anticipate borrowing against this facility; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The credit facility contains certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its property to any lien and certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 64%.

Under the terms of the credit facility, the calculation of KeySpan's debt-to-total capitalization ratio reflects 80% equity treatment for the MEDS Equity Units. At December 31, 2003, consolidated indebtedness, as calculated under the terms of the credit facility, was 58.2% of consolidated capitalization. Violation of this covenant could result in the termination of the credit facility and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements.

The credit facility also requires that net cash proceeds from the sale of subsidiaries be applied to reduce consolidated indebtedness. Further, an acceleration of indebtedness of KeySpan or one of its subsidiaries for borrowed money in excess of $25 million in the aggregate, if not annulled within 30 days after written notice, would create an event of default under the Indenture, dated as of November 1, 2000, between

KeySpan Corporation and the Chase Manhattan Bank, as Trustee. At December 31, 2003, KeySpan was in compliance with all covenants.

At December 31, 2003, we had cash and temporary cash investments of $205.8 million. During 2003, we repaid $433.8 million of commercial paper and, at December 31, 2003, $481.9 million of commercial paper was outstanding at a weighted average annualized interest rate of 1.2%. We had the ability to borrow up to an additional $818.1 million at December 31, 2003, under the commercial paper program.

Houston Exploration has a revolving credit facility with a commercial banking syndicate that provides Houston Exploration with a commitment of $300 million, which can be increased, at its option to a maximum of $350 million with prior approval from the banking syndicate. The credit facility is subject to borrowing base limitations, currently set at $300 million and is re-determined semi-annually. Up to $25 million of the borrowing base is available for the issuance of letters of credit. The new credit facility matures July 15, 2005, is unsecured and, with the exception of trade payables, ranks senior to all existing debt.

Under the Houston Exploration credit facility, interest on base rate loans is payable at a fluctuating rate, or base rate, equal to the sum of (a) the greater of the federal funds rate plus 0.50% or the bank's prime rate plus (b) a variable margin between 0% and 0.50%, depending on the amount of borrowings outstanding under the credit facility. Interest on fixed loans is payable at a fixed rate equal to the sum of (a) a quoted reserve adjusted LIBOR rate plus (b) a variable margin between 1.25% and 2.00%, depending on the amount of borrowings outstanding under the credit facility.

Financial covenants require Houston Exploration to, among other things, (i) maintain an interest coverage ratio of at least 3.00 to 1.00 of earnings before interest, taxes and depreciation ("EBITDA") to cash interest; (ii) maintain a total debt to EBITDA ratio of not more than 3.50 to 1.00; and (iii) hedge no more than 70% of natural gas production during any 12-month period. At December 31, 2003, Houston Exploration was in compliance with all financial covenants.

During 2003, Houston Exploration borrowed $239 million under its credit facility and repaid $264 million. At December 31, 2003, $127 million of borrowings remained outstanding at a weighted average annualized interest rate of 3.42%. Also, $0.4 million was committed under outstanding letters of credit obligations. At December 31, 2003, $172.6 million of borrowing capacity was available.

In 2003, KeySpan Canada replaced its two outstanding credit facilities with one new facility with three tranches that combined allowed KeySpan Canada to borrow up to approximately $125 million. At the time of the partial sale of KeySpan Canada, net proceeds from the sale of $119.4 million plus an additional $45.7 million drawn under the new credit facilities were used to pay down existing outstanding debt of $160.4 million. During the third quarter of 2003, KeySpan Canada issued Cdn$125 million, or approximately US$93 million, in long-term secured notes in a private placement, as previously mentioned. The proceeds of the offering were used to pay-down, in its entirety, outstanding borrowings under the credit facility. Further, one tranch of the credit facility was discontinued. At December 31, 2003, KeySpan Canada's credit facility has the following two tranches with the following maturities: (i) $37.5 million matures in 364 days: and (ii) $37.5 million matures in two years. During 2003, KeySpan Canada borrowed $71.5 million from its prior credit facilities and repaid $240.3 million. During the fourth quarter of 2003, KeySpan Canada borrowed $18.1 million under the new facility and at December 31, 2003 $56.9 million is available for future borrowing. KeySpan is not a guarantor of this facility.

Capital Leases: Our subsidiaries lease certain facilities and equipment under long-term leases, which expire on various dates through 2022. The weighted average interest rate on these obligations was 6.12%.

Debt Maturity: The following table reflects the maturity schedule for our debt repayment requirements, including capitalized leases and related maturities, at December 31, 2003:

(In Thousands of Dollars)

	Long-Term Debt	Capital Leases	Total
Repayments:			
Year 1	$ 333	$ 1,138	$ 1,471
Year 2	1,302,333	1,096	1,303,429
Year 3	512,333	1,003	513,336
Year 4	333	1,063	1,396
Year 5	160,761	1,129	161,890
Thereafter	3,649,613	7,552	3,657,165
	$5,625,706	$12,981	$5,638,687

Note 7. Contractual Obligations, Financial Guarantees and Contingencies

Lease Obligations: Lease costs included in operation expense were $82.1 million in 2003 reflecting, primarily, the Master Lease and the lease of our Brooklyn headquarters of $29.3 million and $14.6 million, respectively. Lease costs also include leases for other buildings, office equipment, vehicles and power operated equipment. Lease costs for the year ended December 31, 2002 and 2001 were $71.1 million and $75.8 million, respectively. As previously mentioned, the Master Lease has been consolidated as required by FIN 46, and as a result, future lease payments will be reflected as interest expense on the Consolidated Statement of Income beginning January 1, 2004. The future minimum cash lease payments under various leases, excluding the Master Lease, all of which are operating leases, are $58.9 million per year over the next five years and $122.2 million, in the aggregate, for all years thereafter. (See discussion below for further information regarding the Master Lease.)

Variable Interest Entity: As mentioned, KeySpan has an arrangement with a variable interest entity through which we lease a portion of the Ravenswood facility. We acquired the Ravenswood facility, a 2,200-megawatt electric generating facility located in Queens, New York, in part, through the variable interest entity from Consolidated Edison on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into the Master Lease with a variable interest, unaffiliated financing entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to our subsidiary. The variable interest unaffiliated financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity. KeySpan has guaranteed all payment and performance obligations of our subsidiary under the Master Lease. Monthly lease payments substantially equal the monthly interest expense on such debt securities.

The initial term of the Master Lease expires on June 20, 2004 and may be extended until June 20, 2009. In June 2004, we have the right to: (i) either purchase the facility for the original acquisition cost of $425 million, plus the present value of the lease payments that would otherwise have been paid through June 2009; (ii) terminate the Master Lease and dispose of the facility; or (iii) otherwise extend the Master Lease to 2009. If the Master Lease is terminated in 2004, KeySpan has guaranteed an amount generally equal to 83% of the residual value of the original cost of the property, plus the present value of the lease payments that would have otherwise been paid through June 20, 2009. At this time, KeySpan intends to maintain a leasing arrangement for the foreseeable future. In June 2009, when the Master Lease terminates, we may purchase the facility in an amount equal to the original acquisition cost, subject to adjustment, or surrender the facility to the lessor. If we elect not to purchase the property, the Ravenswood facility will be sold by the lessor. We have guaranteed to the lessor 84% of the residual value of the original cost of the property.

In December 2003, KeySpan implemented FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." This Interpretation required us to, among other things, consolidate this variable interest entity and classify the Master Lease as $412.3 million long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary. Further, we recorded an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date, or approximately $388 million. As previously mentioned, under the terms of our credit facility the Master Lease has been considered debt in the ratio of debt-to-total capitalization since the inception of the lease and therefore, implementation of FIN 46 has no impact on our credit facility. In addition, we recorded a $37.6 million after-tax charge, or $0.23 per share, change in accounting principle on the Consolidated Statement of Income, representing approximately four and a half years of depreciation. Based upon expected average outstanding shares, we anticipate the incremental impact of the additional depreciation expense for 2004 to be approximately $0.05 per share. Yearly lease payments will be reflected as interest expense on the Consolidated Statement of Income beginning January 1, 2004. Future minimum lease payments are $30.8 per year over the next five years and $15.4 million for 2009.

If our subsidiary that leases the Ravenswood facility was not able to fulfill its payment obligations with respect to the Master Lease payments, then the maximum amount KeySpan would be exposed to under its current guarantees would be $425 million plus the present value of the remaining lease payments through June 20, 2009.

Asset Retirement Obligations: On January 1, 2003, KeySpan adopted SFAS 143, "Accounting for Asset Retirement Obligations." SFAS 143 requires an entity to record a liability and corresponding asset representing the present value of legal obligations associated with the retirement of tangible, long-lived assets. At December 31, 2003, the present value of our future asset retirement obligation ("ARO") was approximately $92.4 million, primarily related to our investment in Houston Exploration. The cumulative effect of SFAS 143 and the change in accounting principle was a benefit to net income of $0.2 million, after-tax.

The following table describes on a pro-forma basis the asset retirement obligation associated with Houston Exploration as if SFAS 143 had been adopted on January 1, 2002.

(In Thousands of Dollars)		
For the Year Ended December 31,	2003	2002
ARO Liability at January 1,	$57,197	$45,759
Additions from drilling	5,738	8,507
Additions from purchases	29,244	286
Deletions from abandonment	(160)	—
Changes resulting from timing	(3,330)	—
ARO accretion expense	3,668	2,645
ARO Liability at December 31,	$92,357	$57,197
Reflected on Consolidated Balance Sheet		
ARO Liability - Current	$ 7,703	N/A
ARO Liability - Long term	$84,654	N/A

KeySpan's largest asset base is its gas transmission and distribution system. A legal obligation exists due to certain safety requirements at final abandonment. In addition, a legal obligation may be construed to exist with respect to KeySpan's liquefied natural gas ("LNG") storage tanks due to clean up responsibilities upon cessation of use. However, mass assets such as storage, transmission and distribution assets are believed to operate in perpetuity and, therefore, have indeterminate cash flow estimates. Since that exposure is in perpetuity and cannot be measured, no liability will be recorded pursuant to SFAS 143. KeySpan's ARO will be re-evaluated in future periods until sufficient information exists to determine a reasonable estimate of fair value.

Financial Guarantees: KeySpan has issued financial guarantees in the normal course of business, primarily on behalf of its subsidiaries, to various third party creditors. At December 31, 2003, the following amounts would have to be paid by KeySpan in the event of non-payment by the primary obligor at the time payment is due:

		(In Thousands of Dollars)	
Nature of Guarantee		Amount of Exposure	Expiration Dates
Guarantees for Subsidiaries			
Medium-Term Notes - KEDLI	(i)	$ 525,000	2008-2010
Industrial Development Revenue Bonds	(ii)	128,000	2027
Master Lease - Ravenswood	(iii)	425,000	2004
Surety Bonds	(iv)	168,000	Revolving
Commodity Guarantees and Other	(v)	43,000	2005
Letters of Credit	(vi)	67,000	2004
		$1,356,000	

The following is a description of KeySpan's outstanding subsidiary guarantees:

(i) KeySpan has fully and unconditionally guaranteed $525 million to holders of Medium-Term Notes issued by KEDLI. These notes are due to be repaid on January 15, 2008 and February 1, 2010. KEDLI is required to comply with certain financial covenants under the debt agreements. Currently, KEDLI is in compliance with all covenants and management does not anticipate that KEDLI will have any difficulty maintaining such compliance. The face value of these notes are included in long-term debt on the Consolidated Balance Sheet.

(ii) KeySpan has fully and unconditionally guaranteed the payment obligations of its subsidiaries with regard to $128 million of Industrial Development Revenue Bonds issued through the Nassau County and Suffolk County Industrial Development Authorities for the construction of the Glenwood and Port Jefferson electric-generation peaking plants. The face value of these notes are included in long-term debt on the Consolidated Balance Sheet.

(iii) KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, the lessee under the $425 million Master Lease associated with the lease of the Ravenswood facility. The initial term of the lease expires on June 20, 2004 and may be extended until June 20, 2009.

(iv) KeySpan has agreed to indemnify the issuers of various surety and performance bonds associated with certain construction projects currently being performed by subsidiaries within the Energy Services segment. In the event that the operating companies in the Energy Services segment fail to perform their obligations under contracts, the injured party may demand that the surety make payments or provide services under the bond. KeySpan would then be obligated to reimburse the surety for any expenses or cash outlays it incurs.

(v) KeySpan has guaranteed commodity-related payments for subsidiaries within the Energy Services segment, as well as KeySpan Ravenswood, LLC. These guarantees are provided to third parties to facilitate physical and financial transactions involved in the purchase of natural gas, oil and other petroleum products for electric production and marketing activities. The guarantees cover actual purchases by these subsidiaries that are still outstanding as of December 31, 2003.

(vi) KeySpan has issued stand-by letters of credit in the amount of $67.0 million to third parties that have extended credit to certain subsidiaries. Certain vendors require us to post letters of credit to guarantee subsidiary performance under our contracts and to ensure payment to our subsidiary subcontractors and vendors under those contracts. Certain of our vendors also require letters of credit to ensure reimbursement for amounts they are disbursing on behalf of our subsidiaries, such as to beneficiaries under our self-funded insurance programs. Such letters of credit are generally issued by a bank or similar financial institution. The letters of credit commit the issuer to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, KeySpan would be required to reimburse the issuer of the letter of credit.

To date, KeySpan has not had a claim made against it for any of the above guarantees or letters of credit and we have no reason to believe that our subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact such defaults may have on our consolidated results of operations, financial condition or cash flows.

In June 2003, Hawkeye Electric, LLC et al. ("Hawkeye") and KeySpan reached an agreement settling certain legal matters. Under the terms of the settlement: (i) certain obligations between the parties have been modified and clarified, (ii) certain contracts were awarded to Hawkeye, (iii) certain credit and bonding support made available by KeySpan to Hawkeye was terminated and (iv) KeySpan and a Hawkeye affiliate closed on a $55 million long-term note receivable due from Hawkeye on July 20, 2018 bearing interest at an annual rate of 5% and secured by a power plant in Greenport, New York.

Fixed Charges Under Firm Contracts: Our utility subsidiaries and the Ravenswood facility have entered into various contracts for gas delivery, storage and supply services. Certain of these contracts require payment of annual demand charges in the aggregate amount of approximately

$452 million. We are liable for these payments regardless of the level of service we require from third parties. Such charges associated with gas distribution operations are currently recovered from utility customers through the gas adjustment clause.

Legal Matters: From time to time we are subject to various legal proceedings arising out of the ordinary course of our business. Except as described below, 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, financial condition or cash flows.

KeySpan has been cooperating in preliminary inquiries regarding trading in KeySpan Corporation stock by individual officers of KeySpan prior to the July 17, 2001 announcement that KeySpan was taking a special charge in its Energy Services business and otherwise reducing its 2001 earnings forecast. These inquiries are being conducted by the U.S. Attorney's Office, Southern District of New York and the SEC.

On March 5, 2002, the SEC, as part of its continuing inquiry, issued a formal order of investigation, pursuant to which it will review the trading activity of certain company insiders from May 1, 2001 to the present, as well as KeySpan's compliance with its reporting rules and regulations, generally during the period following the acquisition by KeySpan Services, Inc., a KeySpan subsidiary, of the Roy Kay companies through the July 17, 2001 announcement.

KeySpan and certain of its current and former officers and directors are defendants in a consolidated class action lawsuit filed in the United States District Court for the Eastern District of New York. This lawsuit alleges, among other things, violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), in connection with disclosures relating to or following the acquisition of the Roy Kay companies. In October 2001, a shareholder's derivative action was commenced in the same court against certain current and former officers and directors of KeySpan, alleging, among other things, breaches of fiduciary duty, violations of the New York Business Corporation Law and violations of Section 20(a) of the Exchange Act. On June 12, 2002, a second derivative action was commenced which asserted similar allegations. Each of these proceedings seeks monetary damages in an unspecified amount. On March 18, 2003, the court granted our motion to dismiss the class action complaint. The court's order dismissed certain class allegations with prejudice, but provided the plaintiffs a final opportunity to file an amended complaint concerning the remaining allegations. In April 2003, plaintiffs filed an amended complaint and in July 2003 the court denied our motion to dismiss the amended complaint but did strike certain allegations. On November 20, 2003, the court granted our motion for reconsideration of the July 2003 order and the court struck additional allegations from the amended complaint which effectively limited the potential class period. On December 19, 2003, KeySpan filed a motion to dismiss the derivative actions. The motion is still pending. KeySpan intends to vigorously defend each of these proceedings. However, we are unable to predict the outcome of these proceedings or what effect, if any, such outcome will have on our financial condition, results of operations or cash flows.

KeySpan subsidiaries, along with several other parties, have been named as defendants in numerous proceedings filed by plaintiffs claiming various degrees of injury from asbestos exposure at generating facilities formerly owned by LILCO and others. In connection with the May 1998 transaction with LIPA, costs incurred by KeySpan for liabilities for asbestos exposure arising from the activities of the generating facilities previously owned by LILCO are recoverable from LIPA through the Power Supply Agreement between LIPA and KeySpan.

KeySpan is unable to determine the outcome of the other outstanding asbestos proceedings, but does not believe that such outcomes, if adverse, will have a material effect on its financial condition, results of operation or cash flows. KeySpan believes that its cost recovery rights under the Power Supply Agreement, its indemnification rights against third parties and its insurance coverage (above applicable deductible limits) cover its exposure for asbestos liabilities generally.

As previously reported, KeySpan, through its subsidiary, formerly known as Roy Kay, Inc., has terminated the employment of the former owners of the Roy Kay companies and commenced a proceeding in the Chancery Division of the Superior Court, Monmouth County, New Jersey (Docket No. Mon. C. 95-01) as a result of the alleged fraudulent acts of the former owners, both before and after the acquisition of the Roy Kay companies in January 2000. KeySpan commenced this proceeding because it believed that, among other things, the former owners misstated the financial statements of the Roy Kay companies and certain underlying work-in-progress schedules. The former owners filed counterclaims against KeySpan and certain of its subsidiaries, as well as certain of their respective officers, to recover damages they claimed to have incurred as a result of, among other things, their alleged improper termination and the alleged fraud on the part of KeySpan in failing to disclose the limitations imposed upon the Roy Kay companies, with respect to the performance of certain services under PUHCA. In March 2004, KeySpan entered into an agreement with these former owners settling this proceeding, the terms of which did not have a material effect on our financial condition or results of operations.

Other Contingencies: We derive a substantial portion of our revenues in our Electric Services segment from a series of agreements with LIPA pursuant to which we manage LIPA's transmission and distribution system and supply the majority of LIPA's customers' electricity needs. The agreements terminate at various dates between May 28, 2006 and May 28, 2013, and at this time, we can provide no assurance that any of the agreements will be renewed or extended, or if they were to be renewed or extended, the terms and conditions thereof. In addition, given the complexity of these agreements, disputes arise from time to time between KeySpan and LIPA concerning the rights and obligations of each party to make and receive payments as required pursuant to the terms of these agreements. As a result, KeySpan is unable to determine what effect, if any, the ultimate resolution of these disputes will have on its financial condition or results of operations.

Air: With respect to NOx emissions reduction requirements for our existing power plants, we are required to be in compliance with the Phase III reduction requirements of the Ozone Transportation Commission memorandum by May 1, 2003, and we fully expect to achieve such emission reductions on time and in a cost-effective manner.

Water: Additional capital expenditures associated with the renewal of the surface water discharge permits for our power plants may be required by the Department of Environmental Conservation ("DEC"). Until our monitoring obligations are completed and changes to the Environmental Protection Agency regulations under Section 316 of the Clean Water Act are promulgated, the need for and the cost of equipment upgrades cannot be determined.

Land, Manufactured Gas Plants and Related Facilities

New York Sites: Within the State of New York we have identified 43 historical manufactured gas plant ("MGP") sites and related facilities, which were owned or operated by KeySpan subsidiaries or such companies' predecessors. These former sites, some of which are no longer owned by us, have been identified to the NYPSC and the DEC for inclusion on appropriate site inventories. Administrative Orders on Consent ("ACO") or Voluntary Cleanup Agreements ("VCA") have been executed with the DEC to address the investigation and remediation activities associated with certain sites. Investigation and remediation activities required at the remaining sites will be addressed as part of an application KeySpan submitted to the DEC in October 2003 under its Voluntary Cleanup Program ("VCA Application").

We have identified 28 of these sites as being associated with the historical operations of KEDNY. One site has been fully remediated. The remaining sites will be investigated and, if necessary, remediated under the terms and conditions of ACOs or VCAs. Expenditures incurred to date by us with respect to KEDNY MGP-related activities total $38.8 million. In July 2001, KEDNY filed a complaint for the recovery of its remediation costs in the New York State Supreme Court against the various insurance companies that issued general comprehensive liability policies to KEDNY. The outcome of this proceeding cannot yet be determined.

The remaining 15 sites have been identified as being associated with the historical operations of KEDLI. Expenditures incurred to date by us with respect to KEDLI MGP-related activities total $32.2 million. One site has been fully investigated and requires no further action. The remaining sites will be investigated and, if necessary, remediated under the conditions of ACOs or VCAs. In January 1998, KEDLI filed a complaint for the recovery of its remediation costs in the New York State Supreme Court against the various insurance companies that issued general comprehensive liability policies to KEDLI. The outcome of this proceeding cannot yet be determined.

We presently estimate the remaining cost of our KEDNY and KEDLI MGP-related environmental remediation activities will be $226.4 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred to date by us with respect to these MGP-related activities total $71 million.

With respect to remediation costs, the KEDNY rate plan provides, among other things, that if the total cost of investigation and remediation varies from that which is specifically estimated for a site under investigation and/or remediation, then KEDNY will retain or absorb up to 10% of the variation. The KEDLI rate plan also provides for the recovery of investigation and remediation costs but with no consideration of the difference between estimated and actual costs. At December 31, 2003, we have reflected a regulatory asset of $245.3 million for our KEDNY/KEDLI MGP sites. In accordance with NYPSC policy, KeySpan records a reduction to regulatory liabilities as costs are incurred for environmental clean-up activities. At December 31, 2003, these previously deferred regulatory liabilities totaled $61.0 million. In October 2003, KEDNY and KEDLI filed a joint petition with the NYPSC seeking rate treatment for additional environmental costs that may be incurred in the future.

We are also responsible for environmental obligations associated with the Ravenswood facility, purchased from Consolidated Edison in 1999, including remediation activities associated with its historical operations and those of the MGP facilities that formerly operated at the site. We are not responsible for liabilities arising from disposal of waste at off-site locations prior to the acquisition closing and any monetary fines arising from Consolidated Edison's pre-closing conduct. We presently estimate the remaining environmental clean up activities for this site will be $3.4 million, which amount has been accrued by us. Expenditures incurred to date total $1.6 million.

New England Sites: Within the Commonwealth of Massachusetts and the State of New Hampshire, we are aware of 76 former MGP sites and related facilities within the existing or former service territories of KEDNE.

Boston Gas Company, Colonial Gas Company and Essex Gas Company may have or share responsibility under applicable environmental laws for the remediation of 66 of these sites. A subsidiary of National Grid USA ("National Grid"), formerly New England Electric System, has assumed responsibility for remediating 11 of these sites, subject to a limited contribution from Boston Gas Company, and has provided full indemnification to Boston Gas Company with respect to 8 other sites. In addition, Boston Gas Company, Colonial Gas Company, and Essex Gas Company have each assumed responsibility for remediating 3 sites. At this time, it is uncertain as to whether Boston Gas Company, Colonial Gas Company or Essex Gas Company have or share responsibility for remediating any of the other sites. No notice of responsibility has been issued to us for any of these sites from any governmental environmental authority.

In March 1999, Boston Gas Company and a subsidiary of National Grid filed a complaint for the recovery of remediation costs in the Massachusetts Superior Court against various insurance companies that issued comprehensive general liability policies to National Grid and its

predecessors with respect to, among other things, the 11 sites for which Boston Gas Company has agreed to make a limited contribution. In October 2002, Boston Gas Company filed a complaint in the United States District Court - Massachusetts District against one of the insurance companies that issued comprehensive general liability policies to Boston Gas Company for its remaining sites. The outcome of these proceedings cannot be determined at this time.

We presently estimate the remaining cost of these Massachusetts KEDNE MGP-related environmental cleanup activities will be $25.4 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred since November 8, 2000 with respect to these MGP-related activities total $13.5 million.

We may have or share responsibility under applicable environmental laws for the remediation of 10 MGP sites and related facilities associated with the historical operations of EnergyNorth. At four of these sites we have entered into cost sharing agreements with other parties who share responsibility for remediation of these sites. EnergyNorth also has entered into an agreement with the United States Environmental Protection Agency ("EPA") for the contamination from the Nashua site that was allegedly commingled with asbestos at the so-called Nashua River Asbestos Site, adjacent to the Nashua MGP site.

EnergyNorth has filed suit in both the New Hampshire Superior Court and the United States District Court for the District of New Hampshire for recovery of its remediation costs against the various insurance companies that issued comprehensive general liability and excess liability insurance policies to EnergyNorth and its predecessors. Settlements have been reached with some of the carriers and one carrier was dismissed from a Superior Court action on summary judgment. The outcome of the remaining proceedings cannot yet be determined.

We presently estimate the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $13.9 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred since November 8, 2000, with respect to these MGP-related activities total $7.8 million.

By rate orders, the DTE and the NHPUC provide for the recovery of site investigation and remediation costs and, accordingly, at December 31, 2003, we have reflected a regulatory asset of $51.5 million for the KEDNE MGP sites. As previously mentioned, Colonial Gas Company and Essex Gas Company are not subject to the provisions of SFAS 71 and therefore have recorded no regulatory asset. However, rate plans currently in effect for these subsidiaries provide for the recovery of investigation and remediation costs.

KeySpan New England LLC Sites: We are aware of three non-utility sites associated with KeySpan New England, LLC, a successor company to Eastern Enterprises, for which we may have or share environmental remediation or ongoing maintenance responsibility. These three sites, located in Philadelphia, Pennsylvania, New Haven, Connecticut and Everett, Massachusetts, were associated with historical operations involving the production of coke and related industrial processes. Honeywell International, Inc. and Beazer East, Inc. (both former owners and/or operators of certain facilities at Everett ("the Everett Facility") together with KeySpan, have entered into an ACO with the Massachusetts Department of Environmental Protection for the investigation and development of a remedial response plan for a portion of that site. KeySpan, Honeywell and Beazer East have entered into a cost-sharing agreement under which each company has agreed to pay one-third of the costs of compliance with the consent order, while preserving any claims it may have against the other companies for, among other things, reallocation of proportionate liability. In 2002, Beazer East commenced an action in the U.S. District Court for the Southern District of New York, which seeks a judicial determination on the allocation of liability for the Everett Facility. The outcome of this proceeding cannot yet be determined.

KeySpan also is recovering certain legal defense costs and may be entitled to recover remediation costs from its insurers. We presently estimate the remaining cost of our environmental cleanup activities for the three non-utility sites will be approximately $25.6 million, which amount has been accrued by us as a reasonable estimate of probable costs for known sites. Expenditures incurred since November 8, 2000, with respect to these sites total $7.2 million.

We believe that in the aggregate, the accrued liability for these MGP sites and related facilities identified above are reasonable estimates of the probable cost for the investigation and remediation of these sites and facilities. As circumstances warrant, we periodically re-evaluate the accrued liabilities associated with MGP sites and related facilities. We did such a re-evaluation in 2003 and the results of this study have been reflected in KeySpan's accruals. The re-evaluation of KeySpan's accruals resulted in a $10 million benefit to earnings in 2003. We may be required to investigate and, if necessary, remediate each site previously noted, or other currently unknown former sites and related facility sites, the cost of which is not presently determinable but may be material to our financial position, results of operations or cash flows. Remediation costs for each site may be materially higher than noted, depending upon remediation experience, selected end use for each site, and actual environmental conditions encountered.

Note 8. Hedging, Derivative Financial Instruments and Fair Values

Financially-Settled Commodity Derivative Instruments - Hedging Activities: From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas exploration and production activities and its electric generating facilities. Derivative financial instruments are employed by Houston Exploration to hedge cash flow variability associated with forecasted sales of natural gas. The Ravenswood facility uses derivative financial instruments to hedge the cash flow variability associated with the purchase of natural gas and oil that will be consumed during the generation of electricity. The Ravenswood facility also hedges the cash flow variability associated with a portion of peak season electric energy sales. In addition, during 2003 KeySpan Canada employed derivative financial instruments to hedge cash flow variability associated with the

purchase of natural gas and electricity used in the operation of its gas processing plants; all such derivative instruments settled during the year.

The majority of these derivative financial instruments are cash flow hedges that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities", as amended by SFAS 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities", collectively SFAS 133, and are not considered held for trading purposes as defined by current accounting literature. Accordingly, we carry the fair market value of our derivative instruments on the Consolidated Balance Sheet as either a current or deferred asset or liability, as appropriate, and defer the effective portion of unrealized gains or losses in accumulated other comprehensive income. Gains and losses are reclassified from accumulated other comprehensive income to the Consolidated Statement of Income in the period the hedged transaction effects earnings. Gains and losses are reflected as a component of either revenue or fuel and purchased power depending on the hedged transaction. Hedge ineffectiveness is measured using the change in variable cash flows and the hypothetical derivative methods and recorded directly to earnings.

Houston Exploration has utilized collars and purchased put options, as well as over-the-counter ("OTC") swaps, to hedge the cash flow variability associated with forecasted sales of a portion of its natural gas production. In 2003, Houston Exploration hedged slightly less than 70% of its gas production. At December 31, 2003, Houston Exploration has hedge positions in place for approximately 70% of its estimated 2004 gas production, with an effective floor price of $4.26 and an effective ceiling price of $5.65. Further, Houston Exploration has hedge positions in place for approximately 44% of its estimated 2005 gas production, with an effective floor price of $4.59 and an effective ceiling price of $5.26. Houston Exploration uses standard New York Mercantile Exchange ("NYMEX") futures prices to value its swap positions, and, in addition, uses published volatility in its Black-Scholes calculation for outstanding options. The maximum length of time over which Houston Exploration has hedged such cash flow variability is through December 2005. The fair market value of these derivative instruments at December 31, 2003 was a liability of $36.9 million. The estimated amount of losses associated with such derivative instruments that are reported in other comprehensive income and that are expected to be reclassified into earnings over the next twelve months is $32.1 million, or $20.9 million after-tax.

With respect to price exposure associated with fuel purchases for the Ravenswood facility, KeySpan employs standard NYMEX natural gas futures contracts and over-the-counter financially settled natural gas basis swaps to hedge the cash flow variability for a portion of forecasted purchases of natural gas. KeySpan also employs the use of financially-settled oil swap contracts to hedge the cash flow variability for a portion of forecasted purchases of fuel oil that will be consumed at the Ravenswood facility. The maximum length of time over which we have hedged cash flow variability associated with forecasted purchases of natural gas and fuel oil is through September 2005. We use standard NYMEX futures prices to value the gas futures contracts and market quoted forward prices to value oil swap and natural gas basis swap contracts. The fair market value of these derivative instruments at December 31, 2003 was an asset of $0.4 million. These derivative instruments are reported in other comprehensive income and are expected to be reclassified into earnings over the next twelve months.

We have also engaged in the use of cash-settled swap instruments to hedge the cash flow variability associated with a portion of forecasted peak season electric energy sales from the Ravenswood facility. The maximum length of time over which we have hedged cash flow variability is through December 2004. We use market quoted forward prices to value these outstanding derivatives. The fair market value of these derivative instruments at December 31, 2003 was an asset of $0.3 million. These derivative instruments are reported in other comprehensive income and are expected to be reclassified into earnings over the next twelve months.

The table below summarizes the fair value of each category of derivative instrument outstanding at December 31, 2003 and its related line item on the Consolidated Balance Sheet. Fair value is the amount at which derivative instruments could be exchanged in a current transaction between willing parties, other than in a forced liquidation sale.

	(In Thousands of Dollars)
December 31,	2003
Gas Contracts:	
Other current assets	$ 3,458
Accounts payable and other liabilities	(35,592)
Other deferred liabilities	(4,734)
Oil Contracts:	
Other deferred charges	385
Electric Contracts:	
Other deferred charges	259
	$(36,224)

Financially-Settled Commodity Derivative Instruments that Do Not Qualify for Hedge Accounting: KeySpan subsidiaries also employ a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133. In November 2003, we sold a "swaption" to hedge the cash flow variability associated with 50 MW of forecasted 2004 summer electric energy sales from the Ravenswood facility. The swaption is an option that gives the counterparty the right, but not the obligation, to enter into a swap transaction with KeySpan in the future at a given strike price. This swaption can be converted into a swap, at the election of the counterparty and has an expiration date of June 1, 2004. The premium payment KeySpan received was recorded as a current liability on the Consolidated Balance Sheet. The premium generally will be recorded into income at the time the swaption is either exercised or expires. An internally developed option-pricing model is used to value the swaption and at December 31, 2003 the fair value of the swaption was immaterial.

At December 31, 2003, KeySpan Canada has a portfolio of financially-settled natural gas collars and swap transactions for natural gas liquids. Such contracts are executed by KeySpan Canada to: (i) fix the price that is paid or received by KeySpan Canada for certain physical transactions involving natural gas and natural gas liquids and (ii) transfer the price exposure to counterparties. These derivative financial instruments also do not qualify for hedge accounting treatment. At December 31, 2003, these instruments had a net fair market value of $1.0 million, which was recorded as a $1.8 million current asset and $0.8 million current liability on the Consolidated Balance Sheet. Based on the non-hedge designation of these instruments, an unrealized gain was recorded in the Consolidated Statement of Income.

Firm Gas Sales Derivative Instruments – Regulated Utilities: We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. The accounting for these derivative instruments is subject to SFAS 71 "Accounting for the Effects of Certain Types of Regulation." Therefore, changes in the fair value of these derivatives have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements. At December 31, 2003, these derivatives had a net fair market value of $9.9 million and are reflected as a regulatory liability on the Consolidated Balance Sheet.

Physically-Settled Commodity Derivative Instruments: SFAS 133 establishes criteria that must be satisfied in order for option contracts, forward contracts with optionality features, or contracts that combine a forward contract and a purchase option contract to be exempted as normal purchases and sales. Based upon a continuing review of our physical gas contracts, we determined that certain contracts for the physical purchase of natural gas associated with our regulated gas utilities are not exempt as normal purchases from the requirements of SFAS 133. Since these contracts are for the purchase of natural gas sold to regulated firm gas sales customers, the accounting for these contracts is subject to SFAS 71. Therefore, changes in the market value of these contracts have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. At December 31, 2003 these contracts had a net negative fair market value of $1.9 million, and are reflected as a $6.9 million regulatory asset and $5.0 million regulatory liability on the Consolidated Balance Sheet.

Interest Rate Derivative Instruments: In May 2003, we entered into interest rate swap agreements in which we swapped $250 million of 7.25% fixed rate debt to floating rate debt. Under the terms of the agreements, we will receive the fixed coupon rate associated with these bonds and pay our swap counterparties a variable interest rate based on LIBOR, that is reset on a semi-annual basis. These swaps are designated as fair-value hedges and qualify for "short-cut" hedge accounting treatment under SFAS 133. During the twelve months ended December 31, 2003, we paid our counterparty an average interest rate of 6.43%, and as a result, we realized interest savings of $1.2 million. The fair market value of this derivative was negligible at December 31, 2003.

During 2002, we had interest rate swap agreements in which we swapped approximately $1.3 billion of fixed rate debt to floating rate debt. Under the terms of the agreements, we received the fixed coupon rate associated with these bonds and paid the swap counterparties a variable interest rate that was reset on a quarterly basis. These swaps were designated as fair-value hedges and qualified for "short-cut" hedge accounting treatment under SFAS 133. In 2002, we terminated two of these interest rate swap agreements with an aggregate notional amount of $1.0 billion. The remaining swap, which had a notional amount of $270.0 million, was terminated on February 25, 2003. We received $18.4 million from our swap counterparties as a result of the latter termination, of which $8.1 million represented accrued swap interest. The difference between the termination settlement amount and the amount of accrued interest, $10.3 million, was recorded as a reduction to interest expense in the first quarter of 2003. This swap was used to hedge a portion of our outstanding promissory notes to LIPA. As discussed in Note 6 "Long-Term Debt," we called a portion of these promissory notes during the first quarter of 2003.

Additionally, we had an interest rate swap agreement that hedged the cash flow variability associated with the forecasted issuance of a series of commercial paper offerings. This hedge expired in March 2003.

Weather Derivatives: The utility tariffs associated with KEDNE's operations do not contain weather normalization adjustments. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate a substantial portion of the effect of fluctuations from normal weather on our financial position and cash flows, we sold heating degree-day call options and purchased heating-degree day put options for the November 2002-March 2003 winter season. With respect to sold call options, KeySpan was required to make a payment of $40,000 per heating degree day to its counterparties when actual weather experienced during the November 2002 - March 2003 time frame was above 4,470 heating degree days, which equates to approximately 1% colder than normal weather. With respect to purchased put options, KeySpan would have received a $20,000 per heating degree day payment from its counterparties when actual weather was below 4,150 heating degree days, or approximately 7% warmer than normal. Based on the terms of such contracts, we account for such instruments pursuant to the requirements of EITF 99-2, "Accounting for Weather Derivatives." In this regard, such instruments were accounted for using the "intrinsic value method" as set forth in such guidance. During the first quarter of 2003, weather was 10% colder than normal and, as a result, $11.9 million was recorded as a reduction to revenues.

In October 2003, we entered into heating-degree day call and put options to mitigate the effect of fluctuations from normal weather on KEDNE's financial position and cash flows for the 2003/2004 winter heating season - November 2003 through March 2004. With respect to sold call options, KeySpan will be required to make a payment of $27,500 per heating degree day to its counterparties when actual weather experienced during this time frame is above 4,440 heating degree days, which equates to approximately 2% colder than normal weather, based on the most recent 20-year average for normal weather. The maximum amount KeySpan may be required to pay on its sold call options is $5.5 million. With respect to purchased put options, KeySpan will receive a $27,500 per heating degree day payment from its counterparties when actual weather is below 4,266 heating degree days, or approximately 2% warmer than normal. The maximum amount KeySpan may receive on its purchased put options is $11 million. The net premium cost for these options was $0.4 million. We account for these derivatives pursuant to the requirements of EITF 99-2. During the fourth quarter of 2003, weather, as measured in heating degree-days, was slightly warmer normal and, as a result, a $0.5 million benefit was recorded through revenues.

Derivative contracts are primarily used to manage exposure to market risk arising from changes in commodity prices and interest rates. In the event of non-performance by a counterparty to a derivative contract, the desired impact may not be achieved. The risk of counterparty non-performance is generally considered a credit risk and is actively managed by assessing each counterparty credit profile and negotiating appropriate levels of collateral and credit support. We believe that our credit risk related to the above mentioned derivative financial instruments is no greater than the risk associated with the primary contracts which they hedge and that the elimination of a portion of the price risk reduces volatility in our reported results of operations, financial position and cash flows and lowers overall business risk.

Long-term Debt: The following tables depict the fair values and carrying values of KeySpan's long-term debt at December 31, 2003 and 2002.

FAIR VALUES OF LONG-TERM DEBT

	(In Thousands of Dollars)	
Year Ended December 31,	2003	2002
First Mortgage Bonds	$ 178,438	$ 180,666
Notes	3,893,158	3,441,619
Gas Facilities Revenue Bonds	683,354	674,828
Authority Financing Notes	66,005	66,005
Promissory Notes	158,837	616,240
MEDS Equity Units	495,880	525,918
Tax Exempt Bonds	129,558	—
	$5,605,230	$5,505,276

CARRYING VALUES OF LONG-TERM DEBT

	(In Thousands of Dollars)	
	2003	2002
First Mortgage Bonds	$ 153,186	$ 163,625
Notes	3,456,425	2,985,000
Gas Facilities Revenue Bonds	648,500	648,500
Authority Financing Notes	66,005	66,005
Promissory Notes	155,422	602,427
MEDS Equity Units	460,000	460,000
Master Lease	412,300	—
Tax Exempt Bonds	128,275	—
	$5,480,113	$4,925,557

Our subsidiary debt is carried at an amount approximating fair value because interest rates are based on current market rates. All other financial instruments included in the Consolidated Balance Sheet such as cash, commercial paper, accounts receivable and accounts payable, are also stated at amounts that approximate fair value.

NOTE 9. DISCONTINUED OPERATIONS

On November 8, 2000, KeySpan acquired Midland Enterprises LLC ("Midland"), an inland marine transportation subsidiary, as part of the Eastern acquisition. In its order approving the acquisition, the SEC required KeySpan to sell this subsidiary by November 8, 2003 because Midland's operations were not functionally related to KeySpan's core utility operations. On July 2, 2002, the sale of Midland to Ingram Industries Inc. was completed and net proceeds of $175.1 million were received from the sale.

Discontinued operations for the year ended December 31, 2001 included an anticipated after-tax loss on disposal of $30.4 million. As a result of a change in the tax structuring strategy related to the sale of Midland, in the second quarter of 2002 we recorded an additional provision for city and state taxes and made adjustments to the estimates used in the December 31, 2001 loss provision. These changes resulted in an additional after tax loss on disposal of $19.7 million.

The following is selected financial information for Midland for the period January 1, 2002 through July 2, 2002 and the year ended December 31, 2001:

	(In Thousands of Dollars)	
	2002	2001
Revenues	$116,149	$266,792
Pre-tax income (loss)	(4,624)	18,489
Income tax (expense) benefit	1,268	(7,571)
Income (loss) from discontinued operations	(3,356)	10,918
Estimated book gain on disposal	5,980	44,580
Tax expense associated with disposal	(22,286)	(74,936)
Estimated loss on disposal	(16,306)	(30,356)
Loss from discontinued operations	$ (19,662)	$ (19,438)

Note 10. Roy Kay Operations

During 2001, we undertook a complete evaluation of the strategy, operating controls and organizational structure of the Roy Kay companies – plumbing, mechanical, electrical and general contracting companies acquired by us in January 2000. We decided to discontinue the general contracting business conducted by these companies based upon our view that the general contracting business is not a core competency of these companies. Certain remaining activities engaged in by the Roy Kay companies have been integrated with those of other KeySpan energy-related businesses. During 2002, substantially all of the remaining field work on outstanding construction projects was completed. We are now engaged in the finalization of claims and collections and, as a result, their operations will continue to be consolidated in our Consolidated Financial Statements until such time as this process is complete. During 2003 KeySpan incurred $11.4 million in operating losses which reflected provisions made for the resolution of outstanding claims and change orders, as well as additional costs incurred in connection with the collection of outstanding contract balances.

For the year ended December 31, 2001, the Roy Kay companies incurred an after-tax loss of $95.0 million ($137.8 million pre-tax) reflecting: (i) unanticipated costs to complete work on certain construction projects; (ii) the impact of inaccuracies in the books of these companies relating to their overall financial and operational performance; (iii) discontinuance costs of the general contracting activities of those companies, including the write-off of goodwill, and certain account and retainage receivables; and (iv) operating losses. For the years ended December 31, 2002 and 2001 the Roy Kay companies recorded operating losses of $10.8 million and $137.8 million respectively. KeySpan and the former Roy Kay companies are currently engaged in litigation relating to the termination of the former owners, as well as other matters relating to the acquisition of the Roy Kay companies. (See Note 7 "Contractual Obligations and Contingencies" – Legal Matters.)

Note 11. Class Action Settlement

During 2001, we reversed a previously recorded loss provision regarding certain pending rate refund issues relating to the 1989 RICO class action settlement. This adjustment resulted from a favorable United States Court of Appeals ruling received on September 28, 2001, overturning a lower court decision, and resulted in a positive pre-tax adjustment to earnings of $33.5 million, or $20.1 million after-tax. This adjustment has been reflected as a $22.0 million reduction to operations and maintenance expense and a reduction of $11.5 million to interest expense on the Consolidated Statement of Income.

Note 12. KeySpan Gas East Corporation Summary Financial Data

KEDLI is a wholly owned subsidiary of KeySpan. KEDLI was formed on May 7, 1998 and on May 28, 1998 acquired substantially all of the assets related to the gas distribution business of LILCO. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway peninsula of Queens county. KEDLI established a program for the issuance, from time to time, of up to $600 million aggregate principal amount of Medium-Term Notes, which will be fully and unconditionally guaranteed by the parent, KeySpan Corporation. On February 1, 2000, KEDLI issued $400 million of 7.875% Medium-Term Notes due 2010. In January 2001, KEDLI issued an additional $125 million of Medium- Term Notes at 6.9% due January 2008. The following condensed financial statements are required to be disclosed by SEC regulations and set forth those of KEDLI, KeySpan Corporation as guarantor of the Medium- Term Notes and our other subsidiaries on a combined basis.

Statement of Income

(In Thousands of Dollars)

Year Ended December 31, 2003	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Revenues	$ 507	$1,046,931	$5,868,230	$ (507)	$6,915,161
Operating Expenses					
Purchased gas	—	574,009	1,921,093	—	2,495,102
Fuel and purchased power	—	—	414,633	—	414,633
Operations and maintenance	11,340	137,223	1,857,233	—	2,005,796
Intercompany expense	5,282	3,570	(3,570)	(5,282)	—
Depreciation and amortization	(53)	77,603	496,524	—	574,074
Operating taxes	—	77,503	340,733	—	418,236
Total Operating Expenses	16,569	869,908	5,026,646	(5,282)	5,907,841
Gain on sale of property	—	13,974	1,149	—	15,123
Income from equity investments	108	—	19,106	—	19,214
Operating Income (Loss)	(15,954)	190,997	861,839	4,775	1,041,657
Interest charges	(209,505)	(62,992)	(299,399)	264,202	(307,694)
Other income and (deductions)	621,151	(8,636)	54,429	(699,415)	(32,471)
Total Other Income and (Deductions)	411,646	(71,628)	(244,970)	(435,213)	(340,165)
Income Taxes (Benefit)	(28,663)	40,796	265,178	—	277,311
Earnings from Continuing Operations	$ 424,355	$ 78,573	$ 351,691	$(430,438)	$ 424,181
Cumulative Change in Acounting Principle	—	—	(37,451)	—	(37,451)
Net Income	$ 424,355	$ 78,573	$ 314,240	$(430,438)	$ 386,730

Statement of Income

(In Thousands of Dollars)

Year Ended December 31, 2002	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Revenues	$ 463	$810,601	$5,160,065	$ (463)	$5,970,666
Operating Expenses					
Purchased gas	—	379,742	1,273,531	—	1,653,273
Fuel and purchased power	—	—	395,860	—	395,860
Operations and maintenance	13,325	45,357	2,043,215	—	2,101,897
Intercompany expense	2,772	79,826	(79,826)	(2,772)	—
Depreciation and amortization	(44)	65,911	448,746	—	514,613
Operating taxes	(2,149)	80,056	303,860	—	381,767
Total Operating Expenses	13,904	650,892	4,385,386	(2,772)	5,047,410
Gain on sale of property	—	317	4,413	—	4,730
Income from equity investments	104	—	13,992	—	14,096
Operating Income (Loss)	(13,337)	160,026	793,084	2,309	942,082
Interest charges	(200,920)	(62,520)	(295,209)	257,145	(301,504)
Other income and (deductions)	565,262	7,835	60,222	(633,068)	251
Total Other Income and (Deductions)	364,342	(54,685)	(234,987)	(375,923)	(301,253)
Income Taxes (Benefit)	(26,683)	36,746	233,416	—	243,479
Earnings from Continuing Operations	$ 377,688	$ 68,595	$ 324,681	$(373,614)	$ 397,350
Discontinued Operations	—	—	(19,662)	—	(19,662)
Net Income	$ 377,688	$ 68,595	$ 305,019	$(373,614)	$ 377,688

Statement of Income

(In Thousands of Dollars)

Year Ended December 31, 2001	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Revenues	$ 504	$889,693	$5,743,422	$ (504)	$6,633,115
Operating Expenses					
Purchased gas	—	464,780	1,706,333	—	2,171,113
Fuel and purchased power	—	—	538,532	—	538,532
Operations and maintenance	(24,537)	45,106	2,094,190	—	2,114,759
Intercompany expense	278	87,738	(87,738)	(278)	—
Depreciation and amortization	4,273	56,274	498,591	—	559,138
Operating taxes	1,094	91,204	356,626	—	448,924
Total Operating Expenses	(18,892)	745,102	5,106,534	(278)	5,832,466
Income from equity investments	—	—	13,129	—	13,129
Operating Income (Loss)	19,396	144,591	650,017	(226)	813,778
Interest charges	(230,618)	(65,206)	(264,286)	206,640	(353,470)
Other income and (deductions)	426,346	9,721	5,326	(447,316)	(5,923)
Total Other Income and (Deductions)	195,728	(55,485)	(258,960)	(240,676)	(359,393)
Income Taxes (Benefit)	(9,130)	28,319	191,504	—	210,693
Earnings from Continuing Operations	$224,254	$ 60,787	$ 199,553	$(240,902)	$ 243,692
Discontinued Operations	—	—	(19,438)	—	(19,438)
Net Income	$224,254	$ 60,787	$ 180,115	$(240,902)	$ 224,254

BALANCE SHEET

(In Thousands of Dollars)

Year Ended December 31, 2003	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Assets					
Current Assets					
Cash and temporary cash investments	$ 97,567	$ 1,554	$ 106,630	$ —	$ 205,751
Accounts receivable, net	3,298	209,151	1,243,459	—	1,455,908
Other current assets	3,250	130,994	590,996	—	725,240
	104,115	341,699	1,941,085	—	2,386,899
Equity Investments	4,475,949	1,123	153,520	(4,382,027)	248,565
Property					
Gas	—	1,899,375	4,622,876	—	6,522,251
Other	—	—	6,150,355	—	6,150,355
Accumulated depreciation and depletion	—	(312,204)	(3,466,099)	—	(3,778,303)
	—	1,587,171	7,307,132	—	8,894,303
Intercompany Accounts Receivable	3,105,571	—	1,191,394	(4,296,965)	—
Deferred Charges	374,076	237,870	2,485,071	—	3,097,017
Total Assets	$8,059,711	$2,167,863	$13,078,202	$(8,678,992)	$14,626,784
Liabilities and Capitalization					
Current Liabilities					
Accounts payable	$ 125,892	$ 165,613	$ 850,092	$ —	$ 1,141,597
Notes payable	481,900	—	—	—	481,900
Other current liabilities	129,168	16,125	80,026	—	225,319
	736,960	181,738	930,118	—	1,848,816
Intercompany Accounts Payable	—	116,197	2,596,202	(2,712,399)	—
Deferred Credits and Other Liabilities					
Deferred income tax	(48,059)	256,882	1,064,828	—	1,273,651
Other deferred credits and liabilities	532,062	179,919	925,839	—	1,637,820
	484,003	436,801	1,990,667	—	2,911,471
Capitalization					
Common shareholders' equity	3,707,785	782,223	3,553,967	(4,382,027)	3,661,948
Preferred stock	83,568	—	—	—	83,568
Long-term debt	3,047,395	650,904	3,497,699	(1,584,566)	5,611,432
Total Capitalization	6,838,748	1,433,127	7,051,666	(5,966,593)	9,356,948
Minority Interest in Subsidiary Companies	—	—	509,549	—	509,549
Total Liabilities & Capitalization	$8,059,711	$2,167,863	$13,078,202	$(8,678,992)	$14,626,784

Balance Sheet

(In Thousands of Dollars)

Year Ended December 31, 2002	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
Assets					
Current Assets					
Cash & temporary cash investments	$ 88,308	$ 6,472	$ 75,837	$ —	$ 170,617
Accounts receivable, net	23,982	208,512	1,299,559	—	1,532,053
Other current assets	1,757	79,206	423,596	—	504,559
	114.047	294.190	1,798,992	—	2,207,229
Equity Investments	3,797,964	1,469	201,675	(3,736,379)	264,729
Property					
Gas	—	1,773,028	4,352,501	—	6,125,529
Other	—	—	4,807,724	—	4,807,724
Accumulated depreciation and depletion	—	(282,832)	(3,065,829)	—	(3,348,661)
	—	1,490,196	6,094,396	—	7,584,592
Intercompany Accounts Receivable	3,619,515	—	712,394	(4,331,909)	—
Deferred Charges	339,443	192,652	2,391,405	—	2,923,500
Total Assets	$7,870,969	$1,978,507	$11,198,862	$(8,068,288)	$12,980,050
Liabilities and Capitalization					
Current Liabilities					
Accounts payable	$ 132,966	$ 68,772	$ 894,916	$ —	$ 1,096,654
Notes payable	915,697	—	—	—	915,697
Other current liabilities	107,605	104,975	30,302	—	242,882
	1,156,268	173,747	925,218	—	2,255,233
Intercompany Accounts Payable	—	178,843	2,071,682	(2,250,525)	—
Deferred Credits and Other Liabilities					
Deferred income tax	(43,110)	139,715	780,408	—	877,013
Other deferred credits and liabilities	481,964	138,209	744,688	—	1,364,861
	438,854	277,924	1,525,096	—	2,241,874
Capitalization					
Common shareholders' equity	2,983,214	647,089	3,050,668	(3,736,379)	2,944,592
Preferred stock	83,849	—	—	—	83,849
Long-term debt	3,208,784	700,904	3,395,777	(2,081,384)	5,224,081
Total Capitalization	6,275,847	1,347,993	6,446,445	(5,817,763)	8,252,522
Minority Interest in Subsidiary Companies	—	—	230,421	—	230,421
Total Liabilities & Capitalization	$7,870,969	$1,978,507	$11,198,862	$(8,068,288)	$12,980,050

Statement of Cash Flows

(In Thousands of Dollars)

Year Ended December 31, 2003	Guarantor	KEDLI	Other Subsidiaries	Consolidated
Operating Activities				
Net Cash (Used in) Provided by Operating Activities	$(547,516)	$ 162,786	$1,569,373	$1,184,643
Investing Activities				
Capital expenditures	—	(130,275)	(881,441)	(1,011,716)
Proceeds from the sale of property and subsidiary stock	—	15,123	294,573	309,696
Investments in subsidiaries	—	—	(211,370)	(211,370)
Issuance of note receivable	(55,000)	—	—	(55,000)
Net Cash (Used in) Investing Activities	(55,000)	(115,152)	(798,238)	(968,390)
Financing Activities				
Proceeds from equity issuance	473,573	—		473,573
Treasury stock issued	96,687	—	—	96,687
Redemption of LIPA promissory notes	(447,005)	—		(447,005)
Issuance of debt, net of payments	300,000	—	119,287	419,287
Redemption of preferred stock		—	(14,293)	(14,293)
Payment of commercial paper	(433,797)	—		(433,797)
Common and preferred stock dividends paid	(280,560)	—		(280,560)
Other	28,933	—	(23,944)	4,989
Net intercompany accounts	873,944	(52,552)	(821,392)	—
Net Cash Provided by (Used in) Financing Activities	611,775	(52,552)	(740,342)	(181,119)
Net (Decrease) Increase in Cash and Cash Equivalents	$ 9,259	$ (4,918)	$ 30,793	$ 35,134
Cash and Cash Equivalents at Beginning of Period	88,308	6,472	75,837	170,617
Cash and Cash Equivalents at End of Period	$ 97,567	$ 1,554	$ 106,630	$ 205,751

Statement of Cash Flows

(In Thousands of Dollars)

Year Ended December 31, 2002	Guarantor	KEDLI	Other Subsidiaries	Consolidated
Operating Activities				
Net Cash (Used in) Provided by Operating Activities	$ (97,981)	$ 188,955	$ 640,518	$ 731,492
Investing Activities				
Capital expenditures	—	(146,450)	(914,572)	(1,061,022)
Other	—	903	151,358	152,261
Net Cash (Used in) Investing Activities	—	(145,547)	(763,214)	(908,761)
Financing Activities				
Treasury stock issued	86,710	—	—	86,710
Issuance (payment) of debt, net	327,247	—	(35,711)	291,536
Common and preferred stock dividends paid	(256,656)	—		(256,656)
Other	70,299	—	(3,255)	67,044
Net intercompany accounts	(41,311)	(36,936)	78,247	—
Net Cash Provided by (Used in) Financing Activities	186,289	(36,936)	39,281	188,634
Net (Decrease) Increase in Cash and Cash Equivalents	$ 88,308	$ 6,472	$ (83,415)	$ 11,365
Cash and Cash Equivalents at Beginning of Period	—	—	159,252	159,252
Cash and Cash Equivalents at End of Period	$ 88,308	$ 6,472	$ 75,837	$ 170,617

Statement of Cash Flows

Year Ended December 31, 2001	Guarantor	KEDLI	Other Subsidiaries	Consolidated
				(In Thousands of Dollars)
Operating Activities				
Net Cash Provided by Operating Activities	$ 121,028	$ 64,294	$ 704,859	$ 890,181
Investing Activities				
Capital expenditures	—	(131,568)	(928,191)	(1,059,759)
Other	—	—	18,452	18,452
Net Cash (Used in) Investing Activities	—	(131,568)	(909,739)	(1,041,307)
Financing Activities				
Treasury stock issued	88,786	—	—	88,786
Issuance (payment) of debt, net	248,213	125,000	3,706	376,919
Common and preferred stock dividends paid	(251,502)	—		(251,502)
Other	10,582	—	2,264	12,846
Net intercompany accounts	(217,107)	(57,726)	274,833	—
Net Cash Provided by (Used in) Financing Activities	(121,028)	67,274	280,803	227,049
Net Increase in Cash and Cash Equivalents	$ —	$ —	$ 75,923	$ 75,923
Cash and Cash Equivalents at Beginning of Period	—	—	83,329	83,329
Cash and Cash Equivalents at End of Period	$ —	$ —	$ 159,252	$ 159,252

Note 13. Workforce Reduction Programs

As a result of the Eastern and ENI acquisitions, we implemented early retirement and severance programs in an effort to reduce our workforce. The early retirement program was completed in December 2000, at which time KeySpan recorded a charge of $51.4 million to reflect termination benefits related to employees who voluntarily elected early retirement. In addition, KeySpan recorded a $13.8 million liability associated with severance programs; Eastern and ENI had previously recorded an additional liability of $8.9 million. The combined liability, therefore, was $22.7 million. During the year ended December 31, 2001, we reduced this liability by $4.1 million as a result of lower than anticipated costs per employee and recorded a corresponding reduction to goodwill. During 2002, we paid $3.5 million for the program and, in total, $13.6 million was distributed to employees during the past two years. The remaining liability of $5.0 million was reversed and recorded to earnings in 2002.

Note 14. Shareholder Rights Plan

On March 30, 1999, our Board of Directors adopted a Shareholder Rights Plan (the "Plan") designed to protect shareholders in the event of a proposed takeover. The Plan creates a mechanism that would dilute the ownership interest of a potential unauthorized acquirer. The Plan establishes one preferred stock purchase "right" for each outstanding share of common stock to shareholders of record on April 14, 1999. Each right, when exercisable, entitles the holder to purchase 1/100th of a share of Series D Preferred Stock, at a price of $95.00. The rights generally become exercisable following the acquisition of more than 20 percent of our common stock without the consent of the Board of Directors. Prior to becoming exercisable, the rights are redeemable by the Board of Directors for $0.01 per right. If not so redeemed, the rights will expire on March 30, 2009.

Note 15. Subsequent Events (Unaudited)

KeySpan is currently analyzing proposals from interested investors to participate in the equity portion of a leveraged lease financing of a new 250 MW combined cycle electric generating facility located at the existing Ravenswood electric generating facility site. KeySpan is seeking to arrange for the lease to be consummated in late April to coincide with the commencement of full commercial operation of the new facility. At the closing, the new facility will be acquired by the lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to it. All obligations of our subsidiary under the lease will be unconditionally guaranteed by KeySpan. We anticipate that this lease transaction will generate cash proceeds equivalent to the fair market value of the facility, currently anticipated to be approximately $360 million. It is expected that the cash proceeds from this transaction will be used to redeem outstanding commercial paper. It is intended for this lease transaction to qualify as an operating lease under SFAS 98 "Accounting for Leases: Sale/Leaseback Transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; an Initial Direct Costs of Direct Financing Leases, an amendment of FASB Statements No.13, 66, 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11." The lease will have a term of approximately 35 years and operating lease expense is anticipated to be between $15 million to $17 million per year. Lease payments will fluctuate from year to year, but are substantially paid over the first 16 years.

On February 27, 2003 KeySpan and KeySpan Facilities Income Fund (the "Fund") announced that the Fund has entered into an agreement to sell 15.617 million units of the Fund at a price of $12.60 per unit for gross total proceeds of approximately CDN$196.8 million. The proceeds of the offering will be used to acquire a 35.91% interest in the business of KeySpan Energy Canada Partnership ("KeySpan Canada") from KeySpan. KeySpan will receive net proceeds of approximately CDN$186.3 million (or approximately US$139 million), after commissions and expenses. This offer is subject to regulatory approvals and is expected to close on or about April 1, 2004. After closing, the Fund's ownership in KeySpan Canada will increase from 39.1% to 75%. KeySpan's ownership of KeySpan Canada will decrease to approximately 25%.

Note 16. Supplemental Gas and Oil Disclosures (Unaudited)

This information includes amounts attributable to 100% of Houston Exploration and KeySpan Exploration and Production, LLC at December 31, 2003. Shareholders other than KeySpan had a minority interest of approximately 45% in Houston Exploration at December 31, 2003, 34% in 2002 and 33% in 2001. Gas and oil operations, and reserves, were located in the United States in all years.

Capitalized Costs Relating to Gas and Oil Producing Activities

(In Thousands of Dollars)

At December 31,	2003	2002	2001
Unproved properties not being amortized	$ 142,905	$ 110,623	$ 195,478
Properties being amortized – productive and nonproductive	2,429,891	1,917,287	1,590,014
Total capitalized costs	2,572,796	2,027,910	1,785,492
Accumulated depletion	(1,159,509)	(968,713)	(791,194)
Net capitalized costs	$ 1,413,287	$1,059,197	$ 994,298

Costs Incurred in Property Acquisition, Exploration and Development Activities

(In Thousands of Dollars)

At December 31,	2003	2002	2001
Acquisition of properties –			
Unproved properties	$ 61,484	$ 14,600	$ 31,718
Proved properties	171,297	90,004	85,435
Exploration	66,259	28,343	74,497
Development	170,493	139,108	191,927
Asset retirement obligation	31,858	—	—
Total costs incurred	$501,391	$272,055	$383,577

Costs included in development costs to develop proved undeveloped reserves for the years ended December 31, 2003, 2002 and 2001 were $49.4 million, $11.0 million and $19.9 million, respectively.

Results of Operations from Gas and Oil Producing Activities*

(In Thousands of Dollars)

At December 31,	2003	2002	2001
Revenues	$497,948	$356,233	$404,584
Production and lifting costs	63,591	44,822	37,574
Shipping and handling costs	10,388	9,450	7,850
Depletion	205,118	177,548	173,566
Total expenses	279,097	231,820	218,990
Income before taxes	218,851	124,414	185,594
Income taxes	76,598	42,519	64,118
Results of operations	$142,253	$ 81,895	$121,476

* *(Excluding corporate overhead and interest costs)*

Summary of Production and Lifting Costs

(In Thousands of Dollars)

At December 31,	2003	2002	2001
Pumping, gauging and other labor	$10,975	$ 7,846	$ 5,342
Compressors and other rental equipment	5,136	4,135	3,023
Property taxes and insurance	7,155	6,801	3,640
Transportation	2,329	2,131	3,162
Processing fees	2,354	3,078	2,267
Workover and well stimulation	5,225	2,348	1,478
Repairs, maintenance and supplies	3,735	2,972	2,204
Fuel and chemicals	3,109	2,582	1,424
Environmental, regulatory and other	7,614	3,307	3,639
Severance taxes	15,959	9,622	11,395
Total production and lifting costs	$63,591	$44,822	$37,574

The gas and oil reserves information is based on estimates of proved reserves attributable to the interest of Houston Exploration and KeySpan Exploration and Production, LLC as of December 31 for each of the years presented. These estimates principally were prepared by independent petroleum consultants. Proved reserves are estimated quantities of natural gas and crude oil which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions.

Reserve Quantity Information Natural Gas (MMcf)

At December 31,	2003	2002	2001
Proved Reserves			
Beginning of year	614,734	585,659	545,858
Revisions of previous estimates	(32,433)	(15,324)	(39,994)
Extensions and discoveries	140,632	105,798	86,401
Production	(100,130)	(107,507)	(90,754)
Purchases of reserves in place	89,380	48,777	84,148
Sales of reserves in place	—	(2,669)	—
Proved reserves – End of year (1)	712,183	614,734	585,659
Proved developed reserves			
Beginning of year	435,629	448,921	431,536
End of Year (2)	488,012	435,629	448,921

(1) Includes minority interest of 318,417, 208,516, and 188,077 in 2003, 2002, and 2001, respectively.

(2) Includes minority interest of 218,190, 148,811and 148,593 in 2003, 2002, and 2001, respectively.

Crude Oil, Condensate and Natural Gas Liquids (MBbls)

At December 31,	2003	2002	2001
Proved reserves			
Beginning of Year	9,548	10,234	7,912
Revisions of previous estimates	(3,542)	(5)	(289)
Extension and discoveries	117	342	3,061
Production	(1,514)	(1,025)	(536)
Purchases of reserves in place	3,753	483	115
Sales of reserves in place	—	(481)	(29)
Proved reserves - End of year (1)	8,362	9,548	10,234
Proved developed reserves			
Beginning of year	2,413	2,479	2,126
End of year (2)	4,273	2,413	2,479

(1) Includes minority interest of 3,739, 2,256 and 2,186 in 2003, 2002, and 2001, respectively.

(2) Includes minority interest of 1,910, 824 and 821 in 2003, 2002, and 2001, respectively.

The standardized measure of discounted future net cash flows was prepared by applying year-end prices of gas and oil to the proved reserves. The standardized measure does not purport, nor should it be interpreted, to present the fair value of gas and oil reserves of Houston Exploration or KeySpan Exploration and Production LLC. An estimate of fair value would also take into account, among other things, the recovery of reserves not presently classified as proved, anticipated future changes in prices and costs, and a discount factor more representative of the time value of money and the risks inherent in reserve estimates.

Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Gas and Oil Reserves

(In Thousands of Dollars)

At December 31,	2003	2002	2001
Future cash flows	$4,375,781	$2,951,622	$1,580,077
Future costs –			
Production	(769,892)	(495,097)	(316,421)
Development	(378,547)	(263,926)	(227,158)
Future net inflows before income tax	3,227,342	2,192,599	1,036,498
Future income taxes	(853,425)	(559,853)	(221,324)
Future net cash flows	2,373,917	1,632,746	815,174
10% discount factor	(853,403)	(528,829)	(228,988)
Standardized measure of discounted future net cash flows (1)	$1,520,514	$1,103,917	$ 586,186

(1) Includes minority interest of $672,620, $361,435 and $182,555 in 2003, 2002 and 2001, respectively.

Costs included in future development costs related to proved undeveloped reserves for the years ending December 31, 2004, 2005 and 2006 are $96.3 million, $135.4 million, and $10.5 million, respectively.

Changes in Standardized Measure of Discounted Future Net Cash Flows from Proved Reserve Quantities

(In Thousands of Dollars)

At December 31,	2003	2002	2001
Standardized measure – beginning of year	$1,103,917	$ 586,186	$2,165,759
Sales and transfers, net of production costs	(492,328)	(285,603)	(359,163)
Net change in sales and transfer prices, net of production costs	384,299	589,632	(2,250,252)
Extensions and discoveries and improved recovery, net of related costs	434,311	242,055	117,326
Changes in estimated future development costs	(9,352)	(6,453)	(23,395)
Development costs incurred during the period that reduced future development costs	81,025	42,075	75,652
Revisions of quantity estimates	(123,954)	(36,368)	(52,928)
Accretion of discount	142,296	68,986	293,581
Net change in income taxes	(236,551)	(215,369)	666,373
Net purchases of reserves in place	254,030	99,741	51,674
Sales of reserves in place	—	(31,488)	(133)
Changes in production rates (timing) and other	(17,179)	50,523	(98,308)
Standardized measure – end of year	$1,520,514	$1,103,917	$ 586,186

Average Sales Prices and Production Costs Per Unit

At December 31,	2003	2002	2001
Average Sales Price*			
Natural gas ($/Mcf)	5.23	3.16	4.09
Oil, condensate and natural gas liquid ($/Bbl)	28.26	24.06	23.09
Production cost per equivalent Mcf ($)	0.58	0.42	0.40

** Represents the cash price received which excludes the effect of any hedging transactions.*

Acreage

At December 31, 2003	Gross	Net
Producing	638,425	396,192
Undeveloped	464,874	388,830

Number of Producing Wells

At December 31, 2003	Gross	Net
Gas wells	2,435.0	1,748.0
Oil wells	31.0	15.9

Drilling Activity (Net)

At December 31, 2003	Producing	Dry	Total
Net developmental wells	84.4	20.0	104.4
Net exploratory wells	5.4	7.0	12.4

At December 31, 2002	Producing	Dry	Total
Net developmental wells	65.1	9.4	74.5
Net exploratory wells	4.0	2.2	6.2

At December 31, 2001	Producing	Dry	Total
Net developmental wells	51.9	10.2	62.1
Net exploratory wells	5.3	4.3	9.6

Wells in Progress

At December 31, 2003	Gross	Net
Exploratory	4.0	3.3
Developmental	12.0	9.2

Note 17. Summary of Quarterly Information (Unaudited)

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2003.

(In Thousands of Dollars, Except Per Share Amounts)

	Quarter Ended 3/31/03	Quarter Ended 6/30/03	Quarter Ended 9/30/03	Quarter Ended 12/31/03
Operating revenues	2,512,525	1,408,152	1,131,814	1,862,670
Operating income	456,694	138,229	107,923	338,811
Earnings (loss) from continuing operations	243,091	(5,938)	12,585	174,443
Cumulative change in accounting principle	174	—	—	(37,625)
Earnings (loss) for common stock	241,804	(7,399)	11,124	135,357
Basic earnings per common share from continuing operations less preferred stock dividends (a)	1.54	(0.05)	0.07	1.08
Change in accounting principle (a)	—	—	—	(0.23)
Basic earnings per common share (a)	1.54	(0.05)	0.07	0.85
Diluted earnings per common share (a)	1.53	(0.05)	0.07	0.84
Dividends declared	0.445	0.445	0.445	0.445

(a) Quarterly earnings per share are based on the average number of shares outstanding during each quarter. Because of the changing number of common shares outstanding in each quarter, the sum of quarterly earnings per share does not necessarily equal earnings per share for the year.

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2002.

(In Thousands of Dollars, Except Per Share Amounts)

	Quarter Ended 3/31/02	Quarter Ended 6/30/02	Quarter Ended 9/30/02	Quarter Ended 12/31/02
Operating revenues	1,873,577	1,218,201	1,078,336	1,800,552
Operating income	406,038	115,383	97,692	322,969
Earnings from continuing operations	214,631	29,174	4,964	148,581
Earnings (loss) from discontinued operations	—	(19,662)	—	—
Earnings for common stock	213,155	8,036	3,629	147,115
Basic earnings per common share from continuing operations less preferred stock dividends (a)	1.52	0.20	0.03	1.03
Basic earnings per common share from discontinued operations (a)	—	(0.14)	—	—
Basic earnings per common share (a)	1.52	0.06	0.03	1.03
Diluted earnings per common share (a)	1.51	0.06	0.02	1.03
Dividends declared	0.445	0.445	0.445	0.445

(a) Quarterly earnings per share are based on the average number of shares outstanding during each quarter. Because of the changing number of common shares outstanding in each quarter, the sum of quarterly earnings per share does not necessarily equal earnings per share for the year.

Selected Financial Data

Year Ended December 31,	2003	2002	2001	2000	1999
				(In Thousands of Dollars, Except Per Share Amounts)	
Income Summary					
Revenues					
Gas Distribution	$4,161,272	$3,163,761	$3,613,551	$2,555,785	$1,753,132
Electric Services	1,503,086	1,421,043	1,421,079	1,444,711	861,582
Energy Services	641,432	938,761	1,100,167	770,110	186,529
Energy Investments and other	609,371	447,101	498,318	310,096	153,370
Total revenues	6,915,161	5,970,666	6,633,115	5,080,702	2,954,613
Operating expenses					
Purchased gas for resale	2,495,102	1,653,273	2,171,113	1,408,680	744,432
Fuel and purchased power	414,633	395,860	538,532	460,841	17,252
Operations and maintenance	2,005,796	2,101,897	2,114,759	1,659,736	1,091,166
Depreciation, depletion and amortization	574,074	514,613	559,138	330,922	253,440
Early retirement and severance charges	—	—	—	65,175	—
Operating taxes	418,236	381,767	448,924	421,936	366,154
Total operating expenses	5,907,841	5,047,410	5,832,466	4,347,290	2,472,444
Gain on sale of property	15,123	4,730	—	—	—
Income from equity investments	19,214	14,096	13,129	20,010	15,347
Operating income	1,041,657	942,082	813,778	753,422	497,516
Other deductions	(340,165)	(301,253)	(359,393)	(233,410)	(102,543)
Income taxes	277,311	243,479	210,693	217,262	136,362
Earnings from continuing operations	424,181	397,350	243,692	302,750	258,611
Discontinued Operations					
Income (loss) from operations, net of tax	—	(3,356)	10,918	(1,943)	—
Loss on disposal, net of tax	—	(16,306)	(30,356)	—	—
Loss from discontinued operations	—	(19,662)	(19,438)	(1,943)	—
Cumulative change in accounting principles	(37,451)	—	—	—	—
Net income	386,730	377,688	224,254	300,807	258,611
Preferred stock dividend requirements	5,844	5,753	5,904	18,113	34,752
Earnings for common stock	$ 380,886	$ 371,935	$ 218,350	$ 282,694	$ 223,859
Financial Summary					
Earnings per share ($)	2.41	2.63	1.58	2.10	1.62
Cash dividends declared per share ($)	1.78	1.78	1.78	1.78	1.78
Book value per share, year-end ($)	22.94	20.67	20.73	20.65	20.26
Market value per share, year-end ($)	36.80	35.24	34.65	42.38	23.19
Shareholders, year-end	75,067	78,281	82,300	86,900	90,500
Capital expenditures ($)	1,011,716	1,061,022	1,059,759	925,257	725,670
Total assets ($)	14,626,784	12,980,050	11,789,606	11,307,465	6,730,691
Common shareholders' equity ($)	**3,661,948**	**2,944,592**	**2,890,602**	**2,815,816**	**2,712,325**
Redeemable preferred stock ($)	—	—	—	—	363,000
Preferred stock ($)	83,568	83,849	84,077	84,205	84,339
Long-term debt ($)	5,611,432	5,224,081	4,697,649	4,116,441	1,682,702
Total capitalization ($)	9,356,948	8,252,522	7,672,328	7,016,462	4,479,366

KeySpan Corporation Directors and Officers

Board of Directors

Robert B. Catell
Chairman and
Chief Executive Officer
KeySpan Corporation

Andrea S. Christensen
Partner
Kaye Scholer LLP

Alan H. Fishman
President and
Chief Executive Officer
Independence Community
Bank

J. Atwood Ives
Former Chairman and
Chief Executive Officer
Eastern Enterprises

James R. Jones
Chairman and
Chief Executive Officer
Manatt Jones Global
Strategies, LLC

James L. Larocca
Dean and
Distinguished Professor
Southampton College
Long Island University

Gloria C. Larson
of Counsel
Foley Hoag LLP

Stephen W. McKessy
Retired Vice Chairman
PricewaterhouseCoopers

Edward D. Miller
Former President
and Chief Executive Officer
AXA Financial, Inc.

Vikki L. Pryor
President and
Chief Executive Officer
SBLI USA Mutual Life
Insurance Company, Inc

Committees of the Board

Executive Committee

Robert B. Catell,
Chairman

Alan H. Fishman
J. Atwood Ives
James R. Jones
Stephen W. McKessy
Edward D. Miller

Audit Committee

Alan H. Fishman,
Chairman

Andrea S. Christensen
James L. Larocca
Stephen W. McKessy

Compensation and Management Development Committee

Edward D. Miller,
Chairman

James R. Jones
James L. Larocca
Stephen W. McKessy

Corporate Governance and Nominating Committee

James R. Jones,
Chairman

Andrea S. Christensen
James L. Larocca
Gloria C. Larson
Vikki L. Pryor

Principal Officers

Office of the Chairman

Robert B. Catell
Chairman and
Chief Executive Officer
KeySpan Corporation

Robert J. Fani
President and
Chief Operating Officer

Wallace P. Parker Jr.
President
Energy Delivery and
Customer Relationship Group

Steven L. Zelkowitz
President
Energy Assets
and Supply Group

Executive Vice Presidents

John A. Caroselli
Executive Vice President
and Chief Strategy Officer

Gerald Luterman
Executive Vice President
and Chief Financial Officer

Anthony Nozzolillo
Executive Vice President
Electric Operations

Lenore F. Puleo
Executive Vice President
Shared Services

Nickolas Stavropoulos
Executive Vice President
KeySpan Energy Delivery
New England

Senior Vice Presidents

John J. Bishar, Jr.
Senior Vice President,
General Counsel and
Secretary

Joseph F. Bodanza, Jr.
Senior Vice President
Regulatory Affairs and
Chief Accounting Officer

John F. Haran
Senior Vice President
KeySpan Energy Delivery
and Chief Engineer

David J. Manning
Senior Vice President
Corporate Affairs

H. Neil Nichols
Senior Vice President
Corporate Development
and Asset Management

Michael J. Taunton
Senior Vice President
and Treasurer

Colin P. Watson
Senior Vice President
Strategic Marketing and
E-Business

Elaine Weinstein
Senior Vice President
Human Resources
and Chief Diversity Officer

Other Officers

Theresa A. Balog
Vice President and
Controller

Lawrence S. Dryer
Vice President and
General Auditor

Cassandra R. Schultz
Vice President and
Chief Risk Officer

KeySpan Corporation
One MetroTech Center
Brooklyn, New York 11201-3850

The Annual Meeting of Shareholders of KeySpan Corporation will be held at 10:00 a.m. Eastern Time, on Thursday, May 20, 2004, at KeySpan Corporation, One MetroTech Center, Brooklyn, New York.

KeySpan common stock is traded primarily on the New York Stock Exchange (NYSE) under the trading symbol 'KSE.' KeySpan 'MEDS' Convertible securities are primarily traded on the NYSE under the ticker KSE.PRA. The Houston Exploration Company is primarily traded on the NYSE under the trading symbol 'THX.' Daily stock quotes are listed in most major newspapers under the headings 'KeySpan' and 'HoustEx,' respectively.

The KeySpan Investor Program is an Open Enrollment/Dividend Reinvestment Plan. The Plan offers individuals a convenient and cost-effective way of purchasing KeySpan common stock. This Plan is open to everyone (NOT just existing shareholders). There is no enrollment fee for joining the Plan.

We welcome your participation in the KeySpan Investor Program. If you are interested in receiving Program material, please contact KeySpan's Stock Transfer Agent, EquiServe (electronic request line) at 1-866-238-5345 (1-866-2-FULFIL).

To enroll in the Plan, individuals must complete an application and mail in an initial investment of at least $250, or authorize electronic deductions of at least $25. Individuals may also enroll in the Plan via our web site http://investor.keyspanenergy.com.

Eligibility: Open Enrollment

None

Minimum: $250 Minimum: $25
Maximum: $150,000 Maximum: $150,000

Weekly on Thursday
Open Market (as of January 2004)
Daily
$5.00 + 5 cents per share
Yes
Yes
Yes

KeySpan's annual common dividend is $1.78 per share. All of the dividends paid to holders of common stock of KeySpan Corporation during the calendar year 2003 are considered to be ordinary dividend income, and are, therefore, taxable (subject to review by the IRS). Tax Forms 1099-Div were mailed by January 31, 2004. Please consult your tax advisor for further information.

Declaration Date	Record Date	Payment Date
Dec. 18, 2003	Jan. 14, 2004	Feb. 1, 2004
Mar. 10, 2004	Apr. 16, 2004	May 1, 2004
Jun. 30, 2004	Jul. 14, 2004	Aug. 1, 2004
Sept. 15, 2004	Oct. 13, 2004	Nov. 1, 2004
Dec. 15, 2004	Jan. 12, 2005	Feb. 1, 2005

Please direct inquiries to:
KeySpan Corporation
Stock Plans Group
One MetroTech Center
22nd Floor
Brooklyn, New York 11201-3850
Or call: 1-718-403-3196 E-mail: financial@keyspanenergy.com

Inquiries from security analysts, stockbrokers, investment managers and other members of the financial community should be addressed to George Laskaris, Director of Investor Relations, at 1-718-403-2526, or by e-mail, glaskaris@keyspanenergy.com. Company information, including financial reports, is available at **http://investor.keyspanenergy.com.**

EquiServe Trust Company, N.A.
Investment Plan Services
P.O. Box 43069
Providence, RI 02940-3069
Call: 1-800-482-3638

The Company files an annual report on Form 10-K with the Securities and Exchange Commission, which includes additional information about the Company. The Company has filed the CEO/CFO certification required by Section 302 and 906 of the Sarbanes-Oxley Act of 2002 as an exhibit to its Form 10-K. This report is available to shareholders upon request to Investor Relations.

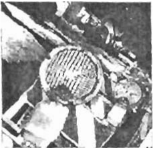
Deloitte & Touche LLP
2 World Financial Center
New York, NY 10281
1-212-436-2000

For more information on KeySpan, or for copies of our press releases and quarterly reports, please visit our web site at **http://investor.keyspanenergy.com.**

Design: MGT Design, I c. Pan ram c Photography: Peter Vidor dditional h t graphy St er, Carl S o, t e Sorensen, Kell oney Pho raphy Pri t Stephen on P ng

This Annual Report is Printed on Recycled Paper

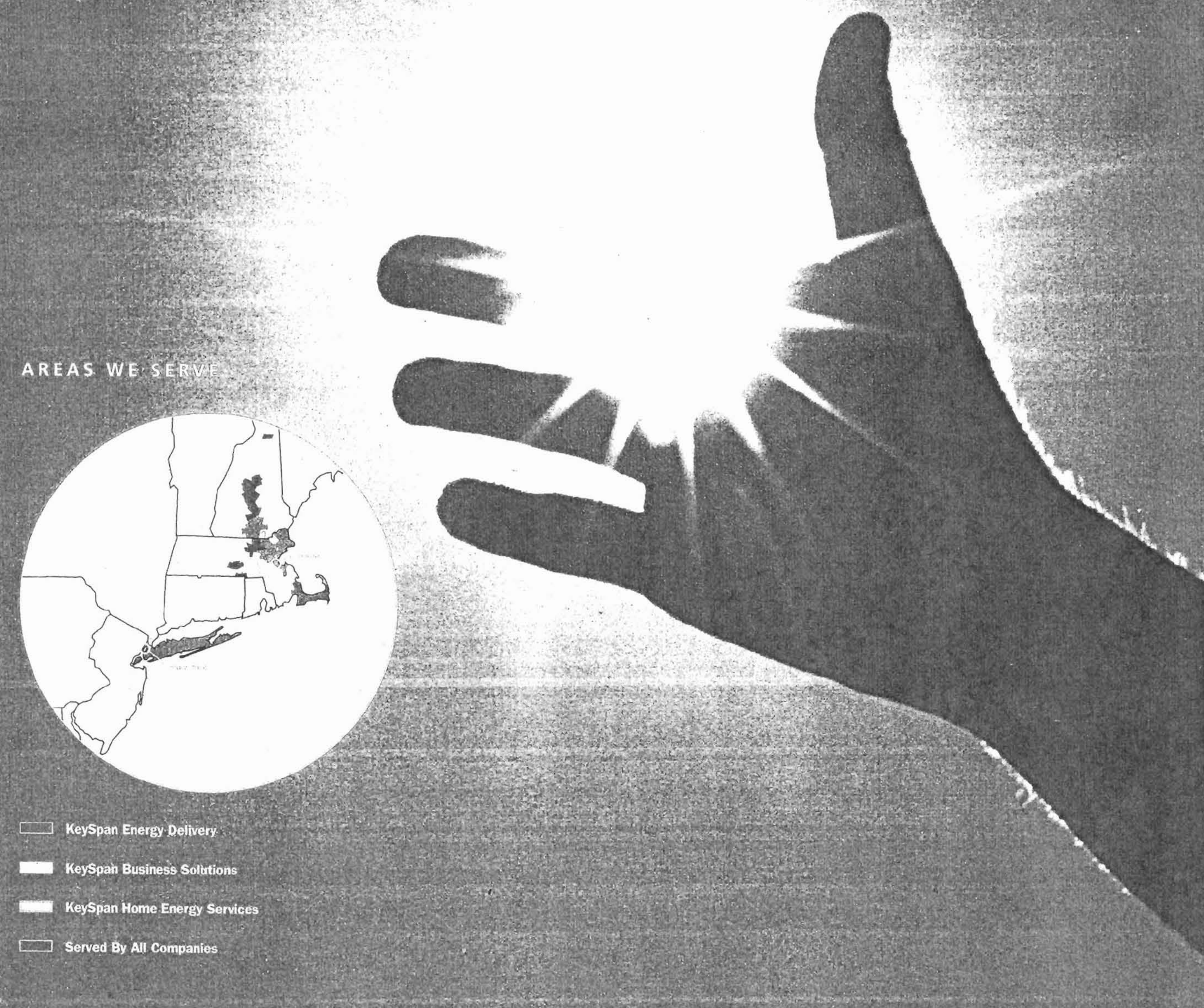
One MetroTech Center
Brooklyn, New York 11201-3850
www.keyspanenergy.com



KEYSPAN
2004
ANNUAL
REPORT
Climate is everything.™

WHO WE ARE

A member of the Standard & Poor's 500 Index, KeySpan Corporation (NYSE: KSE) is the fifth largest distributor of natural gas in the United States and the largest in the Northeast, operating regulated gas utilities in New York, Massachusetts and New Hampshire, serving 2.6 million customers. These customer-focused businesses are complemented by a portfolio of service companies that offer energy-related products, services and solutions to homes and businesses. KeySpan is also the largest electric generator in New York State. We own approximately 6,600 megawatts of generating capacity, providing power to 1.1 million customers of the Long Island Power Authority on Long Island and supplying approximately 25 percent of New York City's capacity needs. In addition to these assets, KeySpan has strategic investments in natural gas exploration and production, transportation, distribution and storage. KeySpan has headquarters in Brooklyn, New England and Long Island. For more information, visit KeySpan's web site at www.keyspanenergy.com.



Climate is everything.™ is a registered trademark of KeySpan Corporation. © Copyright 2005. All rights reserved.

OUR CORPORATE STRATEGY

We will become the most efficient energy distributor and complete customer service provider in those markets where we can most effectively manage and grow gas and electric distribution supported by our complementary energy supply assets.

OUR BUSINESS SEGMENTS

GAS DISTRIBUTION

KeySpan is the largest gas distribution company in the Northeast serving 2.6 million customers. Its subsidiaries include a number of companies providing gas distribution services under the KeySpan brand. KeySpan Energy Delivery New York serves the New York City boroughs of Brooklyn, Staten Island and most of Queens. KeySpan Energy Delivery Long Island provides services on Long Island and the Rockaway Peninsula in Queens. Other subsidiaries, doing business as KeySpan Energy Delivery New England, provide services in Massachusetts and New Hampshire.

ELECTRIC SERVICES

KeySpan's electric services segment is the largest electric generator in New York State. We own and operate electric generation in New York City and Long Island with total capacity of approximately 6,600 megawatts. This segment also manages Long Island's electric transmission and distribution system for 1.1 million customers under long-term contracts with the Long Island Power Authority.

ENERGY SERVICES

This segment markets energy-related services to customers primarily located within the Northeastern United States, with concentrations in the New York City and Boston metropolitan areas. Lines of business include KeySpan Home Energy Services, which provides residential and small commercial customers with service and maintenance of energy systems and appliances, and KeySpan Business Solutions, which provides operation and maintenance, design, engineering and consulting services to commercial and industrial customers.

ENERGY INVESTMENTS

The energy investments segment consists of strategic investments in natural gas exploration and production, pipeline development, transportation, distribution and storage. These investments primarily include ownership of an interstate liquefied natural gas (LNG) storage facility in Providence, Rhode Island, a 20 percent interest in the Iroquois gas pipeline in the Northeast United States and a 50 percent and 21 percent interest, respectively, in the Islander East and Millennium pipeline projects.

WHAT DO WE MEAN WHEN WE SAY "CLIMATE IS EVERYTHING"?

Climate is not just about the weather. It's an important factor in our everyday lives. Climate affects our moods, attitudes and the way we interact with the environment. At KeySpan, the Company recognizes the role it plays in delivering climate to its customers. Every positive experience a customer has with KeySpan creates a climate that makes it easier for all of us to do business. KeySpan's ongoing commitment to improving its customers' lifestyles through innovative products and services creates a climate where success is a daily occurrence.

CONTENTS

1 Business Segments
2 Letter to Shareholders
19 Financial Review and Analysis
52 Consolidated Financial Statements
97 Selected Financial Data
98 Directors and Officers
99 Shareholder Information

DEAR FELLOW SHAREHOLDER:

Climate is

2004 was a successful year for our Company. Overall, it was a year typified by accomplishment, advancement and positioning for the future.

Our success came during an improved, but spotty, economic picture; ongoing volatility in the energy commodity markets; increases in operating costs (many related to rising pension and health benefit costs); and despite the lack of a cohesive national energy policy. As always, we cut through the clamor of the market to protect the long-term interests of our shareholders.

Operating within the Northeast United States, where sizeable organic growth opportunities exist, gives us an advantage over many of our competitors. We made progress on our focused strategy of growing our core gas and electric businesses and energy assets that support those businesses.

HERE ARE THE HIGHLIGHTS FOR 2004:

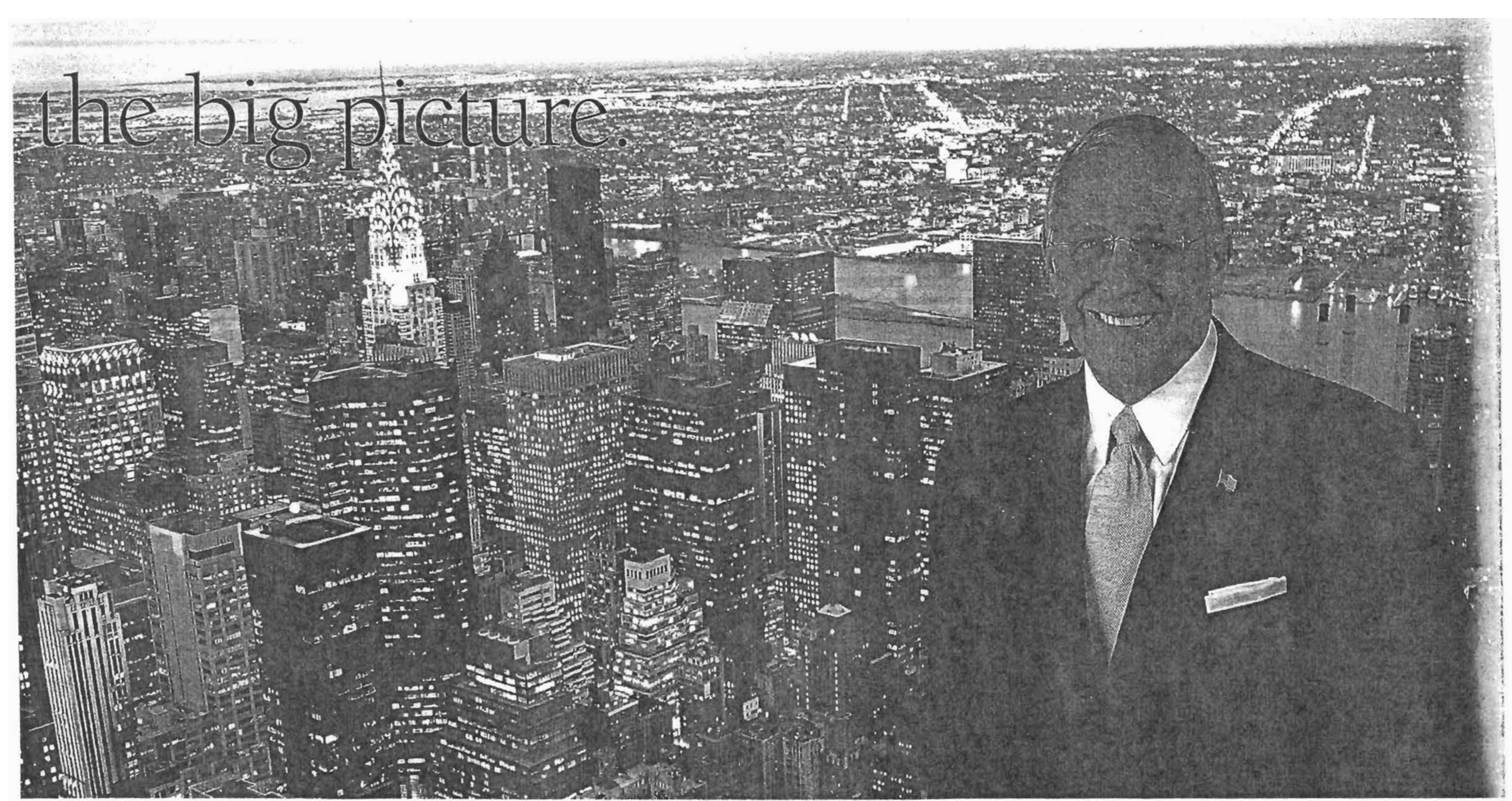
- **Dividend Increase.** Our improved financial performance allowed us to raise our dividend for the first time since 1998, to $1.82 per share.
- **Shareholder Return.** Total shareholder return for 2004 amounted to approximately 12 percent (a dividend yield of 4.5 percent and a stock price appreciation of more than 7 percent). Over the past five years, KeySpan has provided a total return to shareholders of 118 percent (17 percent on an annualized basis), compared to 30 percent for the Standard & Poor's Utilities Index and a loss of 11 percent for the S&P 500.
- **Earnings.** Earnings from continuing operations, less preferred stock dividends and special items, were $443.3 million, or $2.77 per share. Results were ahead of consensus and last year's earnings. Core earnings, which exclude earnings from exploration and production operations, were $2.41 per share, 8 percent higher than in 2003. Earnings from exploration and production operations were $0.36 per share, compared to $0.50 per share in 2003, reflecting the divestiture of our interest in The Houston Exploration Company.

  There were a number of special items that had a substantial, one-time impact in 2004: a gain from non-core asset sales ($1.60 per share, see below) and losses related to discontinued operations ($0.94 per share) and other items ($0.57 per share).
- **Non-core Asset Sales.** We provided substantial shareholder benefit and improved our risk profile by totally divesting our largest non-core assets, specifically The Houston Exploration Company and KeySpan Canada. Combined, the sales of these businesses generated approximately $1 billion in cash proceeds. These proceeds allowed us to pay down debt, increase our ability to purchase additional core assets and concentrate solely on the growth of our core operations
- **Financial Performance.** We have strengthened our balance sheet by reducing our debt-to-capital ratio from 58 to 53 percent. The reaffirmation of our "A" credit rating by Standard & Poor's provides us continued favorable access to capital markets and enhances liquidity. And our attention to managing costs has resulted in the absorption of a $100 million increase in operating and maintenance expenses in 2004, keeping expenses essentially flat with 2003.
- **Gas Business.** We continued to benefit from the economic expansion of our gas distribution system, as we completed close to 51,000 new gas installations, resulting in approximately $55 million in new gross profit margin. Operating income increased $5 million compared to 2003, due to continued organic growth and a full year of contributions from our successful Massachusetts rate proceeding, which was concluded in late 2003.
- **Electric Services**. Our new, state-of-the-art Ravenswood power plant went into commercial operation in May 2004. This 250-megawatt addition was available nearly 100 percent of the time during the summer to serve the capacity-constrained New York City market. Operating income from electric services increased $20 million compared to 2003, supported by the increase in net revenues from the Ravenswood expansion project.

  On Long Island, our approximately 4,200 megawatts of generation were available more than 97 percent of the time during the summer. And, in terms of reliability and restoration times, we were once again the best in New York State for overhead utilities on behalf of our work for the Long Island Power Authority's (LIPA's) transmission and distribution (T&D) system. These accomplishments helped us achieve close to the maximum performance incentive payout from LIPA of $16.4 million.

LIPA is currently considering its future direction, spurred on by the option to purchase KeySpan's Long Island generation assets for fair market value. We have agreed to extend this option until December 15, 2005 to allow LIPA sufficient time to complete its strategic review process. Besides this possible purchase, LIPA is also pondering privatizing Long Island's T&D system, maintaining the status quo and/or any combination thereof. We will work with LIPA to determine what future model works best for Long Island consumers, while protecting the interests of our shareholders and employees.

Despite our accomplishments, the past year was not without its internal challenges. Our Energy Services segment posted another year-



end loss – sustaining losses of $48 million from continuing operations, compared to $33 million for 2003. However, excluding a goodwill impairment charge of $14.4 million in 2004, operating income was essentially the same for both years. Upon a full strategic review of this entire area, we made the decision to exit the mechanical contracting business. Today, we are totally divested of these businesses.

The higher cost and volatility of natural gas remain concerns too, but we believe we have the right strategy in place to address them. Specifically, I am referring to our efforts to create a Northeast natural gas hub, which will include new strategic pipelines and new liquefied natural gas (LNG) infrastructure. Three of our planned multi-year projects are key to the creation of this hub: the Islander East Pipeline; our Providence, Rhode Island LNG expansion; and the Millennium Pipeline, in which we became a 21 percent owner in 2004. This pipeline will provide the Northeast with access to much-needed strategic gas supply and storage basins from the Midwest and the Rockies.

Obtaining the siting permits for these projects is one of our biggest challenges. While we have made progress in 2004, we know that ultimate success will take further persistence and goodwill in the regulatory, legislative and community arenas. We continue to point out the long-term benefit to consumers in terms of increased reliability and competition, which will result in lower prices and less volatility.

I would like to recognize and thank the Board of Directors for their contributions in the past year. Among other things, they are the foundation for a corporate governance structure that ranked among the top 10 corporations in the S&P 500. Robert J. Fani, our President and Chief Operating Officer, deserves recognition as well for his election to the Board in January.

And where would we be without our excellent employees? Whether they are union or management, they know the necessity of operating at a higher level to increase customer satisfaction and shareholder value. They are, indeed, our best assets and are integral to our new brand promise, which is centered on exceeding expectations and creating the right "climate" for our customers.

More than six years ago, I stated my vision for KeySpan to become "the premier energy company in the Northeast." That vision is still strong and guides our growth into the future. We have made substantial progress, gained wisdom and strength along the way, but have not reached the top rung yet. We will reach our goal, like the old adage states, by focusing on the journey – those things we do every day to add value – rather than the destination. In the process, we will build an even stronger energy company, one that is firmly rooted in our core strengths and values.

On behalf of the Board of Directors and our employees, I thank you for joining us on our journey thus far, and invite you to continue to help us grow and thrive in the future.

Robert B. Catell

Robert B. Catell
Chairman and Chief Executive Officer
March 16, 2005

Climate is

Taking Stock of Our Core Capabilities — Reassessing and evaluating changing market conditions are part of a successful long-term strategy. In 2004, KeySpan continued to focus on its core strengths by divesting itself of assets that no longer support its core businesses. Last year, the sales of The Houston Exploration Company and KeySpan Canada generated proceeds of approximately $1 billion for the Company. These transactions further demonstrated KeySpan's commitment to monetize its non-core assets and focus on growing its core businesses.

performance.

Whether it's providing gas or electric services, KeySpan's enterprise-wide efforts were focused on optimizing the performance of its financial and "human" capital in 2004. By evolving into a performance-based culture, the Company built on its past successes, while creating the ability to meet the increasing expectations of its customers and shareholders. During 2004, KeySpan focused on delivering its strategic commitments by divesting non-core assets and adding to its complementary gas supply and electric generation assets. These actions helped the Company increase its dividend while enhancing value for investors.

Climate is

During 2004, KeySpan seized every opportunity to strategically grow its core gas business. Through a new, integrated Retail Market Strategy, the Company has transitioned from a mass market approach to targeting customer segments by using behavioral research to analyze purchasing patterns. For example, in 2005 the Company will reposition itself with various market segments by using "Greenhouse" initiatives to pilot and fine-tune offerings for specific customer groups. This strategy will maximize enterprise-wide alignment while helping the Company optimize profitability through differentiated service offerings.

opportunity.

Serving Up Solutions for Expanding Opportunities — Liquefied natural gas (LNG) provides KeySpan with the opportunity to increase the reliability of natural gas supplies in the Northeast. Already an important part of KeySpan's natural gas portfolio and hedging strategy, the American Gas Association and other government agencies believe that ample LNG supplies are the key to keeping pace with increasing demands for the many uses of natural gas, including outdoor cooking. LNG now represents about 10 percent of the Company's supply in New England. In New York City and Long Island, LNG is used primarily as a "peaking" fuel to supplement supply during the coldest days. KeySpan owns LNG storage locations throughout Massachusetts, New Hampshire and Rhode Island – more than half the storage available in the Northeast.

Climate is

Execution is the key to

working together

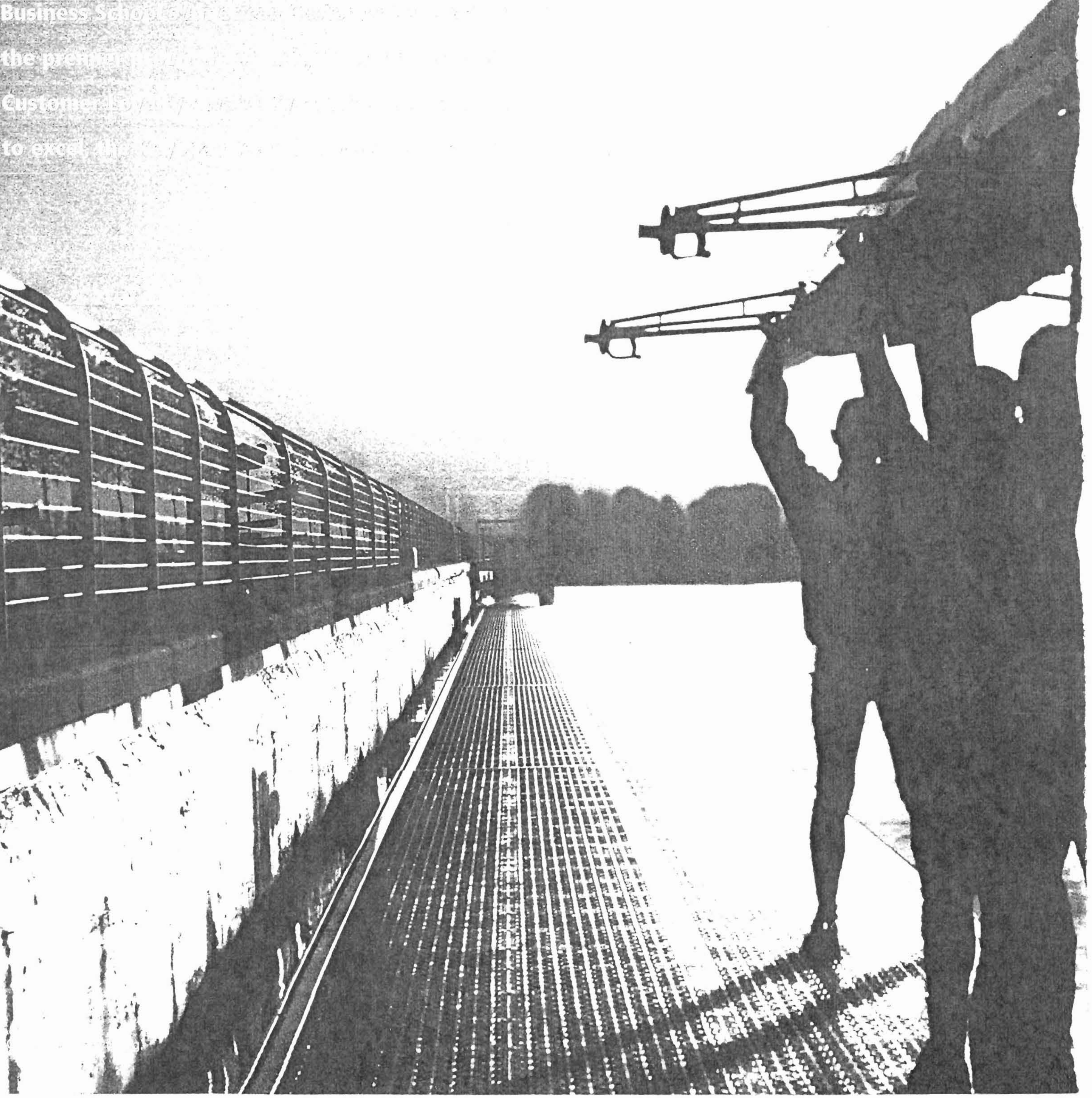
off when Key

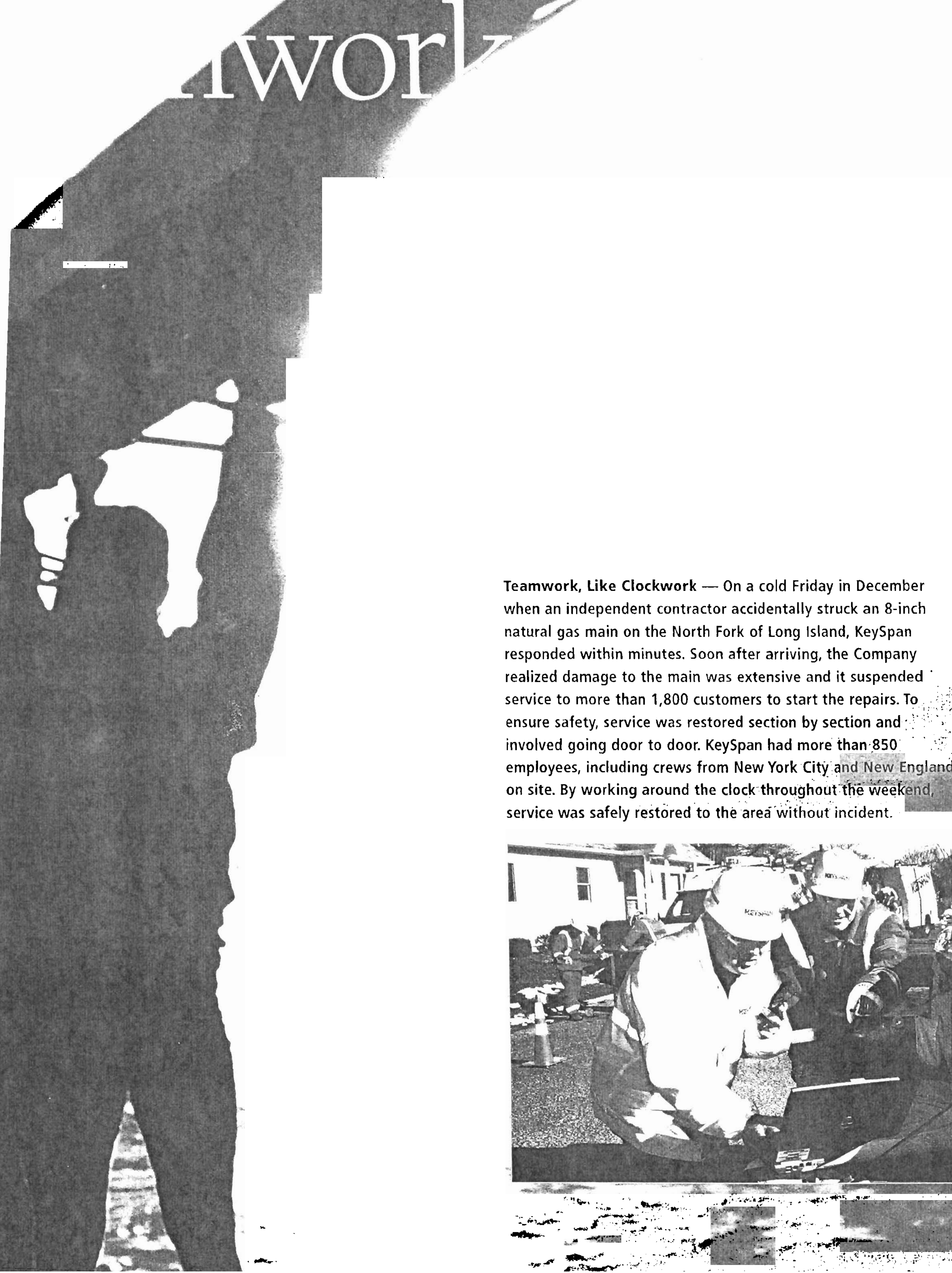
Business School

the prem

Customer

to excel,





Teamwork, Like Clockwork — On a cold Friday in December when an independent contractor accidentally struck an 8-inch natural gas main on the North Fork of Long Island, KeySpan responded within minutes. Soon after arriving, the Company realized damage to the main was extensive and it suspended service to more than 1,800 customers to start the repairs. To ensure safety, service was restored section by section and involved going door to door. KeySpan had more than 850 employees, including crews from New York City and New England on site. By working around the clock throughout the weekend, service was safely restored to the area without incident.

Climate is

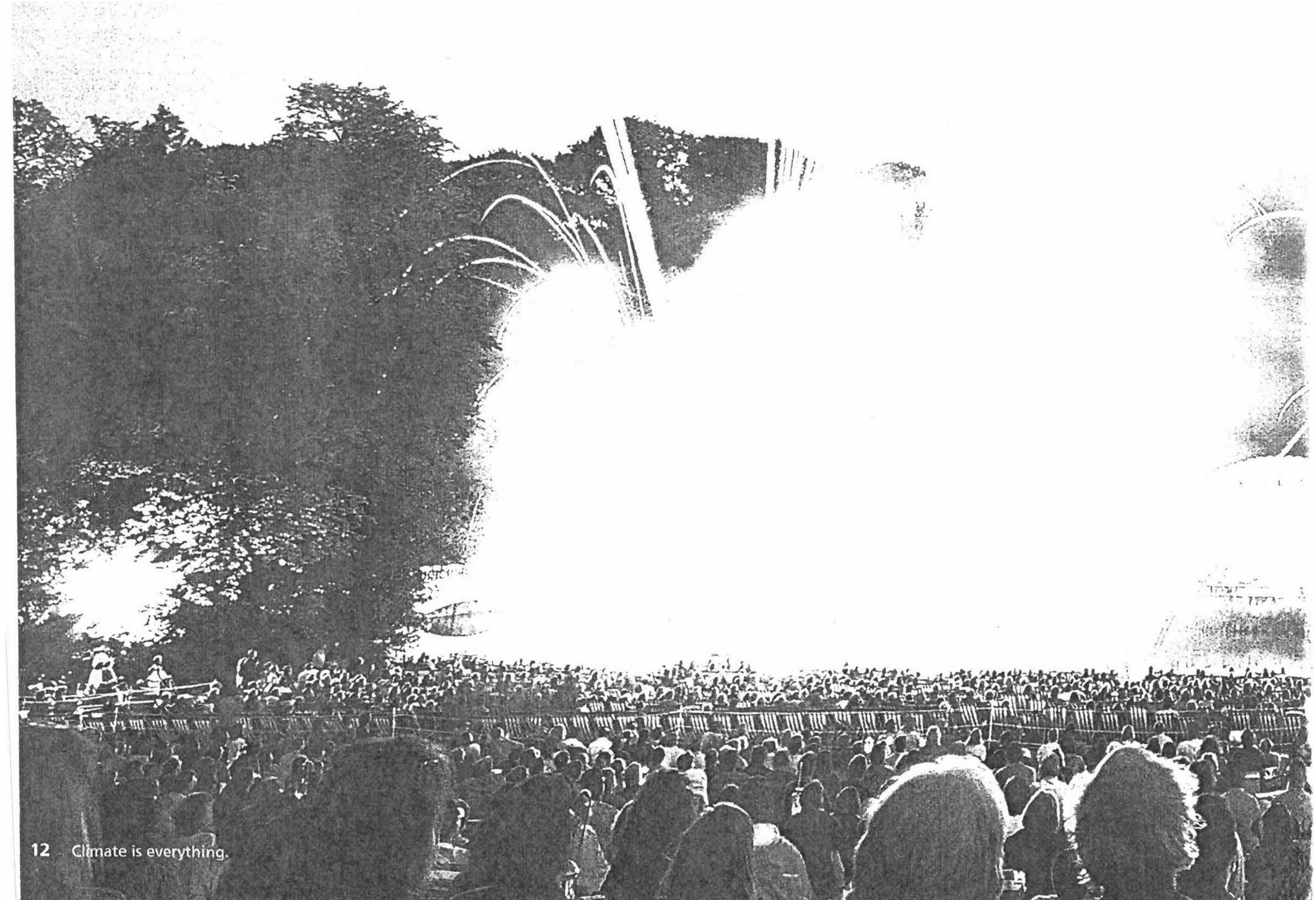
KeySpan, together with LIPA, operates the safest and most reliable overhead electric transmission and distribution system in New York State. Under KeySpan's stewardship, the Long Island region has enjoyed the highest level of reliability for overhead systems in New York State for the past several years. At the same time, KeySpan has kept its power plants on Long Island and New York in top working form by implementing extensive maintenance programs designed to keep them operating efficiently. These achievements are the result of an experienced, hard working and talented group of KeySpan employees whose leadership and experience in the electric industry benefits all Long Islanders and extends KeySpan's corporate reputation.

ience.

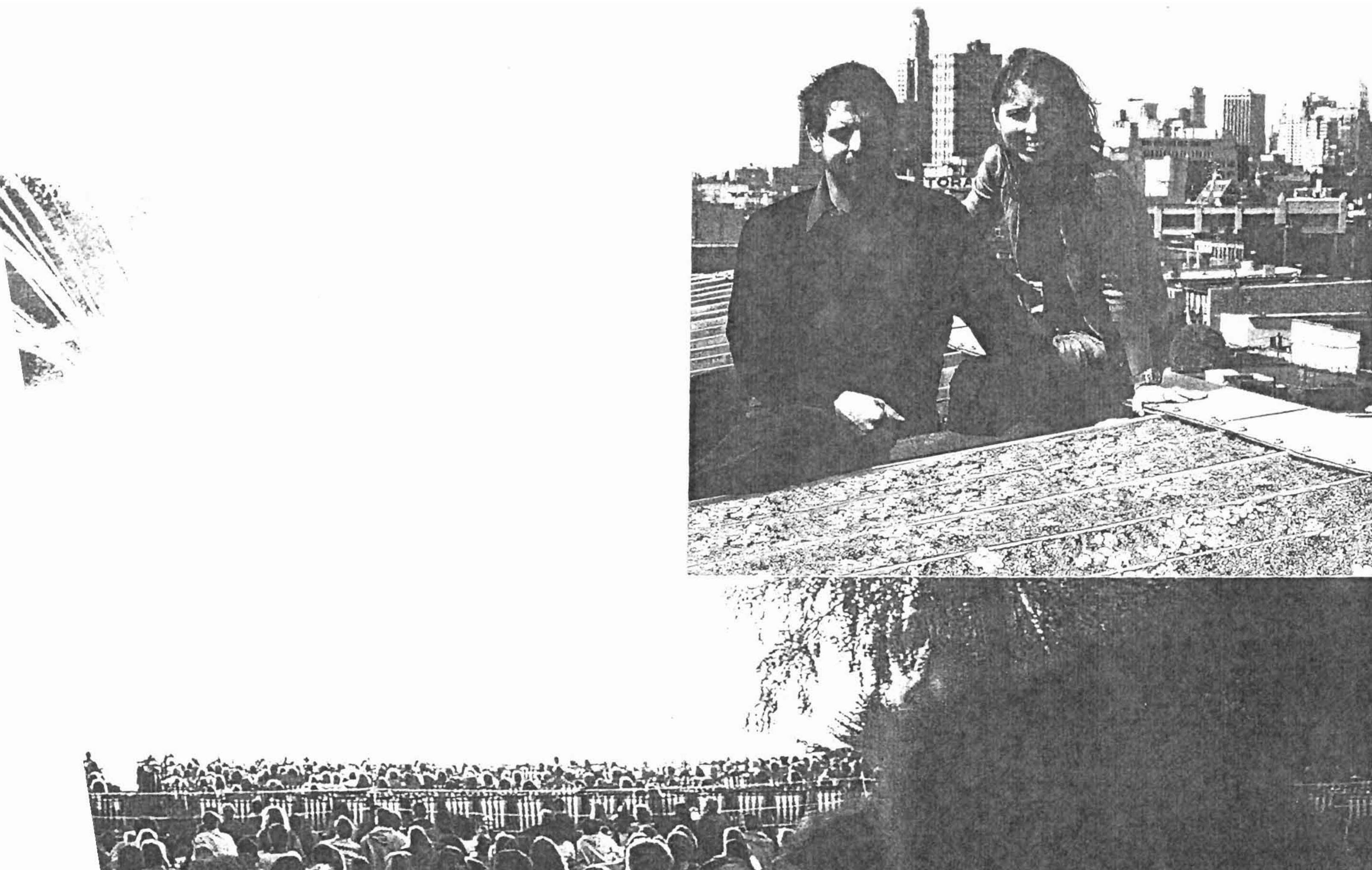
Worth 'Ravin' About — In time for the peak Summer season of 2004, KeySpan turned the power on at its Ravenswood addition – a new 250-megawatt combined (gas/oil) cycle power plant built on 2.4 acres in the heart of New York City. The highly efficient facility has been recognized for its cleanliness by the Natural Resources Defense Council (NRDC) and as the Combined Cycle Journal's 2004 Power Plant Award winner. Ravenswood is the first fossil fuel plant to be endorsed by the NRDC. In addition, listening to and working with local community groups and government agencies, KeySpan brought emissions at the existing 2,200-megawatt Ravenswood facility well below requirements creating a win-win situation for everyone.

Climate is

The many ways that KeySpan serves its communities are as diverse as the communities themselves. Whether it's supporting employee-led groups or making direct contributions to more than 2,000 not-for-profit organizations through the KeySpan Foundation, the Company believes strongly in contributing to the quality of life of its customers. KeySpan is proud of its environmental performance as well. The Company works closely with local and national organizations to improve the quality of area beaches, waterways, urban woodlands and other vital landscapes. Recently, KeySpan restored 10 acres of vital wetlands while constructing its Staten Island Service Center. The state-of-the-art, 59,000 square-foot building was named an "Energy/Environmental Project of the Year" by the Association of Energy Engineers.



A Beautiful Transformation, One Step at a Time—KeySpa
Cinderella program provides grants to stimulate the restorati
of buildings in its service territory. This past year the program
expanded to include the innovative use of "green" technology
like green roofs, raising awareness and interest in environmen
friendly building technologies. In recognition of these program
KeySpan was one of three recipients of the 2004 Ron Brown
Award for Corporate Leadership. Established in 1997, it's the
only presidential award recognizing companies for outstanding
achievement in employee and community relations. Past winners
of the award include companies such as General Mills, IBM,
Hewlett-Packard and GTE.



Climat

Climate isn't just one thing, it's part of everything. In today's business world, it's not enough to provide KeySpan's 2.6 million customers in the Northeast with reliable service and peace of mind. That's why KeySpan is working to create a climate where the Company satisfies its customers by understanding their unique needs while focusing on growth strategies that leverage its core strengths. To help consumers better understand this positioning, in 2004 the Company launched its "Climate is everything" ad campaign on local network and cable television, radio and print media. Going forward, the climate is now right to make KeySpan's vision for a better way of living a reality for the Company, its customers and its shareholders.

By Robert J. Fani, President and Chief Operating Officer

In 2004, KeySpan worked on establishing a climate that brings value to our customers, benefits our shareholders, and in a very substantial way gives our employees accountability for and the opportunity to make decisions about the direction of the Company. We centered our attention on our core businesses. By stepping back and taking a major and critical look at our operations across KeySpan, we continued building a culture that engages everyone to perform at their best.

Growing our two core franchises

We focused on ways to continue to profitably grow our gas and electric businesses and pursue targeted assets that support the distribution of energy to our customers.

To reach new levels of efficiency, our gas business set up a "best in class" operating model and organizational structure, separating the area into asset management and field management functions. Asset management will strengthen our quality assurance, quality control and allocation of resources, while field management is focused on maintaining the quality, safety and reliability of our network while maximizing the productivity of field personnel.

A key component of our electric business – electric generation – benefited from enhanced power plant performance. Heat rate improvements – the amount of fuel needed to produce a kilowatt hour of electricity – helped our bottom line. And with the establishment of the Performance Analysis Center, we have been able to further monitor and support power plant operations to increase efficiency, enhance revenues and reduce expenses.

Developing a performance-driven culture

To support our efforts toward operational excellence, we've embarked on a multi-year initiative across our entire Company to further improve performance and transform the way we do business. As we discover ways to be more efficient and effective, we've been able to offset the effect of increased operations and maintenance costs. And we're developing strategic performance metrics to ensure our business performance remains at a high level as we implement changes.

Here is more of what we were able to achieve in 2004:

- identified synergies of operation between the electric and gas businesses
- utilized the new Performance Analysis Center and data analysis tools to better plan power plant maintenance outages and to monitor power plant performance and market conditions in order to take advantage of revenue opportunities
- increased productivity in field operations—supervisors now use wireless laptops to have more mobility and spend more time in the field
- improved the process for absence management so supervisors spend less time on the reporting process
- centralized warehouse operations to manage materials; reduced excess inventory; identified obsolete inventory for write-off
- placed support services under a Shared Services model to ensure a consistent approach to service delivery to our core businesses
- consolidated back office operations across all regions and instituted self service options for our customers
- continued to focus on synergies within KeySpan Energy Delivery and KeySpan Home Energy Services in the areas of services plans and on-demand services

Challenges in 2005

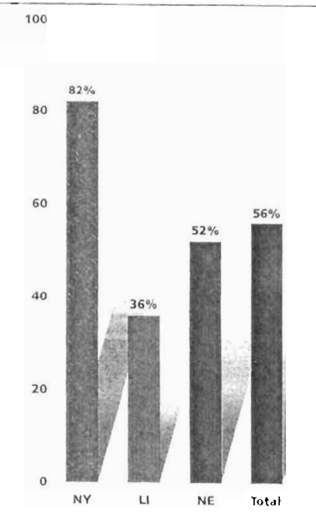
KeySpan continues to establish its own distinct corporate culture that defines us as a company. Culture is sometimes the most difficult aspect of a company to change, but we've already started the hard work of taking the best part of KeySpan's culture and aligning it with the focus on performance. Our employees are excited about the new climate they are helping to create.

And leading us in the right direction are the Guiding Principles — behaviors for employees at all levels that are essential to developing a climate driven by innovation, accountability, accomplishment, service to the customer, and a strong adherence to our corporate values in everything we do.

GAS DATA

Residential Market Saturation Levels

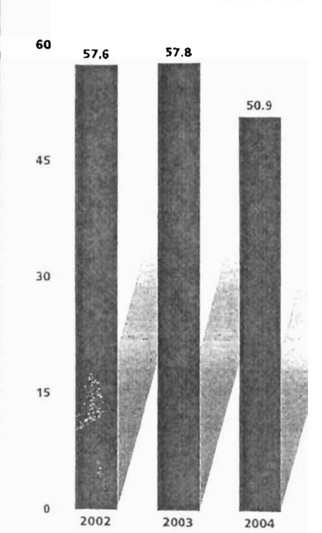
Unlike many energy providers that have limited organic growth opportunities, KeySpan has ample opportunity for growth within its residential markets – particularly on Long Island and in the New England region where saturation levels are low.



New Gas Installations

Natural gas is America's most popular home-heating fuel – warming more households than all other energy forms combined. Despite the volatile energy market and economy, KeySpan has been able to target growth areas for new revenue sources.

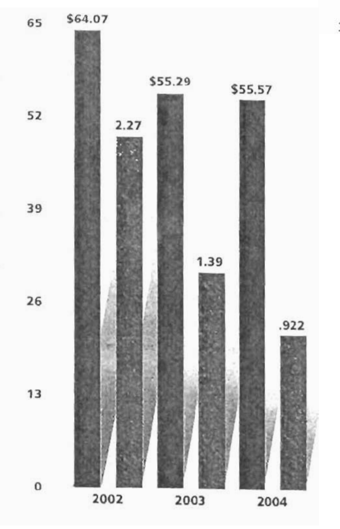
(In Thousands)



Efficient Growth

KeySpan has learned how to do more with less. By targeting customers closer to existing gas mains, more efficient planning and lowering capital expenditures, the Company's gross profit margin remains strong despite a reduction in gas main installations.

■ Gross Profit Margin ($ in Millions)
■ Gas Main Installed (Feet in Millions)

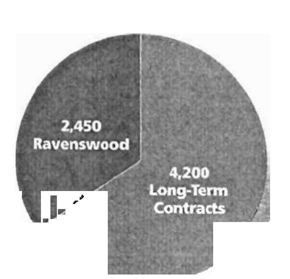


ELECTRIC DATA

Low-Risk Generation Portfolio

KeySpan owns, leases and operates more than 6,600 megawatts of generating capacity, making it the largest electric generator in New York State. Nearly two-thirds of the Company's generating capacity is covered by long-term contracts making it a reliable, steady revenue stream.

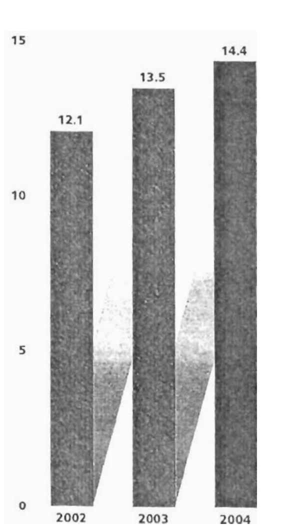
(In Megawatts)



Time Between Interruptions

Under KeySpan's stewardship, the overhead electric transmission and distribution (T&D) system on Long Island has enjoyed the highest level of reliability in New York State for the past several years. This is the result of an experienced, hard working group of KeySpan employees.

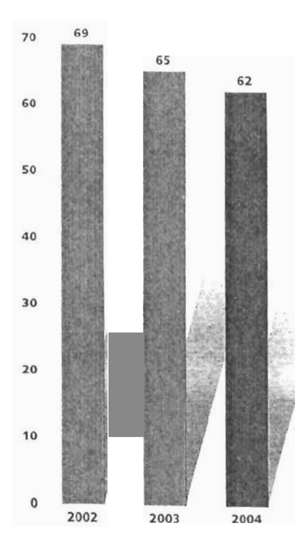
(In Months)



Average Restoration Time

KeySpan, together with LIPA, operates the safest and most reliable overhead electric system in New York State. 2004 marked the second consecutive year that all reliability indices showed significant improvement. Last year, the frequency of electric service interruptions was 5 percent better than in 2003.

(In Minutes)



ABBREVIATIONS AND GLOSSARY

Bbl Abbreviation for barrel. One barrel is the equivalent of 42 standard US gallons

BCFe A billion cubic feet

Btu British Thermal Unit

Degree Days A measure of the number of degrees the average daily outside temperature is below 65° F

Dekatherm One dekatherm equals 10 therms or one million Btu

Dth Abbreviation for dekatherm

FERC Federal Energy Regulatory Commission. The US agency that regulates interstate energy activities

LDC Local Distribution Company

LILCO Long Island Lighting Company

LIPA Long Island Power Authority

LNG Liquefied Natural Gas

MADTE (or DTE) Department of Telecommunications and Energy. Massachusetts agency responsible for regulating pricing, service quality and safety of utilities

Mbbls A thousand barrels

Mcf Abbreviation for a thousand cubic feet

MDTH One thousand dekatherms

MGP Manufactured Gas Plant

Mmcf Abbreviation for a million cubic feet

MW Abbreviation for megawatt. One million watts of electricity (enough to power approximately one thousand homes)

NHPUC New Hampshire Public Utilities Commission. Agency responsible for regulating pricing, service quality and safety of utilities

NYISO New York Independent System Operator. An agency with operational control over most of the state's transmission facilities to ensure reliability

NYMEX New York Mercantile Exchange

NYPSC New York Public Service Commission. Agency responsible for regulating pricing, service quality and safety of utilities

Peaking Plant A power plant with generating units designed to operate during periods of maximum demand for electricity, as opposed to the units of a baseload plant, which usually operate continuously

Proved Reserves Gas or oil that has been discovered and determined to be recoverable under existing economic and operating conditions

PUHCA Public Utility Holding Company Act of 1935

Realized Gas Prices Average wellhead price received for production including hedging gains and losses

Therm A unit of heating value equivalent to 100,000 BTUs

Wellhead Prices The cost of gas as it comes from well excluding cleaning, compression, transportation and distribution charges.

FINANCIAL CONTENTS

19 **Financial Review and Analysis**

52 **Consolidated Financial Statements**

58 **Notes to Consolidated Financial Statements**

97 **Selected Financial Data**

98 **Directors and Officers**

99 **Shareholder Information**

KeySpan Corporation (referred to herein as "KeySpan," "we," "us" and "our") is a registered holding company under the Public Utility Holding Company Act of 1935, as amended ("PUHCA"). KeySpan operates six regulated utilities that distribute natural gas to approximately 2.6 million customers in New York City, Long Island, Massachusetts and New Hampshire, making KeySpan the fifth largest gas distribution company in the United States and the largest in the Northeast. We also own and operate electric generating plants in Nassau and Suffolk Counties on Long Island and in Queens County in New York City and are the largest electric generation operator in New York State. Under contractual arrangements, we provide power, electric transmission and distribution services, billing and other customer services for approximately 1.1 million electric customers of the Long Island Power Authority ("LIPA"). KeySpan's other subsidiaries are involved in gas exploration and production; underground gas storage; liquefied natural gas storage; retail electric marketing; large energy-system ownership, installation and management; appliance service; and engineering and consulting services. We also invest and participate in the development of natural gas pipelines, electric generation and other energy-related projects. (See Note 2 to the Consolidated Financial Statements "Business Segments" for additional information on each operating segment.)

Executive Summary

Below is a table comparing the more significant items impacting earnings from continuing operations and earnings available for common stock for the periods indicated.

Earnings from Continuing Operations 2004 vs 2003

KeySpan's earnings from continuing operations, less preferred stock dividends, for the year ended December 31, 2004 were $609.1 million or $3.80 per share, an increase of $188.9 million, or $1.15 per share compared to $420.2 million, or $2.65 per share realized in 2003. Earnings from continuing operations, less preferred stock dividends, for the year ended December 31, 2002 were $372.5 million, or $2.64 per share. KeySpan's financial results for the year ended December 31, 2004 and 2003 reflect the following items that had a significant impact on comparative results: (i) non-core asset sales recorded in both 2004 and 2003; (ii) impairment charges recorded in 2004; and (iii) debt redemption charges recorded in both 2004 and 2003.

During 2004, KeySpan sold its interest in The Houston Exploration Company ("Houston Exploration") – an independent natural gas and oil exploration and production company located in Houston, Texas. We received cash proceeds of approximately $758 million in two stock transactions and recorded after-tax gains of $222.7 million, or $1.39 per share. Also in 2004, KeySpan sold its remaining ownership interest in KeySpan Canada – previously a 61% owned subsidiary with natural gas processing plants and gathering facilities in Western Canada. We received cash proceeds of approximately $255 million in two transactions and recorded after-tax gains of $34.8 million, or $0.21 per share. Combined, these asset sales provided KeySpan with approximately $1 billion of cash proceeds and after-tax earnings of $257.5 million, or $1.60 per share.

As mentioned, during 2003 KeySpan completed two non-core asset sales. In 2003, KeySpan sold 39.09% of its interest in KeySpan Canada.

(In Thousands of Dollars, Except per Share Amounts)

YEAR ENDED DECEMBER 31,	2004		2003		2002	
	EARNINGS	E.P.S.	EARNINGS	E.P.S.	EARNINGS	E.P.S.
Earnings from continuing operations, less preferred stock dividends	$609,101	$ 3.80	$420,225	$ 2.65	$372,549	$ 2.64
Discontinued operations	(151,048)	(0.94)	(1,888)	(0.01)	(614)	(0.01)
Cumulative change in accounting principle	—	—	(37,451)	(0.23)	—	—
Earnings for Common Stock	$458,053	$ 2.86	$380,886	$ 2.41	$371,935	$ 2.63
Average shares outstanding	160,294		158,256		141,263	
Components of Continuing Operations:						
Core operations	$385,425	$ 2.41	$353,191	$ 2.23	$324,305	$ 2.30
Asset sales	257,506	1.60	995	—	—	—
Ceiling test write-down	(31,074)	(0.19)	—	—	—	—
Impairment charges	(31,318)	(0.20)	—	—	—	—
Debt redemption costs	(29,264)	(0.18)	(13,565)	(0.08)	—	—
Exploration and production operations	57,826	0.36	79,604	0.50	48,242	0.34
Earnings from continuing operations, less preferred stock dividends	$609,101	$ 3.80	$420,225	$ 2.65	$372,547	$ 2.64

Additionally, we sold our 20% interest in Taylor NGL LP that owns and operates two extraction plants also located in Canada. We recorded an after-tax loss of $34.1 million, or $0.22 per share, associated with these sales. Additionally, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. We recorded a gain of $19.0 million, or $0.12 per share, on this transaction. Income taxes were not provided on this transaction since the transaction was structured as a return of capital. Further, in the fourth quarter of 2003, we completed the sale of our 24.5% interest in Phoenix Natural Gas, a natural gas distribution company located in Northern Ireland, and recorded an after-tax gain of $16.0 million, or $0.10 per share. In total, KeySpan recorded a pre-tax gain of $13.4 million from the monetization of these non-core assets. The combined after-tax gain from these asset sales was minimal due to the tax treatment associated with each transaction.

See Note 2 to the Consolidated Financial Statements "Business Segments" and the discussions under the caption "Review of Operating Segments" for a more detailed discussion of each of the above noted non-core stock transactions.

KeySpan recorded three significant impairment charges during 2004 (a goodwill impairment charge recorded in the Energy Services segment, as well as a ceiling test write-down and carrying value impairment charge recorded in the Energy Investment segment) that resulted in after-tax charges to continuing operations of $62.4 million, or $0.39 per share. The Energy Services segment recorded an after-tax non-cash goodwill impairment charge of $12.6 million, or $0.08 per share in continuing operations as a result of an evaluation of the carrying value of goodwill recorded in this segment. Based upon the operating results experienced by the Energy Services segment and management's opinion that it was likely that a significant portion of the Energy Services segment would be sold within one year, KeySpan conducted an evaluation of the carrying value of its investments in this segment, including recorded goodwill. That evaluation resulted in a total impairment charge of $152.4 million after-tax, or $0.95 per share – $12.6 million of this charge is attributable to continuing operations, while the remaining $139.9 million, or $0.87 per share, has been reflected in discontinued operations. (See Note 11 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for additional details on this charge.)

KeySpan's wholly-owned gas exploration and production subsidiaries recorded an after-tax non-cash impairment charge of $31.1 million, or $0.19 per share, to recognize the reduced valuation of proved reserves. (See Note 10 to the Consolidated Financial Statements "Gas Exploration and Production Property – Depletion" for additional details on this transaction.)

In addition to the asset sales noted previously, KeySpan has entered into an agreement to sell its 50% interest in Premier Transmission Limited ("PTL"), a gas pipeline from southwest Scotland to Northern Ireland, before the end of the second quarter of 2005. In the fourth quarter of 2004 KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share, reflecting the difference between the anticipated cash proceeds from the sale of PTL compared to its carrying value. This investment is accounted for under the equity method of accounting in the Energy Investments segment. (See Note 2 to the Consolidated Financial Statements "Business Segments" and the discussions under the caption "Review of Operating Segments" for a more detailed discussion of the anticipated sale.)

The remaining significant item noted above is debt redemption costs incurred in 2004 and 2003. In 2004, KeySpan redeemed approximately $758 million of outstanding long-term debt. KeySpan incurred $54.5 million in call premiums associated with this redemption, of which $45.9 million was expensed and recorded in other income and deductions on the Consolidated Statement of Income. The remaining amount of the call premiums have been deferred for future recovery. Further, KeySpan wrote-off $8.2 million of previously deferred financing costs which have been reflected in interest expense on the Consolidated Statement of Income. The total after-tax expense of the debt redemption was $29.3 million or $0.18 per share. (See Note 6 to the Consolidated Financial Statements "Long-Term Debt" as well as the discussion under the caption "Financing" for additional details on this transaction.) In 2003, KeySpan incurred $18.2 million in debt redemption costs associated with the redemption of approximately $447 million of outstanding promissory notes that were issued to the Long Island Power Authority ("LIPA") in connection with the KeySpan/Long Island Lighting Company ("LILCO") business combination completed in May 1998. Further, Houston Exploration, then a consolidated subsidiary, incurred debt redemption costs of $5.9 million, to retire $100 million 8.625% Notes. The total after-tax expense of the debt redemptions in 2003 was $13.6 million or $0.08 per share.

The net impact of the above mentioned items resulted in an increase to earnings from continuing operations of $165.9 million, or $1.03 per share for the year ended December 31, 2004, compared to a loss of $12.6 million or $0.08 per share in 2003.

The remaining items impacting comparative earnings from continuing operations reflect higher earnings from the Gas Distribution segment, primarily due to a Boston Gas Company rate increase resulting from a rate proceeding concluded in November 2003, partially offset by the adverse effect on earnings from KeySpan's lower ownership level in Houston Exploration. As mentioned above and discussed in more detail in Note 2 to the Consolidated Financial Statements "Business Segments," during the first half of 2004 KeySpan maintained an approximate 55% ownership level in Houston Exploration. In June 2004, KeySpan's ownership decreased to approximately 23.5% and then in November 2004 KeySpan decided to sell its remaining investment.

Earnings Available for Common Stock 2004 vs 2003

Earnings available for common stock for the year ended December 31, 2004 also includes losses from discontinued operations. As noted, at December 31, 2004, KeySpan intended to sell a significant portion of its ownership interest in certain companies within the Energy Services segment – specifically those companies engaged in mechanical contracting activities. As a result, KeySpan recorded a loss in discontinued operations of $151.1 million, or $0.94 per share. This loss reflects the $139.9 million after-tax impairment charges to reflect a reduction to the carrying value of assets associated with mechanical contracting activities and operating losses of $11.2 million. (See Note 11 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for additional details on these items.)

Earnings available for common stock for the year ended December 31, 2003 have been reclassified to reflect an operating loss from discontinued operations of $1.9 million, or $0.01 per share associated with the operations of the mechanical contracting activities. Earnings available for common stock also include a charge for a cumulative change in accounting principle. In January 2003, the Financial Accounting Standards Board ("FASB") issued Financial Interpretation Number 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." This Interpretation required us to, among other things, consolidate the Ravenswood Master Lease (the lease under which KeySpan leases and operates a portion of the Ravenswood electric generating facility ("Ravenswood Facility") and classify the lease obligation as long-term debt on the Consolidated Balance Sheet starting December 31, 2003. As a result of implementing FIN 46, we recognized a non-cash, after-tax charge of $37.6 million, or $0.23 per share related to "catch-up" depreciation of the facility since its acquisition in June 1999 and recorded the charge as a cumulative change in accounting principle. (See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for an explanation of the leasing arrangement for the Ravenswood Facility, as well as an explanation of the implementation of FIN 46.)

Earnings from Continuing Operations 2003 vs 2002

Income from continuing operations, less preferred stock dividends, increased $47.7 million in 2003 compared to 2002 primarily reflecting higher earnings from the Energy Investments and Gas Distribution segments. The Energy Investment segment benefited from higher earnings associated with gas exploration and production activities as a result of significantly higher realized gas prices and higher production volumes. The Gas Distribution segment benefited from colder weather during the January through March 2003 heating season compared to the same period of 2002, as well as from load growth. Further, during 2003 we recorded $15.1 million in gains from property sales, primarily 550 acres of real property located on Long Island. Earnings per share from continuing operations increased only $0.01 per share, reflecting the issuance of 13.9 million shares of common stock on January 17, 2003, as well as the re-issuance of shares held in treasury pursuant to dividend reinvestment and employee benefit plans. The increase in average common shares outstanding reduced 2003 earnings per share by $0.32 compared to 2002.

Earnings Available for Common Stock 2003 vs 2002

As mentioned, earnings available for common stock for the year ended December 31, 2003, reflects an operating loss from discontinued operations of $1.9 million, or $0.01 per share associated with the operations of the mechanical contracting activities, as well as a non-cash, after-tax charge of $37.6 million, or $0.23 per share related to the implementation of FIN 46.

Earnings available for common stock for the year ended December 31, 2002 includes a net loss of $0.6 million, or $0.01 per share, from discontinued operations. The mechanical contracting operations reflected earnings of $19.1 million, or $0.13 per share in discontinued operations. This was offset by an after-tax loss of $19.7 million associated with the sale of Midland Enterprises LLC ("Midland"). In January 2002, KeySpan announced that it had entered into an agreement to sell Midland, its marine barge business. During the fourth quarter of 2001, in anticipation of this divestiture, which closed on July 2, 2002, an estimated loss on the sale of Midland was recorded as discontinued operations, as well as an estimate for Midland's results of operations for the first nine months of 2002. In the second quarter of 2002, we recorded an additional after-tax loss of $19.7 million, primarily reflecting a provision for certain city and state taxes that resulted from a change in our tax structuring strategy. (See Note 9 to the Consolidated Financial Statements "Discontinued Midland Operations" for additional information.)

Consolidated Summary of Results

Operating income by segment, as well as consolidated earnings available for common stock is set forth in the following table for the periods indicated.

(In Thousands of Dollars, Except Per Share Amounts)			
YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Gas Distribution	$ 579,563	$ 574,254	$ 531,134
Electric Services	289,781	269,874	289,694
Energy Services			
Operations	(33,878)	(32,963)	(45,581)
Goodwill impairment charge	(14,424)	—	—
Energy Investments			
Operations	179,424	238,554	142,594
Ceiling test write-down and impairment charge	(74,731)	—	—
Eliminations and other	9,535	(2,090)	(8,506)
Operating Income	935,270	1,047,629	909,335
Interest charges	(331,251)	(307,694)	(301,504)
Gain on Houston Exploration transactions	329,689	19,020	—
Gain (loss) on sale of KeySpan Canada	58,629	(30,345)	—
Gain on sale of Phoenix Natural Gas	—	24,681	—
Cost of debt redemption	(45,879)	(24,094)	—
Other income and (deductions)	(6,205)	(21,847)	136
Income taxes	(325,540)	(281,281)	(229,665)
Income from Continuing Operations	614,713	426,069	378,302
Cumulative change in accounting principles	—	(37,451)	—
Loss from discontinued operations	(151,048)	(1,888)	(614)
Net Income	463,665	386,730	377,688
Preferred stock dividend requirements	5,612	5,844	5,753
Earnings for Common Stock	$ 458,053	$ 380,886	$ 371,935
Basic Earnings per Share:			
Continuing operations, less preferred stock dividends	$ 3.80	$ 2.65	$ 2.64
Change in accounting principles	—	(0.23)	—
Discontinued operations	(0.94)	(0.01)	(0.01)
	$ 2.86	$ 2.41	$ 2.63

Operating income, as indicated in the above table, decreased $112.4 million for the twelve months ended December 31, 2004, compared to the same period of 2003. Comparative operating income was adversely impacted by lower operating income from the Energy Investment segment as a result of KeySpan's reduced ownership interest in Houston Exploration and KeySpan Canada during the latter half of 2004. In addition, operating income in the Energy Investments segment was adversely impacted by the $48.2 million non-cash impairment charge to recognize the reduced valuation of proved reserves, as well as the $26.5 million non-cash impairment charge in our investment in PTL. Further, the decrease in operating income reflects the $14.4 million non-cash goodwill impairment charge recorded in the Energy Services segment. The higher comparative operating income in the Electric Services segment in 2004 primarily reflects higher net electric margins associated with the Ravenswood Expansion, a recently constructed 250 MW combined cycle generating facility located at the Ravenswood Facility site. The Gas Distribution segment benefited from customer additions and oil-to-gas conversions throughout our service territories, as well as from the full effect of the rate increase resulting from the Boston Gas Company rate proceeding concluded in November 2003. As mentioned earlier, in 2003 we recorded $15.1 million in gains from property sales, primarily 550 acres of real property located on Long Island, that were recorded in the Gas Distribution segment. (See the discussion under the caption "Review of Operating Segments" for further details on each segment.)

The increase in interest expense of $23.6 million, or 8%, in 2004, compared to the prior year, reflects a number of items. As noted earlier, interest expense for 2004 includes the write-off of $8.2 million of previously deferred issuance costs as a result of the redemption of $758 million of outstanding long-term debt. In addition, interest expense in 2004 was impacted by the implementation of FIN 46, mentioned earlier. Beginning January 1, 2004, lease payments associated with the Ravenswood Master Lease have been reflected as interest expense on the Consolidated Statement of Income resulting in an increase to interest expense of approximately $30 million in 2004. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for further information on the Master Lease.)

Further, comparative interest expense also reflects the benefits realized in 2003 associated with interest rate swaps. In 2003, we terminated an interest rate swap agreement with a notional amount of $270 million. This swap was used to hedge a portion of outstanding promissory notes that were issued to LIPA in connection with the KeySpan/LILCO business combination. As noted previously, in March 2003, we called approximately $447 million of the outstanding promissory notes, and settled the outstanding derivative instrument. The cash proceeds from the termination of the interest rate hedge were $18.4 million, of which $8.1 million represented accrued swap interest. The difference between the termination settlement amount and the amount of accrued swap interest, $10.3 million, was recorded to earnings (as an adjustment to interest expense) in 2003 and effectively offset a portion of the redemption charges.

Offsetting, to some extent, these adverse impacts to comparative interest expense are the benefits associated with a lower level of outstanding long-term debt.

In addition to the asset sales of $388.3 million and debt redemption costs of $45.9 million previously noted, other income and (deductions) for 2004 reflects a $12.6 million gain recorded on the settlement of a derivative financial instrument entered into in connection with the sale/leaseback transaction associated with the Ravenswood Expansion, as well as a $5.5 million foreign currency gain on cash investments held offshore. Other income and (deductions) also includes the effects of minority

interest of $36.8 million related to our previous controlling interests in Houston Exploration and KeySpan Canada, as well as carrying charges on certain regulatory assets. (See Note 7 and Note 8 to the Consolidated Financial Statements, "Contractual Obligations, Financial Guarantees and Contingencies" and "Hedging, Derivative Financial Instruments and Fair Values" for additional information regarding the sale/leaseback transaction and derivative financial instrument.)

In addition to the asset sales of $13.4 million and debt redemption costs of $24.1 million previously noted, other income and (deductions) in 2003 also reflects severance tax refunds totaling $21.6 million recorded by Houston Exploration for severance taxes paid in 2002 and earlier periods, as well as $6.5 million of realized foreign currency translation gains. Finally, other income and (deductions) reflects minority interest adjustments related to Houston Exploration and KeySpan Canada of $63.9 million, as well as carrying charges on certain regulatory assets.

Income tax expense generally reflects the level of pre-tax income. In addition, tax expense for 2004 reflects: (i) a $6.0 million benefit resulting from a revised appraisal associated with property that was disposed of in 2003; (ii) a tax benefit of $14 million related to the repatriation of earnings from KeySpan's Canadian investments; and (iii) the beneficial tax treatment afforded the stock transaction with Houston Exploration.

Income tax expense for 2003 includes a number of items impacting comparative results. During 2003, the partial monetization of our Canadian investments resulted in tax expense of $3.8 million, reflecting certain United States partnership tax rules. In addition, we recorded an adjustment to income tax expense of $6.1 million due to the Commonwealth of Massachusetts disallowing the carry forward of net operating losses incurred by regulated utilities. Offsetting, to some extent, these increases to tax expense, was a tax benefit recorded in 2003 of $9.0 million associated with certain New York City general corporation tax issues. In addition, certain costs associated with employee deferred compensation plans were deducted for federal income tax purposes in 2003. These costs, however, are not expensed for "book" purposes resulting in a beneficial permanent book-to-tax difference of $6.3 million.

As noted earlier, earnings available for common stock for the year ended December 31, 2004 also includes losses of $151.1 million, or $0.94 per share, from discontinued operations. Earnings available for common stock for the year ended December 31, 2003 includes a charge for a cumulative change in accounting principles of $37.6 million, or $0.23 per share, associated with the implementation of FIN 46, as well as operating losses of $1.9 million, or $0.01 per share associated with discontinued operations.

As a result of the items discussed above, earnings available for common stock were $458.1 million, or $2.86 per share for the year ended December 31, 2004 compared to $380.9 million, or $2.41 per share realized in 2003.

Operating income in 2003 increased $138.3 million compared to 2002. This increase in operating income reflects higher earnings from the Energy Investments and Gas Distribution segments, somewhat offset by a decrease in earnings from the Electric Services segment. The Energy Investment segment benefited from higher earnings associated with gas exploration and production activities as a result of significantly higher realized gas prices and higher production volumes. The Gas Distribution segment benefited from colder weather during the January through March 2003 heating season compared to the same period of 2002, as well as from load growth. Further, as mentioned earlier, during 2003 we recorded $15.1 million in gains in the Gas Distribution segment from property sales. Lower results from the Electric Services segment were attributable to higher operating costs, as well as lower revenues from our merchant generating facility, due in part to cooler summer weather in 2003. (See the discussion under the caption "Review of Operating Segments" for further details on each segment.)

Interest charges increased 2% in 2003, compared to 2002, primarily as a result of the absence of the benefits associated with certain interest-rate derivative swap instruments that were in effect in 2002, but terminated in 2003. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values.")

As discussed in greater detail earlier, other income and (deductions) in 2003 reflects a number of significant items that impacted comparative results. During 2003, we monetized a portion of our Canadian and Northern Ireland investments, as well as a portion of our ownership interest in Houston Exploration and recorded a net gain of $13.4 million associated with these transactions. Further, we incurred debt redemption costs of $24.1 million. Other income and (deductions) in 2003 also reflects severance tax refunds totaling $21.6 million recorded by Houston Exploration for severance taxes paid in 2002 and earlier periods, compared to $9.1 million recorded in 2002, as well as $6.5 million of realized foreign currency translation gains. Finally, other income and (deductions) for both 2003 and 2002 reflects minority interest adjustments related to Houston Exploration and KeySpan Canada, as well as carrying charges on certain regulatory assets.

The increase in income tax expense in 2003 compared to 2002 generally reflects a higher level of pre-tax earnings. Further, income tax expense for 2003 and 2002 includes a number of items impacting comparative results. As mentioned above, the partial monetization of our Canadian investments in 2003 resulted in tax expense of $3.8 million, reflecting certain United States partnership tax rules. In addition, we recorded an adjustment to income tax expense of $6.1 million due to the Commonwealth of Massachusetts disallowing the carry forward of net operating losses incurred by regulated utilities. Offsetting, to some extent, these increases to tax expense, was a tax benefit recorded in 2003 of $9.0 million associated with certain New York City general corporation tax issues. In addition, certain costs associated with employee deferred compensation plans were deducted for federal income tax purposes in 2003 resulting in a beneficial permanent book-to-tax difference of $6.3 million.

Income tax expense for 2002 reflects a tax benefit of $15 million as a result of the favorable resolution of certain outstanding tax issues related to the KeySpan/LILCO merger. Additionally, we recorded an adjustment to deferred income taxes of $177.7 million reflecting a decrease in the tax basis of the assets acquired at the time of the merger. This

tment was a result of a revised valuation study. Concurrent with the red tax adjustment, we reduced current income taxes payable by ‹.2 million, resulting in a $5.5 million income tax benefit. Also, it ld be noted that pre-tax income in the Consolidated Statement of ne reflects minority interest adjustments, whereas income taxes ct the full amount of subsidiary taxes.

As discussed earlier, earnings available for common stock for the ended December 31, 2002 also includes a net loss from discontin- operations of $0.6 million.

As a result of the items just mentioned earnings available for com- n stock, which includes both the cumulative change in accounting nciple, as well as discontinued operations, were $380.9 million, or .41 per share for the year ended December 31, 2003 compared to 71.9 million, or $2.63 per share earned in 2002.

KeySpan's consolidated earnings for 2004 were forecasted to be in e range of $2.55 to $2.75 per share, excluding special items. Earnings om continuing core operations (defined for this purpose as all continu- ıg operations other than exploration and production, less preferred stock ividends) were forecasted to be in the range of $2.20 to $2.30 per hare. Earnings from gas exploration and production operations, exclud- ng the impact of the gain on the sale of Houston Exploration and the mpact of the non-cash impairment charge, were forecasted to be in the ange of $0.35 to $0.45 per share. Actual 2004 earnings from continuing core operations, as defined, were $2.41 per share, while earnings from exploration and production operations were $0.36 per share.

Financial Outlook for 2005

KeySpan's consolidated earnings for 2005 are forecasted to be in the range of $2.30 to $2.40 per share, excluding special items. Since we sold the majority of our non-core assets in 2004, the earnings forecast represents earnings from all continuing operations less preferred stock dividends. Further, the earnings forecast includes the anticipated dilutive impact from the conversion of the MEDS Equity Units. (See Note 6 to the Consolidated Financial Statements "Long-Term Debt" for an explanation of the MEDS Equity Units.)

Consolidated earnings are seasonal in nature due to the significant contribution to earnings of our gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters of our fiscal year.

Review of Operating Segments

KeySpan's segment results are reported on an Operating Income basis. Management believes that this generally accepted accounting principle ("GAAP") based measure provides a reasonable indication of KeySpan's underlying performance associated with its operations. The following is a discussion of financial results achieved by KeySpan's operating segments presented on an Operating Income basis.

Gas Distribution

KeySpan Energy Delivery New York ("KEDNY") provides gas distribution service to customers in the New York City Boroughs of Brooklyn, Staten Island and a portion of Queens. KeySpan Energy Delivery Long Island ("KEDLI") provides gas distribution service to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. Four natural gas distribution companies – Boston Gas Company, Essex Gas Company, Colonial Gas Company and EnergyNorth Natural Gas, Inc., each doing business under the name KeySpan Energy Delivery New England ("KEDNE"), provide gas distribution service to customers in Massachusetts and New Hampshire.

The table below highlights certain significant financial data and operating statistics for the Gas Distribution segment for the periods indicated.

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31,	2004	2003	2002
Revenues	$4,407,292	$4,161,272	$3,163,761
Cost of gas	2,664,662	2,444,485	1,569,325
Revenue taxes	73,294	90,456	83,066
Net Gas Revenues	1,669,336	1,626,331	1,511,370
Operating Expenses			
Operations and maintenance	672,548	659,932	608,266
Depreciation and amortization	276,487	259,934	237,186
Operating taxes	140,738	147,334	135,687
Total Operating Expenses	1,089,773	1,067,200	981,139
Gain on the sale of property	—	15,123	903
Operating Income	$ 579,563	$ 574,254	$ 531,134
Firm gas sales and transportation (MDTH)	324,549	328,073	284,281
Transportation – Electric Generation (MDTH)	27,656	34,778	64,173
Other Sales (MDTH)	155,992	158,722	209,002
Warmer (Colder) than Normal – New York & Long Island	(1.0%)	(8.0%)	7.0%
Warmer (Colder) than Normal – New England	(6.8%)	(10.0%)	4.6%

A MDTH is 10,000 therms and reflects the heating content of approximately one million cubic feet of gas. A therm reflects the heating content of approximately 100 cubic feet of gas. One billion cubic feet (BCF) of gas equals approximately 1,000 MDTH.

Executive Summary

Operating income increased $5.3 million for the twelve months ended December 31, 2004 compared to the same period last year, primarily due to an increase in net revenues of $43.0 million resulting, for the most part, from the Boston Gas Company's rate proceeding that was concluded in November 2003. Partially offsetting the increase in net revenues were higher operating expenses of $22.6 million, primarily due to an increase of $13.0 million in the provision for uncollectible accounts receivable as a result of higher gas costs, as well as higher depreciation and amortization expenses. It should be noted that during 2003 we recorded $15.1 million in gains from property sales on Long Island.

Operating income increased $43.1 million for the twelve months ended December 31, 2003 compared to the same period of 2002, primarily due to an increase in net revenues of $115.0 million resulting from significantly colder than normal weather experienced throughout the Northeastern United States in 2003, particularly during the primary winter heating months of January through March. Partially offsetting the increase in net revenues were higher operating expenses of $86.1 million, attributable, in part, to higher pension and other postretirement benefit costs of $30.9 million. Further, the colder weather experienced during 2003 resulted in a higher level of repair and maintenance work on our gas distribution infrastructure which increased comparative operating expenses. Also depreciation and amortization expense increased as a result of the expansion of the gas distribution system. As noted earlier, during 2003 we recorded $15.1 million in gains from property sales on Long Island.

Net Revenues

Net gas revenues (revenues less the cost of gas and associated revenue taxes) from our gas distribution operations increased by $43.0 million, or 3%, for the year-ended December 31, 2004 compared to the prior year. Net gas revenues benefited from the Boston Gas Company rate increase granted in the fourth quarter of 2003, as well as from customer additions and oil-to-gas conversions. As measured in heating degree days, weather in 2004 in our New York and New England service territories was approximately 1% and 7% colder than normal, respectively, compared to approximately 8% and 10% colder than normal in 2003, respectively. Weather in 2004 was approximately 6% warmer than 2003 in our New York service territory and approximately 3% warmer than last year in our New England service territory.

Net revenues from firm gas customers (residential, commercial and industrial customers) in our New York service territory during the twelve months ended December 31, 2004 were essentially equivalent to the same period of 2003. We realized a $3.5 million benefit to net gas revenues as a result of an additional billing day in the 2004 leap year and $1.6 million associated with regulatory incentives. Weather, which was warmer than 2003, resulted in an adverse impact to comparative net gas revenues of $3.6 million. KEDNY and KEDLI each operate under a utility tariff that contains a weather normalization adjustment that significantly offsets variations in firm net revenues due to fluctuations in normal weather. Since weather was colder than normal we refunded to firm customers $5.2 million through the weather normalization adjustment. The benefits of customer additions and oil-to-gas conversions were effectively offset by conservation and more efficient heating equipment, customer attrition and the adverse impact to customer usage due to higher natural gas prices.

Also included in net gas revenues is the recovery of property taxes that were $0.5 million lower in 2004 compared to 2003. These revenues, however, do not impact net income since the taxes they are designed to recover are expensed as amortization charges on the Consolidated Statement of Income. Firm gas distribution rates for KEDNY and KEDLI during 2004, other than for the recovery of gas costs, have remained substantially unchanged from rates charged in 2003.

Net revenues from firm gas customers in our New England service territory increased by $40.3 million in 2004 compared to 2003. Customer additions and oil-to-gas conversions, net of attrition and conservation, added $8.0 million to net gas revenues. Further, we realized a $2.2 million benefit in net gas revenues as a result of an additional billing day for leap year. As mentioned, the Massachusetts Department of Telecommunications and Energy ("MADTE") approved a $27 million base rate increase for the Boston Gas Company, which became effective November 1, 2003. For the twelve months ended December 31, 2004, the rate increase resulted in a benefit to net gas revenues of $29.4 million. (See the caption under "Regulation and Rate Matters" for further information regarding the rate filing.) The gas distribution operations of our New England based subsidiaries do not have a weather normalization adjustment. Weather, which was warmer in 2004 than 2003, resulted in an adverse impact to comparative net gas revenues of $6.1 million. To mitigate the effect of fluctuations in normal weather patterns on KEDNE's results of operations and cash flows, weather derivatives were in place for the 2003/2004 and the 2004/2005 winter heating seasons. The impact of these derivative instruments resulted in a favorable impact to comparative net revenues of $6.8 million for the twelve months ended December 31, 2004 compared to the same period in 2003. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" for further information.)

In our large-volume heating and other interruptible (non-firm) markets, which include large apartment houses, government buildings and schools, gas service is provided under rates that are designed to compete with prices of alternative fuel, including No. 2 and No. 6 grade heating oil. These "dual-fuel" customers can consume either natural gas or fuel oil for heating purposes. Net revenues in these markets increased $2.2 million in 2004 compared to 2003. The majority of interruptible profits earned by KEDNE and KEDLI are returned to firm customers as an offset to gas costs.

Net gas revenues from our gas distribution operations increased by $115.0 million, or 8%, for the year ended December 31, 2003, compared to the same period in 2002. Both our New York and New England based gas distribution operations benefited from the significantly colder than normal weather experienced throughout the Northeastern United States, particularly during the primary winter heating months, January through March, when our gas distribution operations realize over 60% of their yearly operating income. As measured in heating degree-days, weather during the first quarter of 2003 was approximately 10% colder than normal in our New York and New England service territories. This contrasts with the extremely warm weather experienced during the first quarter of 2002 when weather was approximately 16% – 18% warmer than normal. On a twelve month basis, weather was approximately 8% – 10% colder than normal in 2003 compared to 4% – 7% warmer than normal in 2002.

ıs revenues from firm gas customers in our New York service ncreased by $56.4 million, or 6%, for the twelve months ember 31, 2003, compared to the same period of 2002. additions and oil-to-gas conversions, net of attrition and con- added approximately $22 million to net revenues during 2003. of higher customer consumption in 2003 due primarily to cold- ormal weather, coupled with lower customer consumption in e to the extremely warmer than normal weather resulted in a tive increase to firm net revenues of approximately $41.1 million compared to 2002. However, KEDNY and KEDLI each operate utility tariff that contains a weather normalization adjustment nificantly offsets variations in firm net revenues due to fluctua- om normal weather. These tariff provisions resulted in a $20.4 mil- und to firm gas customers during 2003. Also included in net rev- are regulatory incentives that reduced comparative net revenues by nillion and recovery of certain taxes that added $15.8 million to net ues during 2003. The recovery of taxes through revenues, however, not impact net income since we expense a similar amount as amor- on charges and income taxes, as appropriate, on the Consolidated ment of Income.

Net gas revenues from firm gas customers in our New England serv- erritories increased $31.7 million, or 7%, for the year ended ember 31, 2003, compared to the same period of 2002. Customer itions and oil-to-gas conversions, net of attrition and conservation, ded approximately $13.5 million to net revenues. As with our New k service territories, higher customer consumption in 2003 due to the der than normal weather, coupled with lower customer consumption in 02 due to the warmer than normal weather, resulted in an increase in nparative net revenues for our New England based gas distribution ities of approximately $25.1 million in 2003 compared to 2002. As ted above, the gas distribution operations of our New England based osidiaries do not have a weather normalization adjustment. To mitigate e effect of fluctuations from normal weather patterns on KEDNE's ults of operations and cash flows, weather derivatives were put in ice for the 2002/2003 and 2003/2004 winter heating seasons. Since eather during the first quarter of 2003 was 10% colder than normal in e New England service territories, we recorded an $11.9 million reduc- on to revenues to reflect the loss on these derivative transactions. milarly, in 2002 we recorded a $3.3 million reduction to revenues. As a sult of these transactions, comparative net revenues were adversely pacted by $8.6 million. Weather derivatives had only a marginal impact net revenues during the fourth quarter of 2003, since weather was proximately normal. (See Note 8 to the Consolidated Financial atements "Hedging, Derivative Financial Instruments and Fair Values" r further information).

Also included in net revenues for 2003 are $5.6 million of base-rate djustments resulting from Boston Gas Company's recently concluded te case. Further, included in net revenues for 2002, was a benefit of $3.9 million as a result of a favorable ruling from the Massachusetts Supreme Judicial Court relating to the appeal by Boston Gas Company of its Performance Based Rate Plan ("PBR"). The net effect of these base-rate adjustments was a favorable impact to comparative net revenues in 2003 of $1.7 million. (See "Regulation and Rate Matters" for a further discussion of these matters.)

Firm gas distribution rates for KEDNY and KEDLI in 2003, other than for the recovery of gas costs, have remained substantially unchanged from rates charged in 2002. As noted, firm gas distribution rates for KEDNE reflect an increase of $5.6 million resulting from The Boston Gas Company's rate order, which became effective November 1, 2003.

In our large-volume heating and other interruptible (non-firm) markets, net revenues increased by $26.8 million during the twelve months ended December 31, 2003, compared to the same period of 2002. As mentioned, the majority of interruptible profits earned by KEDNE and KEDLI are returned to firm customers as an offset to gas costs.

We are committed to our expansion strategy initiated during the past few years. We believe that significant growth opportunities exist on Long Island and in our New England service territories. We estimate that on Long Island approximately 37% of the residential and multi-family markets, and approximately 55% of the commercial market currently use natural gas for space heating. Further, we estimate that in our New England service territories approximately 50% of the residential and multi-family markets, as well as the commercial market, currently use natural gas for space heating purposes. We will continue to seek growth in all our market segments, through the economic expansion of our gas distribution system, as well as through the conversion of residential homes from oil-to-gas for space heating purposes and the pursuit of opportunities to grow the multi-family, industrial and commercial markets.

Firm Sales, Transportation and Other Quantities

Firm gas sales and transportation quantities for the year-ended Decemb 31, 2004, were approximately 1% lower compared to such quantities f the same period in 2003 reflecting the warmer weather. Weather norm ized sales quantities increased 2% in our New York service territories d ing 2004. In our New England service territories, weather normalized sales quantities during 2004 were essentially the same as weather no malized sales quantities experienced in 2003. Net revenues are not affected by customers opting to purchase their gas supply from other sources, since delivery rates charged to transportation customers gen ly are the same as delivery rates charged to full sales service custom Transportation quantities related to electric generation reflect the tra portation of gas to our electric generating facilities located on Long Island. Net revenues from these services are not material.

Other sales quantities include on-system interruptible quantiti system sales quantities (sales made to customers outside of our se territories) and related transportation. We have an agreement with Resources, L.P. ("Coral"), a subsidiary of Shell Oil Company, under Coral assists in the origination, structuring, valuation and executic energy-related transactions on behalf of KEDNY and KEDLI. Upon tion of this agreement, March 31, 2005, these services will be pe

with Merrill Lynch Trading, under which Merrill Lynch Trading provides all of the city gate supply requirements at market prices and manages certain upstream capacity, underground storage and term supply contracts for KEDNE. This agreement expires on March 31, 2006.

Total actual firm gas sales and transportation quantities increased by 15% during the year ended December 31, 2003, compared to the same period in 2002. In the New York service territories actual firm sales increased 17%, while firm sales in the New England service territories increased 13%. Weather normalized sales quantities increased 6% in the New York service territories and 3% in the New England service territories. The increases in both actual and weather normalized gas sale quantities reflect higher customer consumption as a result of the significantly colder than normal weather in 2003, as well as from customer additions and oil-to-gas conversions for space heating purposes. Further, as mentioned previously, gas sales quantities in 2002 were adversely impacted by the exceptionally warm weather.

Purchased Gas for Resale

The increase in gas costs for the twelve months ended December 31, 2004, compared to the same period of 2003 of $220.2 million, or 9%, reflects an increase of 13% in the price per dekatherm of gas purchased, and a 3% decrease in the quantity of gas purchased. The current gas rate structure of each of our gas distribution utilities includes a gas adjustment clause, pursuant to which variations between actual gas costs incurred for sale to firm customers and gas costs billed to firm customers are deferred and refunded to or collected from customers in a subsequent period. The increase in gas costs for the year ended December 31, 2003 compared to the same period in 2002 of $875.2 million, or 56%, reflects an increase of 39% in the price per dekatherm of gas purchased, and a 15% increase in the quantity of gas purchased.

Operating Expenses

Total operating expenses for the year ended December 31, 2004 increased $22.6 million, or 2%, compared to the same period last year, reflecting higher operations and maintenance and depreciation expense. Operations and maintenance expense increased $12.6 million, or 2%, in 2004 compared to 2003 primarily due to an increase of $13.0 million in the provision for uncollectible accounts receivable as a result of increasing gas costs, as well as higher employee welfare costs, primarily postretirement expenses of approximately $4 million. These increases to operations and maintenance expenses were partially offset by a benefit of approximately $3 million, net of amounts subject to regulatory deferral treatment, associated with the implementation of the Medicare Prescription Drug Improvement and Modernization Act of 2003 ("Medicare Act") and implementation of Financial Accounting Standards Board Staff Position ("FSP") 106-2. (See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies" Item O "Recent Accounting Pronouncements" for further information regarding the Act and FSP 106-2.) In addition, in September 2004, Boston Gas Company reached an agreement with an insurance carrier for recovery of previously incurred environmental expenditures. Under a previously issued MADTE order, insurance and third-party recoveries, after deducting legal fees, are shared between Boston Gas and its firm gas customers. As a result of the insurance agreement, in September 2004 Boston Gas recorded a $5 million benefit to operations and maintenance expense.

Higher depreciation and amortization expense reflects the continued expansion of the gas distribution system, while the lower operating taxes resulted primarily from a property tax refund in our New York service territory.

Operating expenses in 2003 increased $86.1 million, or 9%, compared to 2002. This increase was primarily attributable to higher pension and other postretirement benefit costs, which increased (net of amounts deferred and subject to regulatory true-ups) by $30.9 million during 2003. The cost of these benefits grew primarily as a result of lower actual returns on plan assets, as well as increased health care costs. Further, the colder weather experienced during 2003 resulted in a higher level of repair and maintenance work on our gas distribution infrastructure which increased comparative operating expenses by approximately $15 million.

Higher depreciation and amortization expense reflects the continued expansion of the gas distribution system. Further, included in depreciation and amortization expense is the amortization of certain property taxes previously deferred and currently being recovered in revenues. Comparative operating taxes reflect a favorable $9.9 million adjustment recorded during 2002 relating to the reversal of excess tax reserves established for the KeySpan/LILCO combination in May 1998.

Sale of Property

During 2003 we recorded $15.1 million in gains from property sales, primarily 550 acres of real property located on Long Island.

Other Matters

In order to serve the anticipated market requirements in our New York service territories, KeySpan and Duke Energy Corporation formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Islander East is owned 50% by KeySpan and 50% by Duke Energy, and was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Shoreham, Long Island. Applications for all necessary regulatory authorizations were filed in 2000 and 2001. Islander East has received a final certificate from the Federal Energy Regulatory Commission ("FERC") and all necessary permits from the State of New York. The State of Connecticut denied Islander East's applications for coastal zone management and Section 401 of the Clean Water Act authorizations. Islander East appealed the State of Connecticut's determination on the coastal zone management issue to the United States Department of Commerce. On May 6, 2004, the Department of Commerce overrode Connecticut's denial and granted the coastal zone management authorization. Islander East's petition for a declaratory order challenging the denial of the Section 401 authorization is pending with Connecticut's State Superior Court. Once in service, the pipeline is expected to transport up to 260,000 DTH daily to the Long Island and New York City energy markets, enough natural gas to heat

600,000 homes. The pipeline will also allow KeySpan to diversify the geographic sources of its gas supply. Various options for the financing of this pipeline construction are being evaluated. At December 31, 2004, our investment in the Islander East pipeline was $20 million.

In addition, in August 2004, KeySpan acquired a 21% interest in the Millennium Pipeline development project which is anticipated to transport up to 500,000 DTH of natural gas a day to the Algonquin pipeline. The project has been approved by the FERC and, pending an amendment to the project's FERC certificate, construction could begin as early as the third quarter of 2005, with service beginning in late 2006. Once constructed, KeySpan anticipates contracting for 150,000 DTH per day of transportation capacity from the Millennium Pipeline system. As of December 31, 2004, our investment in this project was $6 million.

Electric Services

The Electric Services segment primarily consists of subsidiaries that own and operate oil and gas-fired electric generating plants in the Borough of Queens (including the "Ravenswood Projects") and the counties of Nassau and Suffolk on Long Island. In addition, through long-term contracts of varying lengths, we manage the electric transmission and distribution ("T&D") system, the fuel and electric purchases, and the off-system electric sales for LIPA. The Electric Services segment also provides retail marketing of electricity to commercial customers, the earnings from which were previously reported in the Energy Services segment. Financial results for 2003 and 2002 have been reclassified to reflect these activities in the Electric Services segment.

Selected financial data for the Electric Services segment is set forth in the table below for the periods indicated.

			(In Thousands of Dollars)
YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Revenues	$1,738,660	$1,606,074	$1,645,789
Purchased fuel	539,589	464,802	479,603
Net Revenues	1,199,071	1,141,272	1,166,186
Operating Expenses			
Operations and maintenance	653,292	658,652	676,900
Depreciation	88,252	67,161	61,377
Operating taxes	169,746	145,585	139,694
Total Operating Expenses	911,290	871,398	877,971
Gain on the sale of property	2,000	—	1,479
Operating Income	$ 289,781	$ 269,874	$ 289,694
Electric sales (MWH)*	6,232,190	4,738,331	4,998,111
Capacity (MW)*	2,450	2,200	2,200
Summer cooling degree days	1,045	988	1,280

**Reflects the operations of the Ravenswood Projects only.*

Executive Summary

Operating income increased $19.9 million for the twelve months ended December 31, 2004 compared to the same period last year, due primarily to an increase in net revenues from the Ravenswood Projects of $53.8 million, partially offset by higher depreciation expense and operating taxes. In addition, also in 2004, KeySpan recognized a gain of $2.0 million on the sale of a parcel of land in Far Rockaway, Queens, to LIPA.

Operating income decreased $19.8 million for the twelve months ended December 31, 2003 compared to the same period of 2002, primarily due to higher postretirement expenses of $9.0 million. In addition, in 2002 we settled certain outstanding issues with LIPA and The Consolidated Edison Company of New York that resulted in a $13.0 million decrease to operating expenses in 2002.

Net Revenues

Total electric net revenues realized during 2004 were $57.8 million, or 5% higher than such revenues realized during 2003. This increase is primarily attributable to the operation of the Ravenswood Expansion.

Net revenues from the Ravenswood Projects increased $53.8 million, or 18% in 2004 compared to 2003 reflecting increased capacity revenues of $19.1 million, as well as higher energy margins of $34.7 million. The increase in capacity revenues for the twelve months ended December 31, 2004 compared to the corresponding period last year primarily reflects the operation of the Ravenswood Expansion. (See the discussion below under "Other Matters" for a description of the Ravenswood Expansion.)

The increase in energy margins for the twelve months ended December 31, 2004, reflects a 32% increase in the level of megawatt hours ("MWh") sold into the New York Independent System Operator ("NYISO") energy market, as well as an increase of 9% in realized "spark-spreads" (the selling price of electricity less the cost of fuel, plus hedging gains or losses). The increase in energy sales quantities reflects the operations of the Ravenswood Expansion. As measured in cooling degree-days, weather during the peak summer months of 2004 was approximately 6% warmer than last year, but 7% cooler than normal. Further, energy sales quantities in 2003 were adversely impacted by the scheduled major overhaul of our largest electric generating unit.

We employ derivative financial hedging instruments to hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil consumed at the Ravenswood Projects. Further, we have engaged in the use of derivative financial hedging instruments to hedge the cash flow variability associated with a portion of forecasted electric energy sales from the Ravenswood Projects. These derivative instruments resulted in hedging gains, which are reflected in net electric margins, of $23.0 million in 2004 compared to hedging gains of $12.3 million for 2003. The benefits derived from KeySpan's hedging strategy contributed to an increase in realized spark-spreads despite the cooler weather during the peak summer months. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" as well as Item 7A. Quantitative and Qualitative Disclosures about Market Risk for further information).

The rules and regulations for capacity, energy sales and the sale of certain ancillary services to the NYISO energy markets continue to evolve and the Federal Energy Regulatory Commission ("FERC") has adopted several price mitigation measures that have adversely impacted earnings from the Ravenswood Facility. Certain of these mitigation measures are

still subject to rehearing and possible judicial review. (See the caption "Market and Credit Risk Management Activities" for a further discussion of these matters.)

Net revenues from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $5.3 million for the twelve months ended December 31, 2004, compared to 2003. This increase reflects, in part, recovery from LIPA of approximately $26 million in higher property taxes and depreciation charges. These recoveries had no impact on operating income since actual property taxes and depreciation charges increased by a like amount. Further, comparative revenues reflect adjustments to the cost recovery mechanism in the LIPA Service Agreements to match actual costs incurred with recovery of such costs. These adjustments reduced revenues in 2004 by approximately $10 million compared to 2003. These adjustments to revenues had no impact on operating income since actual operating costs decreased by a like amount. Excluding these two items, net revenues from the service agreements with LIPA decreased approximately $10 million in 2004, compared to 2003, reflecting a lower level of off-system sales and emission credits, both of which are shared with LIPA. In 2004 we earned $16.4 million associated with non-cost performance incentives provided for under these agreements, compared to $16.2 million earned in 2003. (For a description of the LIPA Agreements, see the discussion under the caption "LIPA Agreements.")

In addition to the above, net revenues from our electric marketing activities were slightly lower in 2004 compared to 2003.

Total electric net revenues decreased $24.9 million, or 2% for the year ended December 31, 2003 compared to the same period in 2002.

Net revenues from the Ravenswood Facility were $3.1 million lower in 2003 compared to 2002. Comparative net revenues reflect higher capacity revenues of $31.5 million, offset by a decrease in energy margins of $34.6 million. The increase in capacity revenues reflects increases in the level of capacity sold and in the selling price of capacity. Such increases were the result of two measures. First, in 2002, the NYISO employed a revised methodology to assess the available supply of and demand for installed capacity. This revised methodology resulted in insufficient capacity being procured by the market, which caused a reliability concern. Further, the revised methodology resulted in lower capacity volume sold into the NYISO and depressed capacity pricing during the year ended December 31, 2002. The NYISO, however, recognized a calculation flaw in its revised methodology, and prior to the 2002/2003 winter season capacity auction, corrected the calculation methodology to ensure that sufficient capacity was procured. The corrected calculation methodology ensured compliance with New York State reliability rules and resulted in higher capacity revenue realized at the Ravenswood Facility in 2003 compared to the prior year.

In addition, on May 20, 2003, FERC approved the NYISO's revised capacity market procurement design with an effective date of May 21, 2003. This revised capacity market procurement design was based on a demand curve rather than relying on deficiency auctions to procure necessary capacity. The deficiency auction with its associated fixed minimum capacity requirements was replaced with a spot market auction that pays gradually declining prices as additional capacity is offered and gradually increasing prices as capacity offers decrease. This new market design recognizes the value of capacity in excess of the minimum requirement and reduces price spikes during periods of shortage. Essentially, the demand curve design eliminates the high and low cycles inherent in the deficiency auction market design. This new market design also established seasonal electric generator specific price caps. Price caps establish the maximum price per MW that capacity can be sold into the NYISO by divested electric generators like Ravenswood. Prior to this design change, one price cap was established for the entire year and was effective for all electric generators. For the Ravenswood Facility, its 2003 summer price cap was higher than the yearly price cap effective during the 2002 summer. As a result of these market design changes, the Ravenswood Facility realized higher capacity revenues during 2003 compared to 2002. It should be noted, however, that Ravenswood's 2003/2004 structured winter price cap was lower than the yearly price cap effective during the 2002/2003 winter, which was prior to the implementation of the new demand curve methodology.

The decrease in comparative energy margins in 2003 primarily reflects significantly cooler weather during the summer of 2003 compared to the summer of 2002. Measured in cooling degree-days, weather for 2003 was 23% cooler than 2002. The cooler weather resulted in lower realized "spark-spreads" (the selling price of electricity less cost of fuel, plus hedging gains or losses), as well as a reduction in megawatt hours sold into the NYISO. Further, more competitive behavior by market participants that bid into the NYISO, as well as certain price mitigation measures imposed by the FERC (as noted earlier) have resulted in lower comparative realized "spark-spreads." Energy sales quantities during a portion of 2003 were also adversely impacted by the scheduled major overhaul of our largest generating unit, as previously indicated.

As noted earlier, we employ derivative financial hedging instruments to hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil consumed at the Ravenswood Projects, as well as to hedge the cash flow variability associated with a portion of forecasted peak electric energy sales from these facilities. These derivative instruments resulted in hedging gains, which were reflected in net electric margins, of $12.3 million for the year ended December 31, 2003 compared to hedging gains of $17.4 million for the year ended December 31, 2002. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments, and Fair Values" for further information.)

Net revenues from the service agreements with LIPA decreased by $22.7 million for the year ended December 31, 2003 compared to the same period in 2002. Included in revenues for 2003 were billings to LIPA for certain third party costs that were lower than such billings in 2002. These revenues had minimal or no impact on earnings since we record a similar amount of costs in operating expense and we share any cost under-runs with LIPA. Excluding these third party billings, revenues in 2003 associated with these service agreements increased approximately $7 million compared to 2002. The increase reflects a higher level of service fees charged to LIPA for the recovery of past operating costs. In 2003

we earned $16.2 million associated with non-cost performance incentives provided for under these agreements, compared to $16.0 million earned in 2002.

Net revenues from the peaking facilities were $9.6 million higher in 2003 compared to 2002, reflecting a full year of operation. The facilities were placed in service on June 1, 2002 and July 1, 2002. These facilities added a combined 160 megawatts of generating capacity to KeySpan's electric generation portfolio. The capacity of and energy produced by these facilities are dedicated to LIPA under 25 year contracts.

The remaining decrease in net revenues reflects lower net revenues associated with KeySpan's electric marketing subsidiary.

Operating Expenses

Total operating expenses increased $39.9 million, or 5%, for the year-ended December 31, 2004 compared to the same period of 2003, due to higher operating taxes and depreciation charges, partially offset by lower operations and maintenance expenses. Operations and maintenance expense decreased $5.3 million reflecting, in part, $10 million in lower costs associated with the LIPA Service Agreements as noted earlier. Operations and maintenance expense also reflects the impact of FIN 46 which required KeySpan to consolidate the Ravenswood Master Lease and classify the lease obligation as long-term debt on the Consolidated Balance Sheet. Further, an asset was recorded on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date. As a result of implementing FIN 46, beginning January 1, 2004, lease payments associated with the Ravenswood Master Lease have been reflected as interest expense on the Consolidated Statement of Income and the leased assets are being depreciated. The reclassification of lease payments associated with the Ravenswood Master Lease to interest expense resulted in a comparative decrease to operations and maintenance expense of $30 million. However, KeySpan incurred lease costs of $11 million associated with the sale/leaseback transaction involving the Ravenswood Expansion, that went into effect May 2004. In addition, KeySpan incurred increased repair and maintenance costs, including removal costs, associated with the Ravenswood Projects, as well as higher postretirement costs, which, for the most part, offset the beneficial impact of FIN 46.

The increase in depreciation expense of $21.1 million primarily relates to the depreciation of the leased assets under the Ravenswood Master Lease which increased depreciation by $16 million. The remaining increase in depreciation expense is associated with KeySpan's Long Island based electric generating units and is fully recoverable from LIPA. The higher operating taxes primarily reflect an increase in property taxes which are fully recoverable from LIPA, as noted earlier.

Operating expenses decreased $6.6 million for the year ended December 31, 2003, compared to 2002. Included in comparative operating expenses is a decrease in third party capital costs that are fully recoverable from LIPA, as noted earlier. Excluding the decrease in these costs, operating expenses increased approximately $23 million. This increase resulted, in part, from higher pension and other postretirement benefit costs. LIPA reimburses KeySpan for costs directly incurred by KeySpan in providing service to LIPA, subject to certain sharing provisions. Variations between pension and other postretirement costs and the estimates used to bill LIPA are deferred and refunded to or collected from LIPA in subsequent periods. As a result of an adjustment recorded in 2002 relating to this "true-up," comparative pension and other postretirement costs were approximately $9.3 million higher in 2003 compared to 2002. In addition, in 2002 we settled certain outstanding issues with LIPA and The Consolidated Edison Company of New York ("Consolidated Edison") that resulted in a $13.0 million decrease to operating expenses in 2002. Operating taxes reflect an increase in property tax rates associated with the Ravenswood Facility. The increase in depreciation expense is associated with the two peaking facilities.

Other Matters

The Ravenswood Expansion, a 250 MW combined cycle generating facility, was synchronized to the electric grid in December 2003 and commenced operational testing in January 2004. In March, the facility completed full load Dependable Maximum Net Capacity testing and in May 2004 the facility began full commercial operations. The entire capacity and energy produced from this plant is being sold into the NYISO markets.

To finance this facility, KeySpan entered into a leveraged lease financing arrangement. In May 2004, the facility was acquired by a lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to it. All the obligations of our subsidiary under the lease have been unconditionally guaranteed by KeySpan. This lease transaction generated cash proceeds of $385 million, before transaction costs, which approximates the fair market value of the facility, as determined by a third-party appraiser. The lease has an initial term of 36 years and the yearly operating lease expense will be approximately $17 million per year. Lease payments will fluctuate from year to year, but are substantially paid over the first 16 years. (See Note 7 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies" for additional information regarding this financing arrangement.)

In 2003, the New York State Board on Electric Generation Siting and the Environment issued an opinion and order which granted a certificate of environmental capability and public need for a 250 MW combined cycle electric generating facility in Melville, Long Island, which is now final and non-appealable. Also in 2003, LIPA issued a Request for Proposal ("RFP") seeking bids from developers to either build and operate a Long Island generating facility, and/or a new cable that will link Long Island to dedicated off-Long Island power of between 250 to 600 MW of electricity by no later than the summer of 2007. KeySpan and American National Power Inc. ("ANP") filed a joint proposal in response to LIPA's RFP. Under the proposal, KeySpan and ANP would have jointly owned and operated two 250 MW electric generating facilities to be located on Long Island, one of which is the Melville site and the other in the town of Brookhaven which also has received all permits and approvals. In May 2004, LIPA tentatively selected proposals submitted by

two other bidders in response to the RFP. KeySpan remains committed to the Melville project and the benefits to Long Island's energy future that this project would supply. The project has received New York State Article X approval by having met all operational and environmental permitting requirements. Further, the project is strategically located in close proximity to both the high voltage power transmission grid and the high pressure gas distribution network.

LIPA is in the process of performing a long-term strategic review initiative regarding its future direction. Some of the strategic options that LIPA is considering include whether LIPA should continue its operations as they presently exist, fully municipalize or privatize, sell some, but not all of their assets and become a regulator of rates and services. Until LIPA makes a determination on its future direction, we are unable to determine what the outcome of this strategic review will have on the Melville project. At December 31, 2004, total capitalized costs associated with the siting, permitting and procurement of equipment for the Melville facility were approximately $62.5 million.

As part of our growth strategy, we continually evaluate the possible acquisition and development of additional generating facilities in the Northeast. However, we are unable to predict when or if any such facilities will be acquired and the effect any such acquired facilities will have on our financial condition, results of operations or cash flows.

Energy Services

The Energy Services segment includes subsidiaries that provide energy-related services to customers primarily located within the Northeastern United States, with concentrations in the New York City and Boston metropolitan areas, through the following lines of business: (i) Home Energy Services, which provides residential and small commercial customers with service and maintenance of energy systems and appliances and (ii) Business Solutions, which now provides operation and maintenance, design, engineering and consulting services to commercial and industrial customers.

The table below highlights selected financial information for the Energy Services segment. The December 31, 2003 and 2002 data has been restated to reflect certain businesses in the Business Solutions division – specifically the mechanical contracting companies – as discontinued operations due to the sale of these companies in January and February 2005.

		(In Thousands of Dollars)	
YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Revenues	$193,921	$166,375	$208,624
Less: Operating expenses	227,799	199,338	254,205
Goodwill impairment	14,424	—	—
Operating (Loss)	$ (48,302)	$ (32,963)	$ (45,581)

The Energy Services segment incurred operating losses of $48.3 million for the year-ended December 31, 2004 compared to losses of $33.0 million for the same period last year. As noted earlier, in September 2004, KeySpan recorded a non-cash goodwill impairment charge in continuing operations of $14.4 million as a result of an evaluation of the carrying value of goodwill recorded in this segment. Based upon the operating results experienced by the Energy Services segment and management's opinion that it was likely that a significant portion of the Energy Services segment would be sold within one year, KeySpan conducted an evaluation of the carrying value of its investments in this segment. That evaluation resulted in a total pre-tax impairment charge of $208.6 million ($152.4 million, or $0.95 per share after-tax) – $14.4 million of this charge is attributable to continuing operations, while the remaining $194.2 million ($139.9 million after-tax, or $0.87 per share), has been reflected in discontinued operations. (See Note 11 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for additional details on this charge.)

Excluding the goodwill impairment charge, operating income for the twelve months ended December 31, 2004 was essentially the same as 2003. Lower operating results realized by Home Energy Services were offset by lower operating expenses of the remaining Business Solutions companies. Home Energy Services experienced higher operating expenses as a result of the write-off of accounts receivable and contract revenues on certain projects that were deemed to be uncollectible, as well as the write-down of inventory balances.

Operating results were $12.6 million better in 2003 compared to 2002 due to the operations of the Home Energy Services group of companies. Comparative operating results reflect losses incurred during 2002, resulting from the non-renewal of appliance service contracts due to the warm first quarter 2002 weather, as well as from an increase in the provision for bad debts.

Energy Investments

The Energy Investments segment consists of our gas exploration and production investments, as well as certain other domestic and international energy-related investments. In June 2004, KeySpan exchanged 10.8 million shares of common stock of The Houston Exploration Company ("Houston Exploration") an independent natural gas and oil exploration company located in Houston, Texas for 100% of the stock of Seneca Upshur Petroleum, Inc. ("Seneca-Upshur"), previously a wholly owned subsidiary of Houston Exploration. This transaction reduced our interest in Houston Exploration from 55% to approximately 23.5%. As part of this transaction, Houston Exploration retired 4.6 million of its common shares and issued 6.8 million new shares in a public offering. Based on Houston Exploration's announced offering price of $48.00 per share, Seneca-Upshur's shares were valued at the equivalent of $449 million, or $41.57 per share. Seneca-Upshur's assets consisted of West Virginia gas producing properties valued at $60 million, and $389 million in cash. KeySpan follows an accounting policy of income statement recognition for parent company gains or losses from common stock transactions initiated by its subsidiaries. As a result, this transaction resulted in a gain to KeySpan of $150.1 million. Effective June 1, 2004, Houston Exploration's earnings and our ownership interest in Houston Exploration were accounted for on the equity basis of accounting. The deconsolidation of Houston

Exploration required the recognition of certain deferred taxes on our remaining investment resulting in a net deferred tax expense of $44.1 million. Therefore, the net gain on the share exchange less the deferred tax provision was $106 million, or $0.66 per share.

In November 2004, KeySpan sold its remaining 23.5% interest in Houston Exploration (6.6 million shares) and received cash proceeds of approximately $369 million. KeySpan recorded a pre-tax gain of $179.6 million which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was $116.8 million or $0.73 per share.

Our gas exploration and production activities now include our wholly-owned subsidiaries Seneca-Upshur and KeySpan Exploration and Production, LLC ("KeySpan Exploration and Production"), which is engaged in a joint venture with Houston Exploration.

In the second quarter of 2004, KeySpan recorded a $48.2 million non-cash impairment charge to recognize the reduced valuation of proved reserves. See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies" Item F "Gas Exploration and Production Property – Depletion" for further information on this charge.

Asset transactions regarding our investment in Houston Exploration were also recorded in 2003. In February 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. We realized net proceeds of $79 million in connection with this repurchase. KeySpan realized a gain of $19 million on this transaction, which is reflected in other income and (deductions) on the Consolidated Statement of Income. Income taxes were not provided, since this transaction was structured as a return of capital.

Selected financial data and operating statistics for our gas exploration and production activities is set forth in the following table for the periods indicated. Operating income represents 100% of our gas exploration and production subsidiaries' results for all periods prior to May 31, 2004 and five months of equity earnings (June 1, 2004 through October 31, 2004) for our 23.5% interest in Houston Exploration.

			(In Thousands of Dollars)
YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Revenues	$279,999	$501,255	$357,451
Less: Depletion and			
amortization expense	108,791	204,102	176,925
Full cost ceiling test write-down	48,190	—	—
Other operating expenses	49,320	99,944	70,267
Plus: Equity earnings	20,757	—	—
Operating Income	$ 94,455	$197,209	$110,259

Executive Summary

Operating income decreased $102.8 million in 2004 compared to 2003 reflecting KeySpan's lower ownership in Houston Exploration during the year, and its ultimate sale as discussed above.

Operating income increased $87.0 million in 2003 compared to 2002 due to significantly higher average realized gas prices and a moderate increase in production volumes offset, to some extent, by an increase in operating expenses associated with a higher depletion rate, as well as higher lease operating expenses and severance taxes.

Operating Income

The decline in operating income of $102.8 million for the twelve months ended December 31, 2004 compared to the corresponding period in 2003, reflects the reduction in KeySpan's ownership interest in Houston Exploration. As noted, in 2003 KeySpan maintained a 55% ownership interest in Houston Exploration. In 2004, KeySpan maintained a 55% ownership interest for the five month period January 1, 2004 through May 31, 2004, then held an approximate 23.5% interest for the five month period June 1, 2004 through October 31, 2004. KeySpan sold its remaining 23.5% interest in Houston Exploration in November 2004. Further, the reduction in operating income in 2004 also reflects the $48.2 million non-cash impairment charge recorded by KeySpan's wholly-owned gas exploration and production subsidiaries to reflect the reduced valuation of proved reserves, as noted above.

Seneca-Upshur utilizes over-the-counter ("OTC") natural gas swaps to hedge the cash flow variability associated with forecasted sales of a portion of its natural gas production. At December 31, 2004, Seneca-Upshur has hedge positions in place for approximately 85% of its estimated 2005 through 2007 gas production, net of gathering costs. We use forward index prices to value these swap positions. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" for further details on the derivative financial instruments.)

Natural gas prices continue to be volatile and the risk that we may be required to record an impairment charge on our full cost pool again in the future increases when natural gas prices are depressed or if we have significant downward revisions in our estimated proved reserves.

The increase in operating income of $87.0 million or 79% for the year ended December 31, 2003, compared to the same period of 2002, reflected a significant increase in revenues. The higher revenues were offset, to some extent, by an increase in operating expenses associated with a higher depletion rate, as well as higher lease operating expenses and severance taxes, as discussed below. Revenues for the year ended 2003 benefited from the combination of a 37% increase in average realized gas prices (average wellhead price received for production including hedging gains and losses) and a 3% increase in production volumes.

Derivative financial hedging instruments were employed by Houston Exploration to provide more predictable cash flow, as well as to reduce its exposure to fluctuations in natural gas prices. The average realized gas price for the year ended 2003 was 87% of the average unhedged natural gas price, resulting in revenues that were approximately $67 million lower than revenues that would have been achieved if derivative financial

instruments had not been in place during 2003. Houston Exploration hedged slightly less than 70% of its 2003 production, principally through the use of costless collars.

The depletion rate experienced in 2003 was $1.85 per Mcf, compared to $1.68 per Mcf experienced in 2002. The increase in the depletion rate reflected downward reserve revisions related to performance, the addition of more costs to Houston Exploration's depletion base with fewer additions of reserves, as well as an increase in estimated future development costs at year end.

The increase in other operating expenses for the year ended December 31, 2003, compared to the same period of 2002 was primarily due to increased lease operating costs and severance taxes. Lease operating expenses increased $13.1 million in 2003 compared to 2002, as a result of the continued expansion of operations both onshore and offshore. Severance tax, which is a function of volume and revenues generated from onshore production, increased $6.5 million in 2003 compared to 2002 as a result of the increase in average wellhead prices for natural gas. Overall operating expenses were increasing as new wells and facilities were added and production from existing wells was maintained.

For much of 2004, subsidiaries in this segment also held an ownership interest in certain midstream natural gas assets in Western Canada through KeySpan Canada. These assets included 14 processing plants and associated gathering systems that can process approximately 1.5 BCFe of natural gas daily and provide associated natural gas liquids fractionation. At the beginning of 2004, KeySpan held a 60.9% ownership interest in KeySpan Canada. In April 2004, KeySpan and KeySpan Facilities Income Fund (the "Fund"), an open-ended income fund trust which previously owned the other 39.1% interest in KeySpan Canada, consummated a transaction whereby the Fund sold 15.617 million units of the Fund at a price of CDN$12.60 per unit for gross total proceeds of approximately CDN$196.8 million. The proceeds of the offering were used by the Fund to acquire an additional 35.91% interest in KeySpan Canada from KeySpan. We received net proceeds of approximately CDN$186.3 million (or approximately US$135 million), after commissions and expenses. The Fund's ownership in KeySpan Canada increased from 39.1% to 75%, and KeySpan's ownership of KeySpan Canada decreased from 60.9% to 25%. KeySpan recorded a gain of $22.8 million ($10.1 million after-tax, or $0.06 per share) on this transaction. Effective April 1, 2004 KeySpan Canada's earnings and our ownership interest in KeySpan Canada had been accounted for on the equity basis of accounting.

In July 2004, the Fund issued an additional 10.7 million units, the proceeds of which were used to fund the acquisition of the midstream assets of Chevron Canada Midstream Inc. This transaction had the effect of further diluting KeySpan's ownership of KeySpan Canada to 17.4%.

In December 2004, KeySpan sold its remaining 17.4% interest in KeySpan Canada to the Fund and received net proceeds of approximately $119 million and recorded a pre-tax gain of $35.8 million, which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was approximately $24.7 million, or $0.15 per share.

Asset transactions regarding our investment in KeySpan Canada were also recorded in 2003. In 2003, we sold a portion of our interest in KeySpan Canada through the Fund. The Fund acquired a 39.1% ownership interest in KeySpan Canada through an indirect subsidiary, and then issued 17 million trust units to the public through an initial public offering. Each trust unit represented a beneficial interest in the Fund and was registered on the Toronto Stock Exchange under the symbol KEY.UN. Additionally, we sold our 20% interest in Taylor NGL LP that owns and operates two extraction plants also in Canada to AltaGas Services, Inc. Net proceeds of $119.4 million from the two sales, plus proceeds of $45.7 million drawn under a new credit facility made available to KeySpan Canada, were used to pay down existing KeySpan Canada credit facilities of $160.4 million. A pre-tax loss of $30.3 million was recognized on the transactions and was included in other income and (deductions) on the Consolidated Statement of Income. These transactions produced a tax expense of $3.8 million as a result of certain United States partnership tax rules and resulted in an after-tax loss of $34.1 million.

This segment is also engaged in pipeline development activities. KeySpan and Duke Energy Corporation each own a 50% interest in Islander East Pipeline Company, LLC ("Islander East"). Islander East was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Shoreham, Long Island. Once in service, the pipeline is expected to transport up to 260,000 DTH daily to the Long Island and New York City energy markets. Further, in August 2004, KeySpan acquired a 21% interest in the Millennium Pipeline project which will transport up to 500,000 DTH of natural gas a day from Corning to Ramapo, New York, where it will connect to an existing pipeline.

Additionally, subsidiaries in this segment hold a 20% equity interest in the Iroquois Gas Transmission System LP, a pipeline that transports Canadian gas supply to markets in the Northeastern United States and the KeySpan LNG facility in Providence, Rhode Island, a 600,000 barrel liquefied natural gas storage and receiving facility. These subsidiaries are accounted for under the equity method. Accordingly, equity income from these investments is reflected as a component of operating income in the Consolidated Statement of Income.

In addition to the asset sales noted previously, KeySpan anticipates selling its 50% interest in PTL, a gas pipeline from southwest Scotland to Northern Ireland. On February 25, 2005, KeySpan entered into a Share Sale and Purchase Agreement with BG Energy Holdings Limited and Premier Transmission Financing plc ("PTF"), pursuant to which all of the outstanding shares of PTL are to be purchased by PTF. It is expected that the sale of our 50% interest in PTL will result in proceeds of approximately $42.5 million and that the closing of this transaction will occur before the end of the second quarter of 2005. In the fourth quarter of 2004, KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million-$18.8 million after-tax or $0.12 per share, reflecting the difference between the anticipated cash proceeds from the sale of PTL compared to its carrying value. This investment is also accounted for under the equity method.

In the fourth quarter of 2003, we completed the sale of our then 24.5% interest in Phoenix Natural Gas Limited for $96 million and

recorded a pre-tax gain of $24.7 million in other income and (deductions) on the Consolidated Statement of Income.

Selected financial data for our other energy-related investments is set forth in the following table for the periods indicated. Operating income below represents 100% of KeySpan Canada's results for three months ended March 31, 2004 and equity earnings from April 1, 2004 through November 30, 2004.

		(In Thousands of Dollars)	
YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Revenues	$46,988	$113,124	$90,778
Less: Operation and			
maintenance expense	33,453	68,568	57,161
Other operating expenses	7,556	22,317	17,622
Impairment charge	26,541	—	—
Add: Equity earnings	25,779	19,106	13,992
Gain on sale of property	5,021	—	2,348
Operating Income	$10,238	$ 41,345	$32,335

The decrease in comparative operating income in 2004 compared to last year reflects the impairment charge associated with our investment in PTL, as well as our lower ownership interest in KeySpan Canada. Operating income from our other energy-related investments in 2004 was substantially the same as 2003.

The increase in operating income in 2003 compared to 2002 reflects, in part, higher operating income associated with our Canadian investments, primarily KeySpan Canada, as well as higher earnings from our Northern Ireland investments. KeySpan Canada experienced higher unit sales, as well as higher quantities of sales of natural gas liquids in 2003, as a result of increasing oil prices. The pricing of natural gas liquids is directly related to oil prices. The Northern Ireland investments realized higher gas sales quantities, as well as favorable exchange rates during 2003. Operating income for 2003 also reflects our investment in the KeySpan LNG storage facility located in Rhode Island, which we acquired in December 2002.

Allocated Costs

As previously mentioned, KeySpan is subject to the jurisdiction of the Securities and Exchange Commission ("SEC") under the Public Utility Holding Company Act ("PUHCA") as amended. Under PUHCA, the SEC regulates various transactions among affiliates within a holding company system. In accordance with the SEC's regulations under PUHCA and the New York State Public Service Commission, we have service companies that provide: (i) traditional corporate and administrative services; (ii) gas and electric transmission and distribution systems planning, marketing, and gas supply planning and procurement; and (iii) engineering and surveying services to subsidiaries. Operating income variations reflected in "eliminations and other" associated with these non-operating subsidiaries reflect, in part, allocation adjustments recorded in 2003. As required by the SEC, during 2003 we adjusted certain provisions in our allocation methodology that resulted in certain costs being allocated back to certain non-operating subsidiaries. Further, in 2004 KeySpan reached a settlement with its insurance carriers regarding cost recovery for expenses incurred at a non-utility environmental site and recorded an $11.6 million gain from the settlement as a reduction to operating expenses.

The variation in operating income for these non-operating subsidiaries between 2003 and 2002 primarily reflects a $10 million favorable adjustment recorded in 2003 for environmental reserves associated with non-utility environmental sites based on a site investigation study concluded in the fourth quarter of 2003.

Liquidity

Cash flow from operations for the year ended December 31, 2004 decreased $473.3 million, or 39%, compared to 2003 primarily due to federal tax refunds received in 2003. During 2003, KeySpan performed an analysis of costs capitalized for self-constructed property and inventory for income tax purposes. KeySpan filed a change of accounting method for income tax purposes resulting in a cumulative deduction for costs previously capitalized. As a result of this tax method change, along with accelerated deductions resulting from bonus depreciation, Keyspan received in October 2003, a $192.3 million refund from the Internal Revenue Service for prior year taxes, as well as an additional $85 million for tax payments made in 2002. On a comparative basis, tax refunds received in 2003 compared with federal tax payments made in 2004 of $63.2 million, resulted in a comparative cash flow decrease in 2004 of approximately $340.5 million. Further, cash flow from operations for 2004 was adversely impacted by the deconsolidation of Houston Exploration in June 2004.

On October 26, 2004, the American Jobs Creation Act of 2004 (the "Act") was enacted into law. A significant provision of the Act, as it relates to KeySpan, is the 85% dividend deduction for dividends received from foreign corporations. The Act allows KeySpan to tax-effectively bring funds invested outside the United States back into the United States. At December 31, 2004 KeySpan had $360 million of temporary cash investments outside the United States. KeySpan intends to repatriate this cash in 2005.

Cash flow from operations for the year ended December 31, 2003 increased $475.7 million, or 64%, compared to 2002. As noted above, in 2003 KeySpan received approximately $277.3 million in federal tax refunds. These refunds compared to tax payments made in 2002, resulted in a cash flow benefit in 2003, compared to 2002, of approximately $310 million.

Comparative operating cash flow also reflects the collection of gas accounts receivable associated with higher winter gas heating sales. As a result of load additions, colder than normal winter weather during the first quarter of 2003, higher natural gas prices, and higher accounts receivable at the end of 2002, cash receipts from gas heating customers were higher in 2003 than in 2002. Further, the higher natural gas prices resulted in an increase in operating cash flow associated with the operations of Houston Exploration. These benefits to cash flow were partially offset by significantly higher cash expenditures to refill natural gas storage levels as a result of the higher natural gas prices.

At December 31, 2004, we had cash and temporary cash investments of $922.0 million. During 2004, we borrowed an additional $430.3 million of commercial paper and, at December 31, 2004, $912.2 million of commercial paper was outstanding at a weighted-average annualized interest rate of 2.4%. We had the ability to borrow up to an additional $388 million at December 31, 2004, under the terms of our credit facility. As discussed in more detail under the caption "Financing", in January 2005 KeySpan used a portion of its temporary cash investments to redeem $500 million of previously outstanding long-term debt.

In June 2004, KeySpan completed the restructuring of its credit facilities. We entered into a new $640 million five year revolving credit facility to replace the $450 million, 364 day facility which expired in June. We also amended our existing three year $850 million facility due June 2006 to reduce commitments thereunder by $190 million to a new level of $660 million. The two credit facilities total $1.3 billion and are each syndicated among sixteen banks. These facilities continue to support KeySpan's commercial paper program for working capital needs.

The fees for these facilities are subject to a ratings-based grid, with an annual fee of 0.08% on the new five-year facility and 0.125% on the existing three-year facility. Both credit agreements allow for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans in the five-year facility are based on the Eurodollar rate plus a margin of 0.40% for loans up to 33% of the total five-year facility, and an additional 0.125% for loans over 33% of the total five-year facility. In the three-year facility Eurodollar loans are based on the Eurodollar rate plus a margin of 0.625% for loans up to 33% of the total three-year facility, and an additional 0.125% for loans over 33% of the total three-year facility. ABR loans are based on the highest of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders. We do not anticipate borrowing against these facilities; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The facilities contain certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its property to any lien, as well as certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 64% until the expiration of the existing three-year facility in 2006, at which time it will be lowered to 62%. Violation of this covenant could result in the termination of the facilities and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements.

Under the terms of the credit agreements, KeySpan's debt-to-total capitalization ratio reflects 80% equity treatment for the MEDS Equity Units issued in May 2002. At December 31, 2004, consolidated indebtedness, as calculated under the terms of the credit agreements was 53.4% of consolidated capitalization.

Houston Exploration and KeySpan Canada also had revolving credit facilities with commercial banks. During the time period that Houston Exploration's results were consolidated with KeySpan's (the five months ended May 31, 2004) Houston Exploration borrowed $49 million under its credit facility and repaid $136 million. KeySpan Canada repaid $17.7 million under its facility during the first three months of 2004 (the time period in which its results were consolidated with KeySpan's). These borrowings and repayments are included in the Consolidated Cash Flow Statement.

A substantial portion of consolidated revenues are derived from the operations of businesses within the Electric Services segment, that are largely dependent upon two large customers – LIPA and the NYISO. Additionally, our KEDNE gas supply is concentrated with Merrill Lynch Trading. Accordingly, our cash flows are dependent upon the timely payment or delivery of amounts or commodity owed to us by these counterparties.

We satisfy our seasonal working capital requirements primarily through internally generated funds and the issuance of commercial paper We believe that these sources of funds are sufficient to meet our seasonal working capital needs.

Capital Expenditures and Financing

Construction Expenditures

The table below sets forth our construction expenditures by operating segment for the periods indicated:

	(In Thousands of Dollars)	
YEAR ENDED DECEMBER 31,	**2004**	**2003**
Gas Distribution	$414,522	$ 419,549
Electric Services	150,320	256,498
Energy Investments	160,225	314,097
Energy Services and other	25,262	19,249
	$750,329	$1,009,393

Construction expenditures related to the Gas Distribution segment are primarily for the renewal, replacement and expansion of the distribution system. Construction expenditures for the Electric Services segment reflect cost to maintain our generating facilities and construct the Ravenswood Expansion. Construction expenditures related to the Energy Investments segment primarily reflect costs associated with gas exploration and production activities, including those of Houston Exploration through May 31, 2004, as well as costs related to KeySpan Canada's gas processing facilities through April 1, 2004. The decrease in capital expenditures in 2004 compared to 2003 primarily reflects the lower ownership interest in Houston Exploration, as well as the completion of the Ravenswood Expansion in 2004.

Construction expenditures for 2005 are estimated to be approximately $650 million. The amount of future construction expenditures is reviewed on an ongoing basis and can be affected by timing, scope and changes in investment opportunities.

Financing

In August 2004, KeySpan redeemed approximately $758 million of outstanding debt. The table below indicates the various series of debt redeemed and the associated KeySpan subsidiary:

KEYSPAN SUBSIDIARY	SERIES	DUE DATE	AMOUNT ($000)
KeySpan Corporation	7.25 % Medium Term Notes	November 2005	$700,000
EnergyNorth Natural Gas	9.70 % Series B	September 2019	7,000
EnergyNorth Natural Gas	9.75% Series C	September 2020	10,000
EnergyNorth Natural Gas	8.44 % Series D	January 2009	1,667
EnergyNorth Natural Gas	7.40% Series E	September 2027	21,285
Essex Gas Company	10.10% Series 1990	December 2020	8,000
Essex Gas Company	7.28% Series 1996	December 2016	10,000
			$757,952

KeySpan incurred $54.5 million in call premiums associated with these redemptions, of which $45.9 million was expensed and recorded in other income and deductions on the Consolidated Statement of Income. The remaining amount of the call premiums have been deferred for future recovery. Further, KeySpan wrote-off $8.2 million of previously deferred financing costs which have been reflected in interest expense on the Consolidated Statement of Income. The total after-tax expense of the debt redemption was $29.3 million or $0.18 per share.

During the third quarter of 2004, KEDNY retired $8.0 million, of its outstanding Gas Facilities Revenue Bonds. The funds used to retire this debt were drawn from a special deposit defeasance trust previously established by KEDNY. Approximately $640 million of Gas Facilities Revenue Bonds remain outstanding.

In August 2004, KeySpan redeemed 83,268 shares of preferred stock 6.00% Series A par value $100 that were previously issued in a private placement. KeySpan redeemed these shares at a 2% premium and incurred a cash expenditure of $8.5 million.

In addition, on January 14, 2005, KeySpan redeemed $500 million 6.15% Series due 2006 of outstanding debt. KeySpan incurred $20.9 million in call premiums and wrote-off $1.0 million of previously deferred financing costs. Further, KeySpan accelerated the amortization of approximately $10.5 million of previously unamortized benefits associated with an interest rate swap on these bonds. The accelerated amortization was recorded as a reduction to interest expense. Further, $55.3 million 7.07% Series B of mandatory redeemable preferred stock is scheduled to be redeemed in May 2005.

During the second quarter of 2004, KeySpan entered into a leveraged lease financing arrangement associated with the Ravenswood Expansion. In May 2004, the facility was acquired by a lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to that subsidiary. All of the obligations of our subsidiary under the lease have been unconditionally guaranteed by KeySpan. This lease transaction generated cash proceeds of $385 million, before transaction costs, which approximates fair market value of the facility, as determined by a third-party appraiser. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding this financing arrangement.)

In October 2004, KeySpan filed a new universal shelf Registration Statement to issue, from time to time, up to $3 billion in securities. We will continue to evaluate our capital structure and financing strategy for 2005 and beyond.

The following table represents the ratings of our long-term debt at December 31, 2004. During the fourth quarter of 2004 Standard & Poor's reaffirmed its ratings on KeySpan's and its subsidiaries' long-term debt and removed its negative outlook. Moody's Investor Services, however, continues to maintain its negative outlook ratings on KeySpan's and its subsidiaries' long-term debt.

	MOODY'S INVESTOR SERVICES	STANDARD & POOR'S	FITCHRATINGS
KeySpan Corporation	A3	A	A–
KEDNY	N/A	A+	A+
KEDLI	A2	A+	A–
Boston Gas	A2	A	N/A
Colonial Gas	A2	A+	N/A
KeySpan Generation	A3	A	N/A

Off-Balance Sheet Arrangements

Guarantees

KeySpan has a number of financial guarantees with its subsidiaries at December 31, 2004. KeySpan had fully and unconditionally guaranteed: (i) $525 million of medium-term notes issued by KEDLI; (ii) the obligations of KeySpan Ravenswood LLC, which is the lessee under the $425 million Master Lease associated with the Ravenswood Facility and the lessee under the sale/leaseback transaction for the Ravenswood Expansion; and (iii) the payment obligations of our subsidiaries related to $128 million of tax-exempt bonds issued through the Nassau County and Suffolk County Industrial Development Authorities for the construction of two electric-generation peaking facilities on Long Island. The medium-term notes, the Master Lease and the tax-exempt bonds are reflected on the Consolidated Balance Sheet; the sale/leaseback transaction is not recorded on the Consolidated Balance Sheet. Further, KeySpan has guaranteed: (i) up to $258 million of surety bonds associated with certain construction projects currently being performed by former subsidiaries

within the Energy Services segment; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of $74 million; and (iii) $74 million of subsidiary letters of credit. These guarantees are not recorded on the Consolidated Balance Sheet. KeySpan's guarantees on certain performance bonds relating to current construction projects of the discontinued mechanical contracting companies will remain in place throughout the construction period. It is contemplated that the majority of the current contracts will be completed by the end of 2005. KeySpan has received an indemnity bond issued by a third party to offset potential exposure related to a significant portion of the continuing guarantee. At this time, we have no reason to believe that our subsidiaries or former subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact such defaults may have on our consolidated results of operations, financial condition or cash flows. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees, as well as Note 11 "Energy Services – Discontinued Operations" for additional information on the discontinued mechanical contracting companies.)

Contractual Obligations

KeySpan has certain contractual obligations related to its outstanding long-term debt, outstanding credit facility borrowings, outstanding commercial paper borrowings, various leases, and demand charges associated with certain commodity purchases. KeySpan's outstanding short-term and long-term debt issuances are explained in more detail in Note 6 to the Consolidated Financial Statements "Long-Term Debt." KeySpan's leases, as well as its demand charges are more fully detailed in Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies." The table below reflects maturity schedules for KeySpan's contractual obligations at December 31, 2004. Included in the table is the long-term debt that has been consolidated as part of the variable interest entity associated with the Ravenswood Master Lease.

(In Thousands of Dollars)

CONTRACTUAL OBLIGATIONS	TOTAL	1 – 3 YEARS	4 – 5 YEARS	AFTER 5 YEARS
Long-term Debt	$4,442,450	$ 527,000	$1,017,250	$2,898,200
Capital Leases	11,833	3,172	2,326	6,335
Operating Leases	411,149	190,961	124,529	95,659
Master Lease Payments	128,189	85,459	42,730	—
Sale/Leaseback Arrangement	598,920	69,375	72,430	457,115
Preferred Stock Redeemable	75,000	75,000	—	—
Interest Payments	2,680,715	679,487	396,612	1,604,616
Demand Charges	485,209	485,209	—	—
Total Contractual Cash Obligations	$8,833,465	$2,115,663	$1,655,877	$5,061,925
Commercial Paper	$ 912,246	Revolving		

For information regarding projected postretirement contributions, see Note 4 to the Consolidated Financial Statements "Postretirement Benefits."

Discussion of Critical Accounting Policies and Assumptions

In preparing our financial statements, the application of certain accounting policies requires difficult, subjective and/or complex judgments. The circumstances that make these judgments difficult, subjective and/or complex have to do with the need to make estimates about the impact of matters that are inherently uncertain. Actual effects on our financial position and results of operations may vary significantly from expected results if the judgments and assumptions underlying the estimates prove to be inaccurate. The critical accounting policies requiring such subjectivity are discussed below.

Percentage-of-Completion

Percentage-of-completion accounting is a method of accounting for long-term construction type contracts in accordance with Generally Accepted Accounting Principles and, accordingly, the method used for engineering and mechanical contracting revenue recognition by the Energy Services segment. Percentage-of-completion is measured principally by comparing the percentage of costs incurred to date for each contract to the estimated total costs for each contract at completion. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are known. Application of percentage-of-completion accounting results in the recognition of costs and estimated earnings in excess of billings on uncompleted contracts (recorded within the Consolidated Balance Sheet) which arise when revenues have been recognized but the amounts cannot be billed under the terms of the contracts. Such amounts are recoverable from customers based on various measures of performance, including achievement of certain milestones, completion of specified units or completion of the contract. Due to uncertainties inherent within estimates employed to apply percentage-of-completion accounting, it is possible that estimates will be revised as project work progresses. Changes in estimates resulting in additional future costs to complete projects can result in reduced margins or loss contracts. Unapproved change orders and claims also involve the use of estimates, and it is reasonably possible that revisions to the estimated recoverable amounts of recorded change orders and claims may be made in the near-term. Application of percentage-of-completion accounting requires that the impact of those revised estimates be reported in the consolidated financial statements prospectively.

Valuation of Goodwill

KeySpan records goodwill on purchase transactions, representing the excess of acquisition cost over the fair value of net assets acquired. In testing for goodwill impairment under SFAS 142 "Goodwill and Other

Intangible Assets," significant reliance is placed upon a number of estimates regarding future performance that require broad assumptions and significant judgment by management. A change in the fair value of our investments could cause a significant change in the carrying value of goodwill.

As prescribed in SFAS 142, KeySpan is required to compare the fair value of a reporting unit to its carrying amount, including goodwill. This evaluation is required to be performed at least annually, unless facts and circumstances indicated that the evaluation should be performed at an interim period during the year. Prior to the evaluation discussed below, the recorded goodwill for the Energy Services segment, as a result of prior acquisitions, was approximately $173 million.

The Energy Services segment has experienced significantly lower operating profits and cash flows than originally projected. As previously reported, management reviewed the operating performance of this segment. At a meeting held on November 2, 2004, KeySpan's Board of Directors authorized management to begin the process of disposing of a significant portion of its ownership interests in certain companies within the Energy Services segment – specifically those companies engaged in mechanical contracting activities. In January and February of 2005, KeySpan sold its mechanical contracting companies.

During 2004 KeySpan conducted an evaluation of the carrying value of goodwill recorded in its Energy Services segment. As a result of this evaluation, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on Energy Services segment's continuing operations; and (ii) $93.9 million as discontinued operations reflecting the impairment on the mechanical contracting companies. KeySpan employed a combination of two methodologies in determining the estimated fair value for its investment in the Energy Services segment, a market valuation approach and an income valuation approach. Under the market valuation approach, KeySpan utilized a range of near-term potential realizable values for the mechanical contracting businesses. Under the income valuation approach, the fair value was obtained by discounting the sum of (i) the expected future cash flows and (ii) the terminal value. KeySpan was required to make certain significant assumptions, specifically the weighted-average cost of capital, short and long-term growth rates and expected future cash flows. (See Note 11 to the Consolidated Financial Statements "Energy Services-Discontinued Operations" for further details.)

In addition to the goodwill evaluation conducted for the Energy Services segment, KeySpan conducted evaluations of the goodwill recorded in the Gas Distribution and Energy Investments segments. Based on KeySpan's evaluation of the fair value of the Gas Distribution unit, KeySpan concluded that the fair value of the Gas Distribution unit exceeded the carrying value and no impairment was necessary. As noted previously, KeySpan has entered into an agreement to sell its 50% interest in PTL before the end of the second quarter of 2005. This investment is accounted for under the equity method of accounting in the Energy Investments segment. In the fourth quarter of 2004 KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share. The impairment charge reflects the difference between the anticipated cash proceeds from the sale of PTL compared to its carrying value and was recorded as a reduction to goodwill.

Accounting for the Effects of Rate Regulation on Gas Distribution Operations

The financial statements of the Gas Distribution segment reflect the ratemaking policies and orders of the New York Public Service Commission ("NYPSC"), the New Hampshire Public Utilities Commission ("NHPUC"), and the Massachusetts Department of Telecommunications and Energy ("MADTE").

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas Company and EnergyNorth Natural Gas, Inc.) are subject to the provisions of SFAS 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the actions of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies.

In separate merger-related orders issued by the MADTE, the base rates charged by Colonial Gas Company and Essex Gas Company have been frozen at their current levels for ten-year periods ending 2009 and 2008, respectively. Due to the length of these base rate freezes, the Colonial and Essex Gas Companies had previously discontinued the application of SFAS 71.

SFAS 71 allows for the deferral of expenses and income on the Consolidated Balance Sheet as regulatory assets and liabilities when it is probable that those expenses and income will be allowed in the rate setting process in a period different from the period in which they would have been reflected in the consolidated statements of income of an unregulated company. These deferred regulatory assets and liabilities are then recognized in the Consolidated Statement of Income in the period in which the amounts are reflected in rates.

In the event that regulation significantly changes the opportunity for us to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101 "Regulated Enterprises – Accounting for the Discontinuation of Application of FASB Statement No. 71." We estimate that the write-off of our net regulatory assets at December 31, 2004 could result in a charge to net income of approximately $313 million or $1.95 per share, which would be classified as an extraordinary item. In management's opinion, our regulated subsidiaries that currently are subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

...ussed under the caption "Regulation and Rate
...ters," in October 2003 the MADTE rendered its decision on the
...on Gas Company's base rate case and Performance Based Rate Plan
...osal submitted to the MADTE in April 2003. The rate plans previously
...fect for KEDNY and KEDLI have expired. The continued application of
... 71 to record the activities of these subsidiaries is contingent upon
...actions of regulators with regard to future rate plans. We are current-
...aluating various options that may be available to us including, but
...imited to, proposing new rate plans for KEDNY and KEDLI. The ulti-
... resolution of any future rate plans could have a significant impact
...e application of SFAS 71 to these entities and, accordingly, on our
...cial position, results of operations and cash flows. EnergyNorth
...ral Gas, Inc.'s base rates continue as set by the NHPUC in 1993.
...agement believes that currently available facts support the continued
...cation of SFAS 71 and that all regulatory assets and liabilities are
...erable or refundable through the regulatory environment.

...ion and Other Postretirement Benefits

...scussed in Note 4 to the Consolidated Financial Statements,
...retirement Benefits," KeySpan participates in both non-contributory
...ed benefit pension plans, as well as other postretirement benefit
...EB") plans (collectively "postretirement plans"). KeySpan's reported
... of providing pension and OPEB benefits are dependent upon
...rous factors resulting from actual plan experience and assumptions
...ure experience. Pension and OPEB costs (collectively "postretirement
...") are impacted by actual employee demographics, the level of con-
...ons made to the plans, earnings on plan assets, and health care
...ends. Changes made to the provisions of these plans may also
... current and future postretirement costs. Postretirement costs may
... significantly affected by changes in key actuarial assumptions,
...g, anticipated rates of return on plan assets and the discount
...ed in determining the postretirement costs and benefit obliga-
...ual results that differ from our assumptions are accumulated
...tized over ten years.

...in gas distribution subsidiaries are subject to SFAS 71, and, as
...anges in postretirement expenses are deferred for future
...m or refund to gas sales customers. (However, KEDNY,
...bject to SFAS 71, does not have a recovery mechanism in
...nges in postretirement costs.) Further, changes in postretire-
...s associated with subsidiaries that service the LIPA
...re also deferred for future recovery from or refund to LIPA.

... the assumed long-term rate of return on our postretire-
...sets was 8.5% (pre-tax), net of expenses. This is an appro-
... expected rate of return on assets based on KeySpan's
...egy, asset allocation and the historical performance of
... income investments over long periods of time. The actual
...d annual rate of return for the KeySpan Plans is greater

...ster trust investment allocation policy target is 70%
...ed income. At December 31, 2004, the actual investment allocation was in line with the target. In an effort to
...performance, actual asset allocation will fluctuate from yea...
depending on the then current economic environment.

Based on the results of an asset and liability study con...
2003 projecting asset returns and expected benefit payments...
year period, KeySpan has developed a multiyear funding strat...
postretirement plans. KeySpan believes that it is reasonable to...
assets can achieve or outperform the assumed long-term rate ...
with the target allocation as a result of historical performance ...
investments over long-term periods.

A 25 basis point increase or decrease in the assumed long-...
of return on plan assets would have impacted 2004 expense by a...
mately $6 million, before deferrals.

The year-end December 31, 2004 assumed discount rate use...
determine postretirement obligations was 6%. Our discount rate as...
tion is based upon the current investment yield associated with rati...
agency indices that have high quality long-term corporate bonds. A 2...
basis point increase or decrease in the assumed year-end discount ra...
would have had no impact on 2004 expense. However, a 25 basis po...
decrease in the assumed year-end discount rate would result in the
recording of an additional minimum pension liability. A year-end discou...
rate of 5.75% would have required an additional $38 million debit to
other comprehensive income ("OCI") before taxes and deferrals. A year-end discount rate of 5.5% would have required an additional $290 million debit to OCI before taxes and deferrals.

At January 1, 2004, the assumed discount rate used to determine postretirement obligations was 6.25%. A 25 basis point increase or decrease in the assumed discount rate at the beginning of the year would have impacted 2004 expense by approximately $14 million, before deferrals.

Our health care cost trend assumptions are developed based on historical cost data, the near-term outlook and an assessment of likely long-term trends. The salary growth assumptions reflect our long-term outlook

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At December 31, 2004, we had a funding credit balance in excess of the ERISA minimum funding requirements and as a result KeySpan was not required to make any contributions to its qualified pension plans in 2004. However, although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Therefore, during 2004 KeySpan contributed $186 million to its funded and unfunded postretirement plans.

For 2005, KeySpan expects to contribute approximately $120 million to its funded and unfunded postretirement plans. Future funding requirements are heavily dependent on actual return on plan assets and prevailing interest rates.

Full Cost Accounting

As noted previously, during 2004 KeySpan disposed of its ownership interest in Houston Exploration. KeySpan continues to maintain gas

and production subsidiaries use the full cost method to account for their natural gas and oil properties. Under full cost accounting, all costs incurred in the acquisition, exploration, and development of natural gas and oil reserves are capitalized into a "full cost pool." Capitalized costs include costs of all unproved properties, internal costs directly related to natural gas and oil activities, and capitalized interest.

Under full cost accounting rules, total capitalized costs are limited to a ceiling equal to the present value of future net revenues, discounted at 10%, plus the lower of cost or fair value of unproved properties less income tax effects (the "ceiling limitation"). A quarterly ceiling test is performed to evaluate whether the net book value of the full cost pool exceeds the ceiling limitation. If capitalized costs (net of accumulated depreciation, depletion and amortization) less deferred taxes are greater than the discounted future net revenues or ceiling limitation, a write-down or impairment of the full cost pool is required. A write-down of the carrying value of the full cost pool is a non-cash charge that reduces earnings and impacts stockholders' equity in the period of occurrence and typically results in lower depreciation, depletion and amortization expense in future periods. Once incurred, a write-down is not reversible at a later date.

The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, held constant over the life of the reserves. Our gas exploration and production subsidiaries use derivative financial instruments that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" to hedge against the volatility of natural gas prices. In accordance with current SEC guidelines, these derivatives are included in the estimated future cash flows in the ceiling test calculation.

As a result of the disposition of Houston Exploration, during most of 2004 KeySpan calculated the ceiling test on KeySpan Exploration and Production's and Seneca-Uphsur's assets independently of Houston Exploration's assets. Based on a report furnished by an independent reservoir engineer during the second quarter of 2004, it was determined that the remaining proved undeveloped oil reserves held in the joint venture required a substantial investment in order to develop. Therefore, KeySpan and Houston Exploration elected not to develop these oil reserves. As a result, in the second quarter of 2004, we recorded a $48.2 million non-cash impairment charge to write down our wholly-owned gas exploration and production subsidiaries' assets. This charge was recorded in depreciation, depletion and amortization on the Consolidated Statement of Income.

In calculating the ceiling test at December 31, 2004, our subsidiaries estimated that a full cost ceiling "cushion" existed, whereby the carrying value of the full cost pool was less that the ceiling limitation. No write-down is required when a cushion exists. Natural gas prices continue to be volatile and the risk that a write-down to the full cost pool will be required increases when natural gas prices are depressed or if there are significant downward revisions in estimated proved reserves.

Natural gas and oil reserve quantities represent estimates only. Under full cost accounting, reserve estimates are used to determine the full cost ceiling limitation, as well as the depletion rate. KeySpan's subsidiaries estimate proved reserves and future net revenues using sales prices estimated to be in effect as of the date they make the reserve estimates. Natural gas prices, which have fluctuated widely in recent years, affect estimated quantities of proved reserves and future net revenues. Any estimates of natural gas and oil reserves and their values are inherently uncertain, including many factors beyond our control. The accuracy of any reserve estimate is a function of the quality of available data and of engineering and geological interpretation and judgment. In addition, estimates of reserves may be revised based upon actual production, results of future development and exploration activities, prevailing natural gas and oil prices, operating costs and other factors, which revision may be material. Reserve estimates are highly dependent upon the accuracy of the underlying assumptions. Actual future production may be materially different from estimated reserve quantities and the differences could materially affect future amortization of natural gas and oil properties.

Accounting for Sales of Stock by a Subsidiary

KeySpan applies the accounting principle of income recognition for gains or losses associated with the sale of stock by its subsidiaries. As provided for in Staff Accounting Bulletin Topic 5-H ("SAB 51"), the SEC allows for income recognition of gains or losses on subsidiary stock transactions in instances where the transaction is not part of a broader corporate reorganization contemplated by the parent. Provided that no other capital transactions are contemplated with regard to the shares issued, income statement treatment in consolidation for issuance of stock by a subsidiary is appropriate. SAB 51 requires that this accounting treatment, if elected by the parent, must be consistently applied to all subsidiary stock transactions that meet the conditions for income statement recognition. As noted earlier, KeySpan has appropriately applied this accounting treatment to its subsidiary stock transactions.

Accounting for the Sale/Leaseback Transaction

In May 2004 the Ravenswood Expansion, a new 250 MW combined cycle generating facility at the Ravenswood Facility site began full commercial operations. The entire capacity and energy produced from this plant is being sold into the NYISO markets.

KeySpan structured a leverage-lease financing arrangement for this facility. At the closing of the leasing transaction, the new facility was acquired by the lessor from a KeySpan subsidiary and simultaneously leased back to that subsidiary. KeySpan has unconditionally guaranteed all obligations of its subsidiary under the lease. The lease has an initial term of 36 years.

The financing arrangement qualifies for operating lease accounting treatment under Statement of Financial Accounting Standard ("SFAS") 98 "Accounting for Leases: Sale/Leaseback Transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; an Initial Direct Costs of Direct Financing, an amendment of FASB Statements No. 13, 66, 91 and a rescission of FASB Statement No.26 and Technical Bulletin No. 79-11." The terms and conditions of the financing arrangement are also in accordance with the accounting requirements of SFAS 13 "Accounting for Leases," SFAS 66 "Accounting for Sales of Real

Estate," and Financial Interpretation No. ("FIN") 46R "Consolidation of Variable Interest Entities."

As stated in SFAS 98, sale-leaseback accounting shall be used by the seller-lessee only if the transaction includes all of the following: (i) a normal leaseback; (ii) payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the property; and (iii) payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee.

A normal leaseback is a lessee-lessor relationship that involves the active use of the property by the seller-lessee in consideration for the payment of rent. Active use of the property refers to the use of the property during the lease term in the seller-lessee's trade or business. Electric generation is a significant part of KeySpan's normal business and since we operate the new 250 MW facility, this criteria has been met. Further, since the buyer-lessor has paid KeySpan the full fair market value of the facility, as determined by an independent third-party appraiser, the second criteria has also been met.

With regard to criteria (iii), KeySpan is under no obligation to repurchase the generating facility, nor does it have an option to repurchase the facility. Further, the leasing arrangement does not contain a provision under which the buyer-lessor can compel KeySpan to repurchase the facility. Further, the buyer-lessor assumes a significant risk regarding return of and on the initial capital investment.

SFAS 13 contains the following four basic criteria that, if met, would require a lease to be classified as a capital lease: (i) the lease transfers ownership of the property to the lessee by the end of the lease; (ii) the lease contains a bargain purchase option; (iii) the lease term is equal to 75% or more of the estimated economic life of the leased property; and (iv) the present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90% of the fair market value of the leased property. The financing arrangement for the Ravenswood Expansion does not meet any of the above criteria.

Further, FIN 46R does not apply to this financing arrangement since the arrangement meets the criteria for operating lease accounting treatment under SFAS 98. More specifically the leasing arrangement does not absorb variability in the fair value in the underlying assets of the lease since the leasing arrangement does not guaranty (to the buyer/lessor) the residual value of the leased assets and the arrangement does not contain an option for the seller/lessee to acquire the leased assets after the term of the lease.

Dividends

In the third quarter of 2004 KeySpan increased its dividend to an annual rate of $1.82 per common share beginning with the quarterly dividend to be paid in February 2005. Our dividend policy is reviewed annually by the Board of Directors. The amount and timing of all dividend payments is subject to the discretion of the Board of Directors and will depend upon business conditions, results of operations, financial conditions and other factors. Based on currently foreseeable market conditions, we intend to maintain the annual dividend at the $1.82 level.

Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to KeySpan is conditioned upon maintenance of a utility capital structure with debt not exceeding 55% and 58%, respectively, of total utility capitalization. In addition, the level of dividends paid by both utilities may not be increased from current levels if a 40 basis point penalty is incurred under the customer service performance program. At the end of KEDNY's and KEDLI's most recent rate years (September 30, 2004 and November 30, 2004, respectively), the ratio of debt to total utility capitalization was 43% and 44%, respectively. Additionally, we have met the requisite customer service performance standards. Our corporate and financial activities and those of each of our subsidiaries (including their ability to pay dividends to us) are also subject to regulation by the SEC. (For additional information, see the discussion under the heading "Regulation and Rate Matters – Securities and Exchange Commission Regulation.")

Regulation and Rate Matters

Gas Distribution

KEDNY is subject to an earnings sharing provision pursuant to which it is required to credit firm customers with 60% of any utility earnings up to 100 basis points above certain threshold return on equity levels over the term of the rate plan (other than any earnings associated with discrete incentives) and 50% of any utility earnings in excess of 100 basis points above such threshold level. The threshold level for the rate year ended September 30, 2004 was 13.25%. KEDNY did not earn above its threshold return level in its rate year ended September 30, 2004. On September 30, 2002, KEDNY's rate agreement with the NYPSC expired. Under the terms of the agreement, the then current gas distribution rates and all other provisions, including the earnings sharing provision (at the 13.25% threshold level), remain in effect until changed by the NYPSC. At this time, we are currently evaluating various options that may be available to us regarding KEDNY's rates, including but not limited to, proposing a new rate plan.

KEDLI is subject to an earnings sharing provision pursuant to which it is required to credit to firm customers 60% of any utility earnings in any rate year up to 100 basis points above a return on equity of 11.10% and 50% of any utility earnings in excess of a return on equity of 12.10%. KEDLI did not earn above its threshold return level in its rate year ended November 30, 2004. On November 30, 2000, KEDLI's rate agreement with the NYPSC expired. Under the terms of the agreement, the gas distribution rates and all other provisions, including the earnings sharing provision, will remain in effect until changed by the NYPSC. At this time, we are currently evaluating various options that may be available to us regarding KEDLI's rate plan, including but not limited to, proposing a new rate plan.

Boston Gas Company, Colonial Gas Company and Essex Gas Company operations are subject to Massachusetts's statutes applicable to gas utilities. Rates for gas sales and transportation service, distribution safety practices, issuance of securities and affiliate transactions are regulated by the MADTE.

Effective November 1, 2003, the MADTE approved a $25.9 million increase in base revenues for the Boston Gas Company with an allowed return on equity of 10.2% reflecting an equal balance of debt and equity. On January 27, 2004, the MADTE issued its order on Boston Gas Company's Motion for Recalculation, Reconsideration and Clarification that granted an additional $1.1 million in base revenues, for a total of $27 million. The MADTE also approved a Performance Based Rate Plan (the "Plan") for up to ten years. On October 29, 2004, the MADTE approved a base rate increase of $4.6 million under the Plan. In addition, an increase of $7.9 million in the local distribution adjustment clause was approved to recover pension and other postretirement costs. The MADTE also approved a true-up mechanism for pension and other postretirement benefit costs under which variations between actual pension and other postretirement benefit costs and amounts used to establish rates are deferred and collected from or refunded to customers in subsequent periods. This true-up mechanism allows for carrying charges on deferred assets and liabilities at Boston Gas Company's weighted-average cost of capital.

In connection with the Eastern Enterprises acquisition of Colonial Gas Company in 1999, the MADTE approved a merger and rate plan that resulted in a ten year freeze of base rates to Colonial Gas Company's firm customers. The base rate freeze is subject only to certain exogenous factors, such as changes in tax laws, accounting changes, or regulatory, judicial, or legislative changes. Due to the length of the base rate freeze, Colonial Gas Company discontinued its application of SFAS 71. Essex Gas Company is also under a ten-year base rate freeze and has also discontinued its application of SFAS 71.

Electric Rate Matters

KeySpan sells to LIPA all of the capacity and, to the extent requested, energy conversion services from our existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the Federal Energy Regulatory Commission ("FERC") in accordance with the Power Supply Agreement ("PSA") entered into between KeySpan and LIPA in 1998. The prior FERC approved rates, which had been in effect since May 1998, expired on December 31, 2003. KeySpan filed with the FERC an updated cost of service for the Long Island based generating plants in October 2003. The rate filing included, among other things, an annual revenue increase of 2.1% or approximately $6.4 million, a return on equity of 11%, updated operating and maintenance expense levels and recovery of certain other costs. FERC approved implementation of new rates starting January 1, 2004, subject to refund. On October 1, 2004 the FERC approved a settlement reached between KeySpan and LIPA. Under the new Settlement Agreement, KeySpan's rates reflect a cost of equity of 9.5% with no revenue increase in the first year. The FERC approved updated operating and maintenance expense levels and recovery of certain other costs as agreed to by the parties.

Securities and Exchange Commission Regulation

KeySpan and certain of its subsidiaries are subject to the jurisdiction of the SEC under PUHCA. The rules and regulations under PUHCA generally limit the operations of a registered holding company to a single integrated public utility system, plus additional energy-related businesses. In addition, the principal regulatory provisions of PUHCA: (i) regulate certain transactions among affiliates within a holding company system including the payment of dividends by such subsidiaries to a holding company; (ii) govern the issuance, acquisition and disposition of securities and assets by a holding company and its subsidiaries; (iii) limit the entry by registered holding companies and their subsidiaries into businesses other than electric and/or gas utility businesses; and (iv) require SEC approval for certain utility mergers and acquisitions.

KeySpan has the authorization, under PUHCA to do the following through December 31, 2006 (the "Authorization Period"): (a) to issue and sell up to an additional amount of $3.0 billion of common stock, preferred stock, preferred and equity-linked securities, and long-term debt securities (the "Long-Term Financing Limit") in accordance with certain defined parameters; (b) in addition to the Long-Term Financing Limit, to issue and sell up to an aggregate amount of $1.3 billion of short-term debt; (c) to issue up to 13 million shares of common stock under dividend reinvestment and stock-based management incentive and employee benefit plans; (d) to maintain existing and enter into additional hedging transactions with respect to outstanding indebtedness in order to manage and minimize interest rate costs; (e) to issue guarantees and other forms of credit support in an aggregate principal amount not to exceed $4.0 billion outstanding at any one time; (f) to refund, repurchase (through open market purchases, tender offers or private transactions), replace or refinance debt or equity securities outstanding during the Authorization Period through the issuance of similar or any other type of authorized securities; (g) to pay dividends out of capital and unearned surplus as well as paid-in-capital with respect to certain subsidiaries, subject to certain limitations; (h) to engage in preliminary development activities and administrative and management activities in connection with anticipated investments in exempt wholesale generators, foreign utility companies and other energy-related companies; (i) to organize and/or acquire the equity securities of entities that will serve the purpose of facilitating authorized financings; (j) to invest up to $3.0 billion in exempt wholesale generators and foreign utility companies; (k) to create and/or acquire the securities of entities organized for the purpose of facilitating investments in other non-utility subsidiaries; and (l) to enter into certain types of affiliate transactions between certain non-utility subsidiaries involving cost structures above the typical "at-cost" limit.

In addition, we have committed that during the Authorization Period, our common equity will be at least 30% of our consolidated capitalization and each of our utility subsidiaries' common equity will be at least 30% of such entity's capitalization. At December 31, 2004, KeySpan's consolidated common equity was 42% of its consolidated capitalization, including commercial paper, and each of its utility subsidiaries common equity was at least 42% of its respective capitalization.

On October 1, 2004, in accordance with its PUHCA authorization, KeySpan filed a new universal shelf registration statement on Form S-3 with the SEC for the issuance from time to time of up to $3.0 billion in securities.

Agreements

ɔan, through certain of its subsidiaries, provides services to LIPA the following agreements:

ıgement Services Agreement ("MSA")

ɔan manages the day-to-day operations, maintenance and capital vements of the transmission and distribution ("T&D") system. LIPA ses control over the performance of the T&D system through specif- ndards for performance and incentives. In exchange for providing rvices, we earn a $10 million annual management fee and are ting under a contract, which provides certain incentives and impos- tain penalties based upon performance. In 2002, we reached an ment with LIPA to extend the MSA for 31 months through 2008, as sed under the heading "Generation Purchase Right Agreement" Annual service incentives or penalties exist under the MSA if cer- rgets are achieved or not achieved. In addition, we can earn cer- centives for budget underruns associated with the day-to-day oper- maintenance and capital improvements of LIPA's T&D system. incentives provide for us to (i) retain 100% on the first $5 million ual budget underruns, and (ii) retain 50% of additional annual uns up to 15% of the total cost budget, thereafter all savings to LIPA. With respect to cost overruns, we will absorb the first $15 of overruns, with a sharing of overruns above $15 million. There tain limitations on the amount of cost sharing of overruns. To date, e performed our obligations under the MSA within the agreed udget guidelines and we are committed to providing on-going to LIPA within the established cost structure. However, no assur- n be given as to future operating results under this agreement.

ıpply Agreement ("PSA")

ells to LIPA all of the capacity and, to the extent requested, version services from our existing Long Island based oil and nerating plants. Sales of capacity and energy conversion serv- le under rates approved by the FERC. As noted previously, he PSA have been reestablished for the contract year com- ary 1, 2004. Rates charged to LIPA include a fixed and vari- nt. The variable component is billed to LIPA on a monthly hour basis and is dependent on the number of megawatt d. LIPA has no obligation to purchase energy conversion and is able to purchase energy or energy conversion st-cost basis from all available sources consistent with ection limitations of the T&D system. The PSA provides ıalties that can total $4 million annually for the mainte- ıt capability and the efficiency of the generating ıns for a term of fifteen years through May 2013, e option to renew the PSA for an additional fifteen

Energy Management Agreement ("EMA")

The EMA provides for KeySpan to procure and manage fuel behalf of LIPA to fuel the generating facilities under contract perform off-system capacity and energy purchases on a least- meet LIPA's needs. In exchange for these services we earn an of $1.5 million. In addition, we arrange for off-system sales on LIPA of excess output from the generating facilities and other p plies either owned or under contract to LIPA. LIPA is entitled to of the profit from any off-system energy sales. In addition, the EN vides incentives and penalties that can total $5 million annually f formance related to fuel purchases and off-system power purchas EMA is expected to be in effect through 2013 for the procurement supplies and through 2006 for off-system management services.

Under these agreements, we are required to obtain a letter of in the aggregate amount of $60 million supporting our obligations t provide the various services if our long-term debt is not rated in the ' range by a nationally recognized rating agency.

Generation Purchase Right Agreement ("GPRA")

Under the GPRA, LIPA originally had the right for a one-year period beginning on May 28, 2001, to acquire all of our Long Island based gen erating assets formerly owned by LILCO at fair market value at the time of the exercise of such right.

By agreement dated March 29, 2002, LIPA and KeySpan amended the GPRA to provide for a new six month option period ending on May 28, 2005. The other terms of the option reflected in the GPRA remained unchanged. In return for providing LIPA an extension of the GPRA, KeySpan was provided with a corresponding extension of 31 months for the MSA to the end of 2008.

LIPA is in the process of performing a long-term strategic review initiative regarding its future direction. It has engaged a team of advisors and consultants and is conducting public hearings to develop recommendations to be submitted to the LIPA Trustees. Some of the strategic options that LIPA is considering include whether LIPA should continue its operations as they presently exist, fully municipalize or privatize, sell some, but not all of their assets and become a regulator of rates and services. In the near term, LIPA must make a determination by May 28, 2005 as to whether it will exercise its option to purchase our Long Island generating plants pursuant to the terms of the GPRA. Until LIPA makes a determination on its future direction, we are unable to determine what the outcome of this strategic review will have on our financial condition, results of operations or cash flows. Any action that may be taken will have to take into consideration the term of our existing contracts.

KeySpan Glenwood and Port Jefferson Energy Centers

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC have entered into 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 guarantees full recovery of each plant's construction costs, as well as a 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.

Ravenswood Projects

We currently sell capacity, energy and ancillary services associated with the Ravenswood Projects through a bidding process into the NYISO energy and capacity markets. Energy is sold on both a day-ahead and a real-time basis. We also have the ability to enter into bilateral transactions to sell all or a portion of the energy produced by the Ravenswood Projects to load serving entities, i.e. entities that sell to end-users or to brokers and marketers.

Environmental Matters

KeySpan is subject to various federal, state and local laws and regulatory programs related to the environment. Through various rate orders issued by the NYPSC, MADTE and NHPUC, costs related to MGP environmental cleanup activities are recovered in rates charged to gas distribution customers and, as a result, adjustments to these reserve balances do not impact earnings. However, environmental cleanup activities related to the three non-utility sites are not subject to rate recovery.

In 2004 Boston Gas Company reached an agreement with an insurance carrier for recovery of previously incurred environmental expenditures. Under a previously issued MADTE order, insurance and third-party recoveries, after deducting legal fees, are shared between Boston Gas and its firm gas customers. As a result of the insurance agreement, in September 2004 Boston Gas recorded a $5 million benefit to operations and maintenance expense.

Also in 2004, KeySpan reached a settlement with its insurance carriers regarding cost recovery for expenses incurred at a non-utility environmental site and recorded an $11.6 million benefit from the settlement as a reduction to operations and maintenance expense.

We estimate that the remaining cost of our MGP related environmental cleanup activities, including costs associated with the Ravenswood Facility, will be approximately $237.1 million and we have recorded a related liability for such amount. We have also recorded an additional $19.7 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of December 31, 2004, we have expended a total of $138.3 million on environmental investigation and remediation activities. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Guarantees and Contingencies" for a further explanation of these matters.)

Market and Credit Risk Management Activities

Market Risk

KeySpan is exposed to market risk arising from potential changes in one or more market variables, such as energy commodity prices, interest rates, volumetric risk due to weather or other variables. Such risk includes any or all changes in value whether caused by commodity positions, asset ownership, business or contractual obligations, debt covenants, exposure concentration, currency, weather, and other factors regardless of accounting method. We manage our exposure to changes in market prices using various risk management techniques for non-trading purposes, including hedging through the use of derivative instruments, both exchange-traded and over-the-counter contracts, purchase of insurance and execution of other contractual arrangements.

KeySpan is exposed to price risk due to investments in equity and debt securities held to fund benefit payments for various employee pension and other postretirement benefit plans. To the extent that the value of investments held change, or long-term interest rates change, the effect will be reflected in KeySpan's recognition of periodic cost of such employee benefit plans and the determination of contributions to the employee benefit plans.

Credit Risk

KeySpan is exposed to credit risk arising from the potential that our counterparties fail to perform on their contractual obligations. Our credit exposures are created primarily through the sale of gas and transportation services to residential, commercial, electric generation, and industrial customers and the provision of retail access services to gas marketers, by our regulated gas businesses; the sale of commodities and services to LIPA and the NYISO; the sale of power and services to our retail customers by our unregulated energy service businesses; entering into financial and energy derivative contracts with energy marketing companies and financial institutions; and the sale of gas, oil and processing services to energy marketing and oil and gas production companies.

We have regional concentration of credit risk due to receivables from residential, commercial and industrial customers in New York, New Hampshire and Massachusetts, although this credit risk is spread over a diversified base of residential, commercial and industrial customers. Customers' payment records are monitored and action is taken, when appropriate and in accordance with various regulatory requirements.

We also have credit risk from LIPA, our largest customer, and from other energy and financial services companies. Counterparty credit risk may impact overall exposure to credit risk in that our counterparties may be similarly impacted by changes in economic, regulatory or other considerations. We actively monitor the credit profile of our wholesale counterparties in derivative and other contractual arrangements, and manage our level of exposure accordingly. In instances where counterparties' credit quality has declined, or credit exposure exceeds certain levels, we may limit our credit exposure by restricting new transactions with the counterparty, requiring additional collateral or credit support and negotiating the early termination of certain agreements.

Regulatory Issues and Competitive Environment

We are subject to various other risk exposures and uncertainties associated with our gas and electric operations. Set forth below is a description of these exposures.

The Gas Industry

Long Island and New York

For the last several years, the NYPSC has been monitoring the progress of competition in the energy market. Based upon its findings of the current market and its continued desire to move toward fully competitive markets, the NYPSC, in August 2004, issued a second policy statement. The underlying vision remains unchanged. The items of importance in the new policy include:

- Elimination of a timeframe for the exit of utilities from the merchant function. Experience, time and maturation of each market/customer class will dictate the exit of utilities.
- Acknowledgement that competitive commodity markets for the largest customers has occurred. However, workable competition for the mass markets (i.e. residential and small commercial customers) is taking longer and needs to be nurtured.

  Future rate filings must include a plan for facilitating customer migration to competitive markets and a fully embedded cost of service study that develops unbundled rates for the utility's delivery service and all potentially competitive services.
- Utilities should avoid entering into long term capacity arrangements unless it is necessary for reliability and safety purposes.
- Where markets are not workably competitive, the NYPSC must ensure that rates continue to be just and reasonable, and protect customers from price volatility.

On May 23, 2002, the NYPSC issued an Order Adopting Terms of Gas Restructuring Joint Proposal Petition of KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island for a Multi-Year Restructuring Agreement ("Joint Proposal"). The Joint Proposal did not alter base rate levels, but established a merchant function backout credit of $.21/dth and $.19/dth for KEDNY and KEDLI, respectively. These credits are designed to lower transportation rates charged to transportation only customers. These credits were based on established levels of projected avoided costs and levels of customer migration to non-utility commodity service. Lost revenues resulting from application of these credits are recovered from firm gas sales customers. The Joint Proposal expired on November 30, 2003. However, by Order dated November 25, 2003 the NYPSC approved tariff amendments that allow KEDNY and KEDLI to continue the merchant function backout credit and the lost revenue recovery mechanism through May 31, 2005.

New England

In July 1997, the MADTE directed Massachusetts gas distribution companies to undertake a collaborative process with other stakeholders to develop common principles under which comprehensive gas service unbundling might proceed. A settlement agreement by the local distribution companies ("LDCs") and the marketer group regarding model terms and conditions for unbundled transportation service was approved by the MADTE in November 1998. In February 1999, the MADTE issued its order on how unbundling of natural gas service will proceed. For a five year transition period, the MADTE determined that LDC contractual commitments to upstream capacity will be assigned on a mandatory, pro-rata basis to marketers selling gas supply to the LDCs' customers. The approved mandatory assignment method eliminates the possibility that the costs of upstream capacity purchased by the LDCs to serve firm customers will be absorbed by the LDC or other customers through the transition period. The MADTE also found that, through the transition period, LDCs will retain primary responsibility for upstream capacity planning and procurement to assure that adequate capacity is available to support customer requirements and growth. The MADTE approved the LDCs' Terms and Conditions of Distribution Service that conform to the settled upon model terms and conditions. Since November 1, 2000, all Massachusetts gas customers have the option to purchase their gas supplies from third party sources other than the LDCs. Further, the New Hampshire Public Utility Commission required gas utilities to offer transportation services to all commercial and residential customers starting November 1, 2001. In January 2004, the MADTE began a proceeding to re-examine whether the upstream capacity market has been sufficiently competitive to allow voluntary capacity assignment.

KeySpan submitted comments maintaining its position that the upstream capacity market is not at this time sufficiently competitive to remove or modify the MADTE's mandatory capacity assignment requirement.

Electric Industry

Due to volatility in the market clearing price of 10-minute spinning and non-spinning reserves during the first quarter of 2000, the NYISO requested that FERC approve a bid cap on reserves as well as requiring a refunding of so called alleged "excess payments" received by sellers, including Ravenswood. On May 31, 2000, FERC issued an order that granted approval of a $2.52 per MWh bid cap for 10 minute non-spinning reserves, plus payments for the opportunity cost of not making energy sales. The other requests, such as a bid cap for spinning reserves, retroactive refunds, recalculation of reserve prices for March 2000, and convening a technical conference and settlement proceeding, were rejected.

The NYISO, Con Edison, Niagara Mohawk Power Corporation and Rochester Gas and Electric each individually appealed FERC's order to Federal court. The appeals were consolidated into one case by the court. On November 7, 2003 the United States Court of Appeals for the District of Columbia (the "Court") issued its decision in the case of Consolidated Edison Company of New York, Inc., v. Federal Energy Regulatory Commission ("Decision"). Essentially, the Court found errors in the Commission's decision and remanded some issues in the case back to the Commission for further explanation and action. The FERC has not acted on the remand.

On June 25, 2004, the NYISO submitted a motion to FERC seeking refunds as a result of the Decision. KeySpan and others submitted statements of opposition opposing the refunds. On November 29, 2004, KeySpan filed a motion seeking a settlement judge be appointed to settle the case. On January 6, 2005 FERC denied KeySpan's request but has not yet issued a decision on the merits. We cannot predict the outcome of these proceedings or what effect, if any, the outcome may have on our financial position, results of operations or cash flows.

The Ravenswood Facility and our New York City Operations
The NYISO's New York City local reliability rules currently require that 80% of the electric capacity needs of New York City be provided by "in-City" generators. As the electric infrastructure develops and the demand for electric power increases over time in New York City and the surrounding areas, the requirement that 80% of in-City load be served by in-City generators could be modified. Construction of new transmission and generation facilities could also cause significant changes to the market. KeySpan currently anticipates that approximately 1,100 MW of new capacity may be available by the end of 2006 as a result of the completion of in-City generation projects currently under construction. We cannot, however, be certain as to when, or if, the new power plants will be in operation or the nature of future New York City energy requirements or market design.

NYISO Demand Curve Capacity Market Implementation
On March 21, 2003 the NYISO made a filing at FERC seeking approval of a Demand Curve to be used in place of its current deficiency auction for capacity procurement. On May 20, 2003, FERC approved, with some modifications, the Demand Curve to become effective May 21, 2003. On October 23, 2003, FERC denied various requests for rehearing of its order approving the Demand Curve and approved the NYISO's compliance filing. On December 9, 2003, the NYISO filed its first status report with FERC with respect to how the Demand Curve was working. The NYISO report found that there was no evidence of inappropriate withholding of capacity resources and that the Demand Curve was working as intended. On December 22, 2003, the Electric Consumers Resource Council filed an appeal with the DC Circuit Court of Appeals of FERC's May 20, 2003 order approving the Demand Curve and its October 23, 2003 order denying rehearing. This appeal is still pending and we are unable to determine to what extent, if any, this proceeding will impact the Ravenswood facility's financial condition, results of operations or cash flows.

NYISO Standard Market Design 2.0 ("SMD2")
The NYISO's revised market design and software SMD2, was implemented on February 1, 2005. It replaced the NYISO's current two step real-time market system, which consists of the Balancing Market Evaluation and Security Constrained Dispatch applications, with a more integrated Real Time Scheduling system ("RTS"). RTS uses a common computing platform, algorithms, and network models for both the real-time commitment and real-time dispatch functions. This synergy between commitment and dispatch functions is expected to result in improved consistency between advisory and real-time price schedules, as well as more efficient use of control area resources. SMD2 will more closely align the NYISO markets with the FERC Standard Market Design Notice of Proposed Rule Making, issued on July 31, 2002.

Quantitative and Qualitative Disclosures About Market Risk

Financially-Settled Commodity Derivative Instruments – Hedging Activities
From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas distribution operations, gas exploration and production activities and its electric generating facilities. Our gas distribution operations utilize over-the-counter ("OTC") natural gas and fuel oil swaps to hedge the cash-flow variability of specified portions of gas purchases and sales associated with certain large-volume customers. Seneca-Upshur utilizes OTC natural gas swaps to hedge cash flow variability associated with forecasted sales of natural gas. The Ravenswood Projects use derivative financial instruments to hedge the cash flow variability associated with the purchase of a portion of natural gas and oil that will be consumed during the generation of electricity. The Ravenswood Projects also hedge the cash flow variability associated with a portion of electric energy sales using OTC electricity swaps.

KeySpan uses standard NYMEX futures prices to value gas futures and market quoted forward prices to value OTC swap contracts.

The following tables set forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2004.

TYPE OF CONTRACT GAS	YEAR OF MATURITY	VOLUMES (MMCF)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($000)
Swaps/Futures – Long Natural Gas	2005	6,595	4.95 – 7.11	6.07 – 6.28	(6,146)
OTC Swaps – Short Natural Gas	2005	1,980	6.58 – 6.70	6.33 – 7.15	212
	2006	1,884	6.17 – 6.29	6.07 – 7.39	(516)
	2007	1,812	5.86 – 5.97	5.71 – 6.93	(362)
		12,271			(6,812)

TYPE OF CONTRACT OIL	YEAR OF MATURITY	VOLUMES (BARRELS)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($000)
Swaps – Long Fuel Oil	2005	84,000	24.65 – 34.40	33.90 – 34.75	268
	2006	12,000	34.40	34.30	(1)
Swaps – Short Heating Oil	2005	52,372	55.44	47.25 – 52.75	7,451
		148,372			7,718

TYPE OF CONTRACT ELECTRICITY	YEAR OF MATURITY	MWH	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($000)
Swaps – Energy	2005	1,562,400	29.95 – 103.10	33.89 – 101.69	353

The following tables detail the changes in and sources of fair value for the above derivatives:

(In Thousands of Dollars)

Change in Fair Value of Derivative Hedging Instruments	2004
Fair value of contracts at January 1, 2004	$(36,224)
Net (gains) on contracts realized	(510)
Derivative balance that has been de-consolidated (Houston Exploration)	14,331
Increase in fair value of all open contracts	23,662
Fair value of contracts outstanding at December 31,	$ 1,259

(In Thousands of Dollars)

SOURCES OF FAIR VALUE	FAIR VALUE CONTRACTS MATURITY IN 12 MONTHS	MATURITY IN 2006 AND 2007	TOTAL FAIR VALUE
Prices actively quoted	$1,305	$ —	$1,305
Local published indicies	834	(880)	(46)
	$2,139	$(880)	$ 1,259

We measure the commodity risk of our derivative hedging instruments (indicated in the above table) using a sensitivity analysis. Based on a sensitivity analysis as of December 31, 2004, a 10% increase in heating oil and natural gas prices would decrease the value of derivative instruments maturing in 2005 by $3.3 million, while the value of expected physical deliveries for 2005 would be enhanced $6.4 million (net benefit to KeySpan of $3.1 million). A 10% decrease in heating oil and natural gas prices would enhance the value of derivative instruments maturing in 2005 by $3.3 million, while the value of expected physical deliveries for 2005 would be decreased $6.4 million (net cost to KeySpan of $3.1 million).

Based on a sensitivity analysis as of December 31, 2004, a 10% increase in electricity and fuel prices would decrease the value of derivative instruments maturing in 2005 by $5.2 million, while the value of expected physical power production for 2005 would be enhanced $13.3 million (net benefit to KeySpan of $8.1 million). A 10% decrease in electricity and fuel prices would have a $5.2 million favorable impact on the value of derivative instruments maturing in 2005, while the value of expected physical power production would be reduced $15.9 million (net cost to KeySpan of $10.7 million).

Firm Gas Sales Derivative Instruments – Regulated Utilities

We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. The accounting for these derivative instruments is subject to SFAS 71 "Accounting for the

Effects of Certain Types of Regulation." Therefore, changes in the fair value of these derivatives are recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements.

The following table sets forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2004.

TYPE OF CONTRACT	YEAR OF MATURITY	VOLUMES (MMCF)	FLOOR ($)	CEILING ($)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($000)
Options	2005	10,330	5.00 – 6.00	5.00 – 7.00	–	6.07 – 6.88	(1,126)
	2006	4,160	5.00 – 6.00	5.00 – 7.00	–	5.82 – 7.10	881
Swaps	2005	38,400	–	–	6.48 – 6.56	6.07 – 6.88	(9,327)
	2006	15,340	–	–	6.76 – 7.03	5.82 – 7.10	(820)
		68,230					(10,392)

See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" for a further description of all our derivative instruments.

Cautionary Statement Regarding Forward-Looking Statements

Certain statements contained herein are forward-looking statements, which reflect numerous assumptions and estimates and involve a number of risks and uncertainties. For these statements, we claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

There are possible developments that could cause our actual results to differ materially from those forecast or implied in the forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which are current only as of the date of this filing. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Among the factors that could cause actual results to differ materially are: volatility of energy prices of fuel used to generate electricity; fluctuations in weather and in gas and electric prices; general economic conditions, especially in the Northeast United States; our ability to successfully reduce our cost structure and operate efficiently; our ability to successfully contract for natural gas supplies required to meet the needs of our firm customers; implementation of new accounting standards; inflationary trends and interest rates; the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of recent and future acquisitions; available sources and cost of fuel; creditworthiness of counter-parties to derivative instruments and commodity contracts; retention of key personnel; federal and state regulatory initiatives that increase competition, threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses; the impact of federal and state utility regulatory policies and orders on our regulated and unregulated businesses; potential write-down of our investment in natural gas properties when natural gas prices are depressed or if we have significant downward revisions in our estimated proved gas reserves; competition in general facing our unregulated Energy Services businesses, including but not limited to competition from other plumbing, heating, ventilation and air conditioning, and engineering companies, as well as, other utilities and utility holding companies that are permitted to engage in such activities; the degree to which we develop unregulated business ventures, as well as federal and state regulatory policies affecting our ability to retain and operate such business ventures profitably; and other risks detailed from time to time in other reports and other documents filed by KeySpan with the Securities and Exchange Commission.

·ols and Procedures

ıintain disclosure controls and procedures (as defined under ıge Act Rule 13a-15(e)) that are designed to ensure that informa- ·quired to be disclosed by us in the reports we file or submit under :change Act is recorded, processed, summarized and reported within ne periods specified in the Securities and Exchange Commission's and forms, and that such information is accumulated and communi- l to KeySpan's management, including our Chief Executive Officer Chief Financial Officer, as appropriate, to allow timely decisions rding required disclosure. Any control system, no matter how well gned and operated, can provide only reasonable assurance of achiev- the desired control objectives. Our management, under the supervi- ı and with the participation of our Chief Executive Officer and Chief ancial Officer, has evaluated the effectiveness of our disclosure controls l procedures as of December 31, 2004. Based upon that evaluation, r Chief Executive Officer and Chief Financial Officer concluded that the sign and operation of our disclosure controls and procedures provided asonable assurance that the disclosure controls and procedures are fective to accomplish their objectives.

Furthermore, there has been no change in KeySpan's internal control ver financial reporting identified in connection with the evaluation of uch control that occurred during KeySpan's last fiscal quarter, which has naterially affected, or is reasonably likely to materially affect, KeySpan's nternal control over financial reporting.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined under Exchange Act Rule 13a-15(f)). KeySpan's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements, errors or fraud. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of or compliance with the policies or procedures may deteriorate.

Under the supervision and with participation of KeySpan's Chief Executive Officer and Chief Financial Officer, our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2004. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in a report entitled Internal Control-Integrated Framework. Our management concluded, as of December 31, 2004, that KeySpan's internal control over financial reporting is effective based on the COSO criteria.

Our independent registered public accounting firm, Deloitte & Touche LLP, has issued this report on management's assessment of KeySpan's internal control over financial reporting as of December 31, 2004, which is included herein.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of KeySpan Corporation:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that KeySpan Corporation and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2004, of the Company and our report dated February 28, 2005 expressed an unqualified opinion on those financial statements.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
February 28, 2005
New York, New York

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of KeySpan Corporation:

We have audited the accompanying Consolidated Balance Sheets and the Consolidated Statement of Capitalization of KeySpan Corporation and subsidiaries (the "Company") as of December 31, 2004 and 2003, and the related Consolidated Statements of Income, Retained Earnings, Comprehensive Income and Cash Flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of KeySpan Corporation and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1(G) to the consolidated financial statements, on January 1, 2002, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 142, "Goodwill and Other Intangible Assets," to change its method of accounting for goodwill and other intangibles. As discussed in Note 1(N) and Note 1(P), on January 1, 2003, the Company adopted SFAS No. 148, "Accounting for Stock-Based Compensation-Transaction and Disclosure" and SFAS No. 143, "Accounting for Asset Retirement Obligations", respectively. Also, as discussed in Note 1(P), on December 31, 2003, the Company adopted FASB Interpretation No. 46 "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" (FIN 46).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, based on the criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2005, expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
February 28, 2005
New York, New York

DECEMBER 31,	2004	2003
	(In Thousands of Dollars)	
ASSETS		
Current Assets		
Cash and temporary cash investments	**$ 921,973**	$ 203,358
Accounts receivable	**788,454**	909,613
Unbilled revenue	**591,394**	446,573
Allowance for uncollectible accounts	**(67,796)**	(75,671)
Gas in storage, at average cost	**515,459**	488,521
Material and supplies, at average cost	**123,476**	118,912
Other	**162,739**	114,196
Assets of discontinued operations	**42,923**	181,823
	3,078,622	2,387,325
Investments and Other	**272,893**	248,565
Property		
Gas	**6,871,221**	6,522,251
Electric	**2,402,052**	2,636,537
Other	**398,628**	407,813
Accumulated depreciation	**(2,702,298)**	(2,601,701)
Gas exploration and production, at cost	**187,053**	3,088,242
Accumulated depletion	**(97,475)**	(1,167,427)
Property of discontinued operations	**8,743**	8,588
	7,067,924	8,894,303
Deferred Charges		
Regulatory assets	**555,414**	578,383
Goodwill and other intangible assets, net of amortization	**1,677,601**	1,717,010
Goodwill of discontinued operations	**—**	92,702
Other	**711,676**	721,894
	2,944,691	3,109,989
Total Assets	**$13,364,130**	$14,640,182

See accompanying Notes to the Consolidated Financial Statements.

DECEMBER 31,	2004	2003
	(In Thousands of Dollars)	
LIABILITIES AND CAPITALIZATION		
Current Liabilities		
Current maturities of long-term debt and capital leases	$ 16,103	$ 1,471
Current redemption requirement of preferred stock	55,300	—
Accounts payable and other liabilities	906,650	1,065,742
Commercial paper	912,246	481,900
Dividends payable	74,059	72,289
Taxes accrued	161,629	43,943
Customer deposits	43,262	40,370
Interest accrued	48,822	64,609
Liabilities of discontinued operations	64,245	81,956
	2,282,316	1,852,280
Deferred Credits and Other Liabilities		
Regulatory liabilities:		
Miscellaneous liabilities	73,963	104,034
Removal costs recovered	496,482	450,034
Deferred income tax	1,124,129	1,275,558
Postretirement benefits and other reserves	901,318	961,931
Other	139,149	121,624
	2,735,041	2,913,181
Commitments and Contingencies (See Note 7)	—	—
Capitalization		
Common stock	3,501,950	3,487,645
Retained earnings	792,177	621,430
Accumulated other comprehensive income	(54,336)	(59,932)
Treasury stock	(345,081)	(378,487)
Total common shareholders' equity	3,894,710	3,670,656
Preferred stock	19,700	83,568
Long-term debt and capital leases	4,418,729	5,610,948
Total Capitalization	8,333,139	9,365,172
Minority Interest in Consolidated Companies	13,634	509,549
Total Liabilities and Capitalization	$13,364,130	$14,640,182

See accompanying Notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENT OF INCOME

YEAR ENDED DECEMBER 31,	2004	2003	2002
	In Thousands of Dollars, Except Per Share Amounts)		
Revenues			
Gas Distribution	**$4,407,292**	$4,161,272	$3,163,761
Electric Services	**1,738,660**	1,605,973	1,645,688
Energy Services	**182,406**	158,908	208,624
Gas Exploration and Production	**279,999**	501,255	357,451
Energy Investments	**42,109**	108,116	89,650
Total Revenues	**6,650,466**	6,535,524	5,465,174
Operating Expenses			
Purchased gas for resale	**2,664,492**	2,495,102	1,653,273
Fuel and purchased power	**540,302**	414,633	395,860
Operations and maintenance	**1,567,022**	1,622,592	1,631,297
Depreciation, depletion and amortization	**551,760**	571,669	513,708
Operating taxes	**404,212**	418,236	380,527
Impairment charges	**40,965**	—	—
Total Operating Expenses	**5,768,753**	5,522,232	4,574,665
Gain on sale of property	**7,021**	15,123	4,730
Income from equity investments	**46,536**	19,214	14,096
Operating Income	**935,270**	1,047,629	909,335
Other Income and (Deductions)			
Interest charges	**(331,251)**	(307,694)	(301,504)
Sale of subsidiary stock	**388,319**	13,356	—
Cost of debt redemption	**(45,879)**	(24,094)	—
Minority interest	**(36,797)**	(63,852)	(24,918)
Other	**30,591**	42,005	25,054
Total Other Income and (Deductions)	**4,983**	(340,279)	(301,368)
Income Taxes			
Current	**201,909**	(99,798)	(36,588)
Deferred	**123,631**	381,079	266,253
Total Income Taxes	**325,540**	281,281	229,665
Earnings from Continuing Operations	**614,713**	426,069	378,302
Discontinued Operations			
Income (loss) from operations, net of tax	**(78,960)**	(1,888)	15,692
Loss on disposal, net of tax	**(72,088)**	—	(16,306)
Loss from Discontinued Operations	**(151,048)**	(1,888)	(614)
Cumulative Change in Accounting Principles, net of tax	—	(37,451)	—
Net Income	**463,665**	386,730	377,688
Preferred stock dividend requirements	**5,612**	5,844	5,753
Earnings for Common Stock	**$ 458,053**	$ 380,886	$ 371,935
Basic Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 3.80**	$ 2.65	$ 2.64
Discontinued Operations	**(0.94)**	(0.01)	(0.01)
Cumulative Change in Accounting Principles	—	(0.23)	—
Basic Earnings Per Share	**$ 2.86**	$ 2.41	$ 2.63
Diluted Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 3.78**	$ 2.63	$ 2.62
Discontinued Operations	**(0.94)**	(0.01)	(0.01)
Cumulative Change in Accounting Principles	—	(0.23)	—
Diluted Earnings Per Share	**$ 2.84**	$ 2.39	$ 2.61
Average Common Shares Outstanding (000)	**160,294**	158,256	141,263
Average Common Shares Outstanding – Diluted (000)	**161,277**	159,232	142,300

See accompanying Notes to the Consolidated Financial Statements.

YEAR ENDED DECEMBER 31,	2004	2003	2002
			(In Thousands of Dollars)
Operating Activities			
Net income	**$ 463,665**	$ 386,730	$ 377,688
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation, depletion and amortization	**551,760**	571,669	513,708
Deferred income tax	**123,631**	188,689	89,284
Income from equity investments	**(46,536)**	(18,038)	(14,096)
Dividends from equity investments	**14,162**	2,807	3,905
Amortization of interest rate swap	**(2,265)**	(9,861)	—
(Gain) on interest rate swap	**(12,656)**	—	—
(Gain) loss on disposal of subsidiary stock	**(388,319)**	(13,356)	—
(Gain) on sale of assets	**(7,021)**	(15,123)	(4,730)
Impairment charges	**40,965**	—	—
Loss/(Income) from discontinued operations	**151,048**	1,888	(19,048)
Cumulative change in accounting principle	—	37,451	—
Environmental reserve adjustment	—	(10,459)	—
Minority interest	**36,797**	63,852	24,918
Changes in assets and liabilities			
Accounts receivable	**(234,188)**	60,394	(223,983)
Materials and supplies, fuel oil and gas in storage	**(38,967)**	(198,966)	42,547
Accounts payable and accrued expenses	**159,513**	225,756	(11,240)
Reserve payments	**(37,270)**	(36,486)	(23,369)
Other	**(24,250)**	(13,591)	(7,921)
Net Cash Provided by Operating Activities	**750,069**	1,223,356	747,663
Investing Activities			
Construction expenditures	**(750,329)**	(1,009,393)	(1,057,507)
Cost of removal	**(36,287)**	(31,103)	(27,431)
Other investments	—	(211,370)	(27,579)
Net proceeds from sale of subsidiary stock	**1,001,142**	294,573	175,110
Proceeds from sale of property	**20,159**	15,123	4,730
Issuance of long-term note	—	(55,000)	—
Net Cash Provided by (Used in) Investing Activities	**234,685**	(997,170)	(932,677)
Financing Activities			
Treasury stock issued	**33,406**	96,687	86,710
Common stock issuance	—	473,573	—
Issuance of long-term debt	**49,336**	1,024,553	549,260
Payment of long-term debt	**(920,081)**	(604,331)	(124,863)
Net proceeds from sale/leaseback transaction	**382,049**	—	—
Issuance/(Payment) of commercial paper	**430,346**	(433,797)	(132,753)
Redemption of promissory notes	—	(447,005)	—
Redemption of preferred stock	**(8,483)**	(14,293)	—
Gain on interest rate swap	**12,656**	—	57,415
Common and preferred stock dividends paid	**(291,148)**	(280,560)	(256,656)
Other	**36,187**	4,989	9,629
Net Cash (Used in) Provided by Financing Activities	**(275,732)**	(180,184)	188,742
Net Increase in Cash and Cash Equivalents	**$ 709,022**	$ 46,002	$ 3,728
Net Cash Flow from Discontinued Operations	**9,593**	(13,261)	14,166
Cash and Cash Equivalents at Beginning of Period	**203,358**	170,617	152,723
Cash and Cash Equivalents at End of Period	**$ 921,973**	$ 203,358	$ 170,617
Interest Paid	**$ 336,546**	$ 355,136	$ 343,933
Income Tax Paid	**$ 122,033**	$ 65,495	$ 98,344

See accompanying Notes to the Consolidated Financial Statements

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

			(In Thousands of Dollars)
YEAR ENDED DECEMBER 31,	2004	2003	2002
Balance at Beginning of Period	**$ 621,430**	$522,835	$452,206
Net Income for Period	**463,665**	386,730	377,688
	1,085,095	909,565	829,894
Deductions:			
Cash dividends declared on common stock	**287,306**	282,291	252,175
Cash dividends declared on preferred stock	**5,612**	5,844	5,753
MEDS Equity Units	**—**	—	49,131
Balance at End of Period	**$ 792,177**	$621,430	$522,835

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

			(In Thousands of Dollars)
YEAR ENDED DECEMBER 31,	2004	2003	2002
Net Income	**$463,665**	$386,730	$ 377,688
Other comprehensive income, net of tax			
Net losses (gains) on derivative instruments	**(332)**	23,042	(17,033)
Deconsolidation of certain subsidiaries	**9,315**	—	—
Foreign currency translation adjustments	**(21,536)**	28,696	9,759
Unrealized gains (losses) on marketable securities	**7,111**	8,480	(10,019)
Premium on derivative instrument	**3,437**	(3,437)	—
Accrued unfunded pension obligation	**(7,818)**	8,380	(55,768)
Unrealized (losses) gains on derivative financial instruments	**15,419**	(25,379)	(39,845)
Other comprehensive income (loss), net of tax	**5,596**	39,782	(112,906)
Comprehensive Income	**$469,261**	$426,512	$ 264,782
Related tax (benefit) expense			
Net losses (gains) on derivative instruments	**$ (178)**	$ 12,407	$ (9,172)
Deconsolidation of certain subsidiaries	**5,016**	—	—
Foreign currency translation adjustments	**(11,596)**	15,451	5,255
Unrealized gains (losses) on marketable securities	**3,830**	4,568	(5,395)
Accrued unfunded pension obligation	**(4,210)**	4,513	(30,029)
Premium on derivative instrument	**1,851**	(1,851)	—
Unrealized (losses) gains on derivative financial instruments	**8,240**	(13,666)	(21,454)
Total Tax (Benefit) Expense	**$ 2,953**	$ 21,422	$ (60,795)

See accompanying Notes to the Consolidated Financial Statements.

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31,	2004	2003	2004	2003
	SHARES ISSUED			
Common Shareholders' Equity				
Common stock, $0.01 par value	**172,737,654**	172,737,654	**$ 1,727**	$ 1,727
Premium on capital stock			**3,500,223**	3,485,918
Retained earnings			**792,177**	621,430
Other comprehensive income			**(54,336)**	(59,932)
Treasury stock	**11,919,343**	13,073,219	**(345,081)**	(378,487)
Total Common Shareholders' Equity	**160,818,311**	159,664,435	**3,894,710**	3,670,656
Preferred Stock – Redemption Required				
Par Value $100 per share				
7.07% Series B – private placement	**553,000**	553,000	**55,300**	55,300
7.17% Series C – private placement	**197,000**	197,000	**19,700**	19,700
6.00% Series A – private placement	**—**	85,676	**—**	8,568
Less: current redemption requirements	**(553,000)**	—	**(55,300)**	—
Total Preferred Stock – Redemption Required			**19,700**	83,568
Long-Term Debt	INTEREST RATE	MATURITY		
Notes				
Medium term notes	4.65% – 9.75%	2005 – 2033	**2,485,000**	3,185,000
Senior secured notes	6.08% – 8.8%	2008 – 2013	**—**	96,425
Senior subordinated notes	7.0%	2013	**—**	175,000
Total Notes			**2,485,000**	3,456,425
Gas Facilities Revenue Bonds	Variable	2020	**125,000**	125,000
	5.50% – 6.95%	2020 – 2026	**515.500**	523.500
Total Gas Facilities Revenue Bonds			**640,500**	648,500
Promissory Notes to LIPA				
Pollution Control Revenue Bonds	5.15%	2016	**108,020**	108,022
Electric Facilities Revenue Bonds	5.30%	2023 – 2025	**47,400**	47,400
Total Promissory Notes to LIPA			**155,420**	155,422
MEDS Equity Units	8.75%	2005	**460,000**	460,000
Industrial Development Bonds	5.25%	2027	**128,275**	128,275
First Mortgage Bonds	6.08% – 8.80%	2008 – 2028	**95,000**	153,186
Authority Financing Notes	Variable	2027 – 2028	**66,005**	66,005
Other Subsidiary Debt			**—**	145,128
Ravenswood Master Lease & Capital Leases		2005 – 2022	**424,083**	425,262
Subtotal			**4,454,283**	5,638,203
Unamortized interest rate hedge and debt discount			**(55,185)**	(69,243)
Derivative impact on debt			**35,734**	43,459
Less: current maturities			**16,103**	1,471
Total Long-Term Debt			**4,418,729**	5,610,948
Total Capitalization			**$8,333,139**	$9,365,172

See accompanying Notes to the Consolidated Financial Statements.

Note 1. Summary of Significant Accounting Policies

A. Organization of the Company

KeySpan Corporation, a New York corporation, was formed in May 1998, as a result of the business combination of KeySpan Energy Corporation, the parent of The Brooklyn Union Gas Company, and certain businesses of the Long Island Lighting Company ("LILCO"). On November 8, 2000, KeySpan acquired Eastern Enterprises ("Eastern"), a Massachusetts business trust, and the parent of several gas utilities operating in Massachusetts. Also on November 8, 2000, Eastern acquired EnergyNorth, Inc. ("ENI"), the parent of a gas utility operating in central New Hampshire. KeySpan Corporation will be referred to in these notes to the Consolidated Financial Statements as "KeySpan," "we," "us" and "our."

Our core business is gas distribution, conducted by our six regulated gas utility subsidiaries: The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York ("KEDNY") and KeySpan Gas East Corporation d/b/a KeySpan Energy Delivery Long Island ("KEDLI") distribute gas to customers in the Boroughs of Brooklyn, Staten Island, a portion of the Borough of Queens in New York City, and the counties of Nassau and Suffolk on Long Island and the Rockaway Peninsula in Queens, respectively; Boston Gas Company, Colonial Gas Company and Essex Gas Company, each doing business as KeySpan Energy Delivery New England ("KEDNE"), distribute gas to customers in southern, eastern and central Massachusetts; and EnergyNorth Natural Gas, Inc., d/b/a KeySpan Energy Delivery New England distributes gas to customers in central New Hampshire. Together, these companies distribute gas to approximately 2.6 million customers throughout the Northeast.

We also own, lease and operate electric generating plants on Long Island and in New York City. Under contractual arrangements, we provide electric power, electric transmission and distribution services, billing and other customer services for approximately 1.1 million electric customers of the Long Island Power Authority ("LIPA").

Our other subsidiaries are involved in gas production; gas storage; liquefied natural gas storage; wholesale and retail electric marketing; appliance service; a minimum amount of fiber optic services; and engineering and consulting services. We also invest in, and participate in the development of natural gas pipelines; electric generation, and other energy-related projects. (See Note 2, "Business Segments" for additional information on each operating segment.)

We are a registered holding company under the Public Utility Holding Company Act of 1935 ("PUHCA"), as amended. Therefore, our corporate and financial activities and those of our subsidiaries, including their ability to pay dividends to us, are subject to regulation by the Securities and Exchange Commission ("SEC"). Under our holding company structure, we have no independent operations or source of income of our own and conduct all of our operations through our subsidiaries and, as a result, we depend on the earnings and cash flow of, and dividends or distributions from, our subsidiaries to provide the funds necessary to meet our debt and contractual obligations. Furthermore, a substantial portion of our consolidated assets, earnings and cash flow is derived from the operations of our regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation by state regulatory authorities.

B. Basis of Presentation

The Consolidated Financial Statements presented herein reflect the accounts of KeySpan and its subsidiaries. Most of our subsidiaries are fully consolidated in the financial information presented, except for certain subsidiary investments in the Energy Investments segment which are accounted for on the equity method as we do not have a controlling voting interest or otherwise have control over the management of such companies. All intercompany transactions have been eliminated. Certain reclassifications were made to conform prior period financial statements to current period financial statement presentation. For December 31, 2004, 2003 and 2002 we have reclassified the operations of KeySpan's mechanical contracting subsidiaries, which are part of the Energy Services segment, as discontinued operations on the Consolidated Statement of Income, Consolidated Balance Sheet and Consolidated Statement of Cash Flows. (See Note 11 "Energy Services – Discontinued Operations" for additional details regarding these operations.) In addition, for December 31, 2003 we reclassified the minimum pension liability for Boston Gas Company from accumulated other comprehensive income to regulatory assets. (See Note 4 "Postretirement Benefits" for additional information.)

The preparation of financial statements in conformity with generally accepted accounting principles ("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.

C. Accounting for the Effects of Rate Regulation

The accounting records for our six regulated gas utilities are maintained in accordance with the Uniform System of Accounts prescribed by the Public Service Commission of the State of New York ("NYPSC"), the New Hampshire Public Utility Commission ("NHPUC"), and the Massachusetts Department of Telecommunications and Energy ("MADTE"). Our electric generation subsidiaries are not subject to state rate regulation, but they are subject to Federal Energy Regulatory Commission ("FERC") regulation. Our financial statements reflect the ratemaking policies and actions of these regulators in conformity with GAAP for rate-regulated enterprises.

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas Company and EnergyNorth Natural Gas, Inc.) and our Long Island based electric generation subsidiaries are subject to the provisions of Statement of Financial Accounting Standards ("SFAS") 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the ability of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies. Accordingly, we record these future economic benefits and obligations as regulatory assets and regulatory liabilities on the Consolidated Balance Sheet, respectively.

In separate merger related orders issued by the MADTE, the base rates charged by Colonial Gas Company and Essex Gas Company have been frozen at their current levels for ten-year periods ending 2009 and 2008, respectively. Due to the length of these base rate freezes, the Colonial and Essex Gas companies had previously discontinued the application of SFAS 71.

The following table presents our net regulatory assets at December 31, 2004 and December 31, 2003.

	(In Thousands of Dollars)	
DECEMBER 31,	**2004**	**2003**
Regulatory Assets		
Regulatory tax asset	$ 53,149	$ 60,700
Property taxes	45,235	51,390
Environmental costs	272,545	296,888
Postretirement benefits	110,603	106,682
Costs associated with the KeySpan/LILCO transaction	39,091	50,585
Derivative financial instruments	27,293	6,909
Other	7,498	5,229
Total Regulatory Assets	$555,414	$578,383
Miscellaneous Regulatory Liabilities	(73,963)	(104,034)
Net Regulatory Assets	481,451	474,349
Removal Costs Recovered	(496,482)	(450,034)
	$ (15,031)	$ 24,315

The regulatory assets above are not included in rate base. However, we record carrying charges on the property tax and costs associated with the KeySpan/LILCO transaction cost deferrals. We also record carrying charges on our regulatory liabilities. The remaining regulatory assets represent, primarily, costs for which expenditures have not yet been made, and therefore, carrying charges are not recorded. We anticipate recovering these costs in our gas rates concurrently with future cash expenditures. If recovery is not concurrent with the cash expenditures, we will record the appropriate level of carrying charges. Deferred gas costs of $37.7 million and $53.4 million at December 31, 2004 and December 31, 2003, respectively are reflected in accounts receivable on the Consolidated Balance Sheet. Deferred gas costs are subject to current recovery from customers. We estimate that full recovery of our regulatory assets will not exceed 10 years.

Rate regulation is undergoing significant change as regulators and customers seek lower prices for utility service and greater competition among energy service providers. In the event that regulation significantly changes the opportunity to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of all or a portion of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101, "Regulated Enterprises – Accounting for the Discontinuation of Application of FASB Statement 71." We estimate that the write-off of all net regulatory assets at December 31, 2004, before consideration of removal costs recovered, could result in a charge to net income of $313 million or $1.95 per share, which would be classified as an extraordinary item. In 2003, KeySpan implemented SFAS 143 "Accounting for Asset Retirement Obligations" and reclassified the cost of removal reserve from accumulated depreciation to regulatory liability. In management's opinion, the regulated subsidiaries that are currently subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

D. Revenues

Gas Distribution: Utility gas customers are billed monthly or bi-monthly on a cycle basis. Revenues include unbilled amounts related to the estimated gas usage that occurred from the most recent meter reading to the end of each month.

The cost of gas used is recovered when billed to firm customers through the operation of gas adjustment clauses ("GAC") included in utility tariffs. The GAC provision requires periodic reconciliation of recoverable gas costs and GAC revenues. Any difference is deferred pending recovery from or refund to firm customers. Further, net revenues from tariff gas balancing services, off-system sales and certain on-system interruptible sales are refunded, for the most part, to firm customers subject to certain sharing provisions.

The New York and Long Island gas utility tariffs contain weather normalization adjustments that largely offset shortfalls or excesses of firm net revenues (revenues less gas costs and revenue taxes) during a heating season due to variations from normal weather. Revenues are adjusted each month the clause is in effect and are generally included in rates in the following month. The New England gas utility rate structures contain no weather normalization feature, therefore their net revenues are subject to weather related demand fluctuations. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate the effect of fluctuations from normal weather on our financial position and cash flows, we may enter into weather related derivative instruments from time to time. (See Note 8 "Hedging, Derivative Financial Instruments and Fair Values" for additional information on these derivatives.)

Electric Services: Electric revenues are primarily derived from: (i) billings to LIPA for management of LIPA's transmission and distribution ("T&D") system, electric generation, and procurement of fuel, and (ii): subsidiaries that own lease and operate the 2,200 megawatt ("MW") Ravenswood electric generation facility ("Ravenswood Facility") and the recently completed 250 MW combined cycle generating facility located at the Ravenswood facility site ("Ravenswood Expansion").

LIPA Agreements

KeySpan manages the day-to-day operations, maintenance and capital improvements of the T&D system under a Management Service Agreement ("MSA"). KeySpan's billings to LIPA are based on certain agreed upon terms. In addition, KeySpan earns a $10 million annual management fee. Annual service incentives or penalties exist under the

MSA if certain targets are achieved or not achieved. In addition, we can earn certain incentives for budget underruns associated with the day-to-day operations, maintenance and capital improvements of LIPA's T&D system. These incentives provide for KeySpan to (i) retain 100% on the first $5 million in annual budget underruns, and (ii) retain 50% of additional annual underruns up to 15% of the total cost budget, thereafter all savings accrue to LIPA. With respect to cost overruns, KeySpan will absorb the first $15 million of overruns, with a sharing of overruns above $15 million. There are certain limitations on the amount of cost sharing of overruns.

In addition, KeySpan sells to LIPA under a Power Supply Agreement ("PSA") all of the capacity and, to the extent requested, energy conversion services from its existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC. Rates charged to LIPA include a fixed and variable component. The variable component is billed to LIPA on a monthly per megawatt hour basis and is dependent on the number of megawatt hours dispatched. The PSA provides incentives and penalties that can total $4 million annually for the maintenance of the output capability and the efficiency of the generating facilities.

KeySpan also procures and manages fuel supplies on behalf of LIPA, under an Energy Management Agreement ("EMA"), to fuel the generating facilities under contract to it and perform off-system capacity and energy purchases on a least-cost basis to meet LIPA's needs. In exchange for these services KeySpan earns an annual fee of $1.5 million. In addition, we arrange for off-system sales on behalf of LIPA of excess output from the generating facilities and other power supplies either owned or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales. In addition, the EMA provides incentives and penalties that can total $5 million annually for performance related to fuel purchases and off-system power purchases.

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC have entered into 25 year Power Purchase Agreements with LIPA (the "PPAs"). Under the terms of the PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Each plant is designed to produce 79.9 megawatts ("MW"). Under the PPAs, LIPA pays a monthly capacity fee, which guarantees full 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.

The Electric Services segment also conducts retail marketing of electricity to commercial customers. Energy sales made by our electric marketing subsidiary are recorded upon delivery of the related commodity.

LIPA is in the process of performing a long-term strategic review initiative regarding its future direction which may impact the above mentioned service agreements. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for further information regarding LIPA's strategic review.)

Ravenswood Facilities

In addition, electric revenues are derived from our investment in the 2,200 megawatt ("MW") Ravenswood electric generation facility ("Ravenswood Facility"), (which KeySpan acquired in June 1999). KeySpan has an arrangement with a variable interest entity through which we lease a portion of the Ravenswood Facility. Further, in May 2004 KeySpan completed construction of a 250 MW combined cycle generating facility located at the Ravenswood facility site ("Ravenswood Expansion"). To finance the Ravenswood Expansion, KeySpan entered into a leveraged lease financing arrangement. Collectively the Ravenswood Facility and Ravenswood Expansion will be referred to as the Ravenswood Projects. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for a description of the financing arrangements associated with the Ravenswood Projects.) We realize revenues from our investment in the Ravenswood Projects through the sale, at wholesale, of energy, capacity, and ancillary services to the New York Independent System Operator ("NYISO"). Energy and ancillary services are sold through a bidding process into the NYISO energy markets on a day ahead or real time basis.

Energy Services: Revenues earned by our Energy Services segment for mechanical and other contracting services are derived from service rendered under fixed price, cost-plus, guaranteed maximum price, and time and materials-type contracts and generally recognized on the percentage-of-completion method. Percentage-of-completion is measured principally by the percentage of costs incurred to date for each contract to the estimated total costs for each contract at completion. Provisions for estimated losses on uncompleted contracts are made in the period in which such losses are determined. In the case of customer change orders, estimated recoveries are included for work performed in forecasting ultimate profitability. Due to uncertainties inherent in the estimation process, changes in job performance, job conditions, estimated profitability and final contract settlements may result in revisions to estimated costs and, therefore, revenues. Such revisions to costs and income are recognized in the period in which the revisions are determined.

Costs and estimated earnings in excess of billings on uncompleted contracts arise when revenues have been recorded but the amounts cannot be billed under the terms of the contracts. Such amounts are recoverable from customers upon various measures of performance, including achievement of certain milestones, completion of specified units or completion of the contract.

Also included in costs and estimated earnings on uncompleted contracts are amounts to be collected from customers for changes in contract specifications or design, contract change orders in dispute or unapproved as to scope or price, or other customer-related causes of unanticipated additional contract costs. These amounts are recorded at their estimated net realizable value when realization is probable and can be reasonably estimated. Claims and unapproved change orders involve negotiation and, in certain cases, litigation. Unapproved change orders and claims also involve the use of estimates, and it is reasonably possible that

revisions to the estimated recoverable amounts of recorded change orders and claims may be made in the near-term. If KeySpan does not successfully resolve these matters, an expense may be required, in addition to amounts that have been previously provided for. Claims against KeySpan are recognized when a loss is considered probable and amounts are reasonably determinable.

KeySpan has recently sold its mechanical contracting companies, the operations of which have been reflected in discontinued operations on the Consolidated Statement of Income and on the Consolidated Balance Sheet and Statement of Cash Flows. (See Note 11 "Energy Services – Discontinued Operations" for additional details on the mechanical contracting companies.)

Energy service and maintenance revenues associated with small commercial and residential appliances are recognized as earned or over the life of the service contract, as appropriate. Fiber optic service revenue is recognized upon delivery of service access. We have unearned revenue recorded in deferred credits and other liabilities – other on the Consolidated Balance Sheet totaling $28.5 million and $23.8 million as of December 31, 2004, and December 31, 2003, respectively. These balances represent primarily unearned revenues for service contracts and leases on fiber optic cables. The unearned revenues from the service contracts are generally amortized to income within one year, while the lease related unearned revenues are amortized over periods ranging from five to 30 years.

Gas Exploration and Production: Natural gas and oil revenues earned by our gas exploration and production activities are recognized using the entitlements method of accounting. Under this method of accounting, income is recorded based on the net revenue interest in production or nominated deliveries. Production gas volume imbalances are incurred in the ordinary course of business. Net deliveries in excess of entitled amounts are recorded as liabilities, while net under deliveries are recorded as assets. Imbalances are reduced either by subsequent recoupment of over and under deliveries or by cash settlement, as required by applicable contracts. Production imbalances are marked-to-market at the end of each month using the market price at the end of each period. During 2004 KeySpan disposed of its interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company. KeySpan continues to maintain, on a significantly smaller scale, gas exploration and production activities. (See Note 2 "Business Segments" for a discussion on the disposition of Houston Exploration and KeySpan's remaining gas exploration activities.)

E. Utility and Other Property – Depreciation and Maintenance

Property, principally utility gas property is stated at original cost of construction, which includes allocations of overheads, including taxes, and an allowance for funds used during construction. The rates at which KeySpan subsidiaries capitalized interest for the year ended December 31, 2004 ranged from 1.54% to 6.47%. Capitalized interest for 2004, 2003 and 2002 was $7.4 million, $13.5 million and $19.7 million, respectively.

Depreciation is provided on a straight-line basis in amounts equivalent to composite rates on average depreciable property. The cost of property retired is charged to accumulated depreciation.

KeySpan recovers certain asset retirement costs through rates charged to customers as a portion of depreciation expense. At December 31, 2004 and 2003, KeySpan had costs recovered in excess of costs incurred totaling $496 million and $450 million, respectively. These amounts are reflected as a regulatory liability.

The cost of repair and minor replacement and renewal of property is charged to maintenance expense. The composite rates on average depreciable property were as follows:

YEAR ENDED DECEMBER 31,	2004	2003	2002
Electric	3.87%	3.81%	3.88%
Gas	3.55%	3.37%	3.44%

We also had $398.6 million of other property at December 31, 2004, consisting of assets held primarily by our Corporate Service subsidiary of $293.7 million and $89.9 million in Energy Services assets. The Corporate Service assets consist largely of land, buildings, office equipment and furniture, vehicles, computer and telecommunications equipment and systems. These assets have depreciable lives ranging from three to 40 years. We allocate the carrying cost of these assets to our operating subsidiaries through our PUHCA allocation methodology. Energy Services assets consist largely of construction equipment and fiber optic cable and related electronics and have service lives ranging from seven to 40 years.

KeySpan's repair and maintenance costs, including planned major maintenance in the Electric Services segment for turbine and generator overhauls, are expensed as incurred unless they represent replacement of property to be capitalized. Planned major maintenance cycles primarily range from seven to eight years. Smaller periodic overhauls are performed approximately every 18 months.

KeySpan capitalizes costs incurred in connection with its projects to develop and build energy facilities after a project has been determined to be probable.

F. Gas Exploration and Production Property – Depletion

As noted previously and discussed in more detail in Note 2 "Business Segments", during 2004, KeySpan disposed of its ownership interest in Houston Exploration. KeySpan continues to maintain gas exploration and production activities through its two wholly-owned subsidiaries – KeySpan Exploration and Production, LLC ("KeySpan Exploration"), which is engaged in a joint venture with Houston Exploration, and Seneca-Upshur Petroleum, Inc. ("Seneca-Upshur"). At December 31, 2004, these subsidiaries had net exploration and production property in the amount of $89.6 million. These assets are accounted for under the full cost method of accounting. Under the full cost method, costs of acquisition, exploration and development of natural gas and oil reserves plus asset retirement obligations are capitalized into a "full cost pool" as incurred. Unproved properties and related costs are excluded from the depletion and amortization base until a determination is made as to the existence

of proved reserves. Properties are depleted and charged to operations using the unit of production method using proved reserve quantities.

To the extent that such capitalized costs (net of accumulated depletion) less deferred taxes exceed the present value (using a 10% discount rate) of estimated future net cash flows from proved natural gas and oil reserves and the lower of cost or fair value of unproved properties, less deferred taxes, such excess costs are charged to operations, but would not have an impact on cash flows. Once incurred, such impairment of gas properties is not reversible at a later date even if gas prices increase.

The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, held flat over the life of the reserves. We use derivative financial instruments that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," to hedge the volatility of natural gas prices. In accordance with current SEC guidelines, we have included estimated future cash flows from our hedging program in ceiling test calculations.

As a result of the disposition of Houston Exploration, during most of 2004 KeySpan calculated the ceiling test on KeySpan Exploration and Production's and Seneca-Uphsur's assets independently of Houston Exploration's assets. Based on a report furnished by an independent reservoir engineer during the second quarter of 2004, it was determined that the remaining proved undeveloped oil reserves held in the joint venture required a substantial investment in order to develop. Therefore, KeySpan and Houston Exploration elected not to develop these oil reserves. As a result, in the second quarter of 2004, we recorded a $48.2 million non-cash impairment charge to write down our wholly-owned gas exploration and production subsidiaries' assets. This charge was recorded in depreciation, depletion and amortization on the Consolidated Statement of Income.

As of December 31, 2004, we estimated, using an average wellhead price adjusted for derivative instruments of $6.45 per MCF, that our capitalized costs did not exceed the ceiling test limitation. As of December 31, 2003 and December 31, 2002, we estimated, using wellhead prices of $5.79 and $4.35 per MCF, respectively, that our capitalized costs did not exceed the ceiling test limitation for those periods.

Natural gas prices continue to be volatile and the risk that a write down to the full cost pool increases when, among other things, natural gas prices are low, there are significant downward revisions in our estimated proved reserves or we have unsuccessful drilling results.

Houston Exploration capitalized interest related to its unevaluated natural gas and oil properties, as well as some properties under development which are not currently being amortized. For years ended December 31, 2004, 2003 and 2002, capitalized interest was $3.4 million, $7.3 million and $8.0 million, respectively.

G. Goodwill and Other Intangible Assets

The balance of goodwill and other intangible assets was $1.7 billion at December 31, 2004 and $1.8 billion at December 31, 2003, representing primarily the excess of acquisition cost over the fair value of net assets acquired. Goodwill and other intangible assets reflect the Eastern and ENI acquisitions, the KeySpan/LILCO transaction, as well as acquisitions of energy-related service companies and also relates to certain ownership interests of 50% or less in energy-related investments in Northern Ireland which are accounted for under the equity method.

The table below summarizes the goodwill and other intangible assets balance for each segment at December 31, 2004 and 2003:

	(In Thousands of Dollars)	
AT DECEMBER 31,	**2004**	**2003**
Operating Segment		
Gas Distribution	$1,436,917	$1,436,917
Energy Services	65,782	172,874
Energy Investments and other	174,902	199,921
	$1,677,601	$1,809,712

On January 1, 2002, KeySpan adopted SFAS 142 "Goodwill and Other Intangible Assets". Under SFAS 142, among other things, goodwill is no longer required to be amortized and is to be tested for impairment at least annually. The initial impairment test was performed within six months of adopting SFAS 142 using a discounted cash flow method, compared to an undiscounted cash flow method allowed under a previous standard. Any amounts impaired using data as of January 1, 2002, was to be recorded as a "Cumulative Effect of an Accounting Change." Any amounts impaired using data after the initial adoption date is recorded as an operating expense. During 2002, KeySpan conducted an impairment analysis for all its reporting units and determined that no consolidated impairment existed.

In 2003, KeySpan updated its review of the carrying value of goodwill associated with the Energy Services segment. KeySpan employed a combination of two methodologies in determining the fair value for its investment in the Energy Services segment, a market valuation approach and an income valuation approach. A third party specialist was engaged to assist with the valuation and evaluate the reasonableness of key assumptions employed. Under the market valuation approach, KeySpan compared relevant financial information relating to the companies included in the Energy Services segment to the corresponding financial information for a peer group of companies in the specialty trade-contracting sector of the construction industry. Under the income valuation approach, the fair value of a firm is obtained by discounting the sum of (i) the expected future cash flows to a firm; and (ii) the terminal value of a firm. As a result of this valuation, management determined that the fair value of the assets adequately exceeded their carrying value and no impairment charge was necessary.

The Energy Services segment has experienced significantly lower operating profits and cash flows than originally projected. As previously reported, management had reviewed the operating performance of this segment. At a meeting held on November 2, 2004, KeySpan's Board of Directors authorized management to begin the process of disposing of a significant portion of its ownership interests in certain companies within

the Energy Services segment – specifically those companies engaged in mechanical contracting activities. In January and February of 2005, KeySpan sold these mechanical contracting investments.

In anticipation of these sales and in connection with the preparation of the third quarter and fourth quarter financial statements, KeySpan conducted an evaluation of the carrying value of these investments, including recorded goodwill. Further, we evaluated the carrying value of goodwill for the entire Energy Services segment.

As a result of this evaluation, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on Energy Services segment's continuing operations; and (ii) $93.9 million as discontinued operations reflecting the impairment on the mechanical contracting companies. (See Note 11 "Energy Services – Discontinued Operations" for further details on the discontinued companies.)

In addition to the goodwill evaluation conducted for the Energy Services segment, KeySpan conducted evaluations of the goodwill recorded in the Gas Distribution and Energy Investments segments. Based on KeySpan's evaluation of the fair value of the Gas Distribution unit, KeySpan concluded that the fair value of the Gas Distribution unit exceeded the carrying value and no impairment charge was necessary.

KeySpan has entered into an agreement to sell its 50% interest in Premier Transmission Limited ("PTL"), a gas pipeline from southwest Scotland to Northern Ireland, before the end of the second quarter of 2005. In the fourth quarter of 2004 KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share, reflecting the difference between the anticipated cash proceeds from the sale of PTL compared to its carrying value. The impairment charge was recorded as a reduction to goodwill. This investment is accounted for under the equity method of accounting in the Energy Investments segment.

H. Hedging and Derivative Financial Instruments

From time to time, we employ derivative instruments to hedge a portion of our exposure to commodity price risk and interest rate risk, as well as to hedge cash flow variability associated with a portion of our peak electric energy sales. Whenever hedge positions are in effect, we are exposed to credit risk in the event of nonperformance by counter-parties to derivative contracts, as well as nonperformance by the counter-parties of the transactions against which they are hedged. We believe that the credit risk related to the futures, options and swap instruments is no greater than that associated with the primary commodity contracts which they hedge. Our derivative instruments do not qualify as energy trading contracts as defined by current accounting literature.

Financially-Settled Commodity Derivative Instruments: We employ derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with forecasted purchases and sales of various energy-related commodities. All such derivative instruments are accounted for pursuant to the requirements of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS 149, "Amendment of Statement 133 Derivative Instruments and Hedging Activities" (collectively, "SFAS 133"). With respect to those commodity derivative instruments that are designated and accounted for as cash flow hedges, the effective portion of periodic changes in the fair market value of cash flow hedges is recorded as other comprehensive income on the Consolidated Balance Sheet, while the ineffective portion of such changes in fair value is recognized in earnings. Unrealized gains and losses (on such cash flow hedges) that are recorded as other comprehensive income are subsequently reclassified into earnings concurrent when hedged transactions impact earnings. With respect to those commodity derivative instruments that are not designated as hedging instruments, such derivatives are accounted for on the Consolidated Balance Sheet at fair value, with all changes in fair value reported in earnings.

Firm Gas Sales Derivatives Instruments – Regulated Utilities: We utilize derivative financial instruments to reduce cash flow variability associated with the purchase price for a portion of our future natural gas purchases. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. Since these derivative instruments are being employed to support our gas sales prices to regulated firm gas sales customers, the accounting for these derivative instruments is subject to SFAS 71. Therefore, changes in the market value of these derivatives are recorded as regulatory assets or regulatory liabilities on our Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers during the appropriate winter heating season consistent with regulatory requirements.

Physically-Settled Commodity Derivative Instruments: Upon implementation of Derivative Implementation Group ("DIG") Issue C16 on April 1, 2002, certain of our contracts for the physical purchase of natural gas were assessed as no longer being exempt from the requirements of SFAS 133 as normal purchases. As such, these contracts are recorded on the Consolidated Balance Sheet at fair market value. However, since such contracts were executed for the purchases of natural gas that is sold to regulated firm gas sales customers, and pursuant to the requirements of SFAS 71, changes in the fair market value of these contracts are recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet.

Weather Derivatives: The utility tariffs associated with our New England gas distribution operations do not contain a weather normalization adjustment. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate the effect of fluctuations from normal weather on our financial position and cash flows, we may enter into derivative instruments from time to time. Based on the terms of the contracts, we account for these instruments pursuant to the requirements of Emerging Issues Task Force ("EITF") 99-2 "Accounting for Weather Derivatives." In this regard, we account for weather derivatives using the "intrinsic value method" as set forth in such guidance.

Interest Rate Derivative Instruments: We continually assess the cost relationship between fixed and variable rate debt. Consistent with our objective to minimize our cost of capital, we periodically enter into hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable or variable to fixed. Payments made or received on these derivative contracts are recognized as an adjustment to interest expense as incurred. Hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable are designated and accounted for as fair-value hedges pursuant to the requirements of SFAS 133. Hedging transactions that effectively convert the terms of underlying debt obligations from variable to fixed are considered cash flow hedges.

I. Equity Investments

Certain subsidiaries own as their principal assets, investments (including goodwill), representing ownership interests of 50% or less in energy-related businesses that are accounted for under the equity method. None of these current investments are publicly traded.

J. Income and Excise Tax

Upon implementation of SFAS 109, "Accounting for Income Taxes", certain of our regulated subsidiaries recorded a regulatory asset and a net deferred tax liability for the cumulative effect of providing deferred income taxes on certain differences between the financial statement carrying amounts of assets and liabilities, and their respective tax bases. This regulatory asset continues to be amortized over the lives of the individual assets and liabilities to which it relates. Additionally, investment tax credits which were available prior to the Tax Reform Act of 1986, were deferred and generally amortized as a reduction of income tax over the estimated lives of the related property.

We report our collections and payments of excise taxes on a gross basis. Gas distribution revenues include the collection of excise taxes, while operating taxes include the related expense. For the years ended December 31, 2004, 2003 and 2002, excise taxes collected and paid were $73.3 million, $90.5 million, $83.1 million, respectively.

K. Subsidiary Common Stock Issuances to Third Parties

We follow an accounting policy of income statement recognition for parent company gains or losses from issuances of common stock by subsidiaries to unaffiliated third parties.

L. Foreign Currency Translation

We follow the principles of SFAS 52, "Foreign Currency Translation," for recording our investments in foreign affiliates. Under this statement, all elements of the financial statements are translated by using a current exchange rate. Translation adjustments result from changes in exchange rates from one reporting period to another. At December 31, 2004 and 2003, the foreign currency translation adjustment was included on the Consolidated Balance Sheet. The functional currency for our foreign affiliates is their local currency.

M. Earnings Per Share

Basic earnings per share ("EPS") is calculated by dividing earnings for common stock by the weighted average number of shares of common stock outstanding during the period. No dilution for any potentially anti-dilutive securities is included. Diluted EPS assumes the conversion of all potentially dilutive securities and is calculated by dividing earnings for common stock, as adjusted, by the sum of the weighted average number of shares of common stock outstanding plus all potentially dilutive securities.

At December 31, 2004 all options outstanding to purchase KeySpan common stock were used in the calculation of diluted EPS. In 2003 and 2002 we had 85,676 shares of convertible preferred stock outstanding that could have been converted into 221,153 shares of common stock. These shares were redeemed in 2004.

Under the requirements of SFAS 128, "Earnings Per Share" our basic and diluted EPS are as follows:

(In Thousands of Dollars, Except Per Share Amounts)

YEAR ENDED DECEMBER 31,	2004	2003	2002
Earnings for common stock	$458,053	$380,886	$371,935
Houston Exploration dilution	—	(269)	(471)
Preferred stock dividend	—	514	531
Earnings for common stock – adjusted	$458,053	$381,131	$371,995
Weighted average shares outstanding (000)	160,294	158,256	141,263
Add dilutive securities:			
Options	983	755	809
Convertible preferred stock	—	221	228
Total weighted average shares outstanding – assuming dilution	161,277	159,232	142,300
Basic earnings per share	$ 2.86	$ 2.41	$ 2.63
Diluted earnings per share	$ 2.84	$ 2.39	$ 2.61

N. Stock Options and Other Stock Based Compensation

Stock options are issued to all KeySpan officers and certain other management employees as approved by the Board of Directors. These options generally vest over a three-to-five year period and have exercise periods between five to ten years. Up to approximately 21 million shares have been authorized for the issuance of options and approximately 5.2 million of these shares were remaining at December 31, 2004. Moreover, under a separate plan, Houston Exploration had issued and outstanding approximately 2.5 million stock options to key Houston Exploration employees. KeySpan and Houston Exploration adopted the prospective method of transition in accordance with SFAS 148 "Accounting for Stock-Based Compensation – Transition and Disclosure." Accordingly, compensation expense has been recognized by employing the fair value recognition provisions of SFAS 123 "Accounting for Stock-Based Compensation" for grants awarded after January 1, 2003.

KeySpan continues to apply APB Opinion 25, "Accounting for Stock Issued to Employees," and related Interpretations in accounting for grants awarded prior to January 1, 2003. Prior to the disposition of Houston Exploration, Houston Exploration also applied APB Opinion 25, and related Interpretations in accounting for grants awarded prior to January 1, 2003. Accordingly, no compensation cost has been recognized for these fixed stock option plans in the Consolidated Financial Statements since the exercise prices and market values were equal on the grant dates. Had compensation cost for these plans been determined based on the fair value at the grant dates for awards under the plans consistent with SFAS 123, our net income and earnings per share would have decreased to the pro-forma amounts indicated as follows:

(In Thousands of Dollars, Except Per Share Amounts)

YEAR ENDED DECEMBER 31,	2004	2003	2002
Earnings available for common stock:			
As reported	$458,053	$380,886	$371,935
Add: recorded stock-based compensation expense, net of tax	9,109	3,650	221
Deduct: total stock-based compensation expense, net of tax	(12,356)	(9,358)	(7,547)
Pro-forma earnings	$454,806	$375,178	$364,609
Earnings per share:			
Basic – as reported	$ 2.86	$ 2.41	$ 2.63
Basic – pro-forma	$ 2.84	$ 2.37	$ 2.58
Diluted – as reported	$ 2.84	$ 2.39	$ 2.61
Diluted – pro-forma	$ 2.82	$ 2.36	$ 2.56

All grants are estimated on the date of the grant using the Black-Scholes option-pricing model. The following table presents the weighted average fair value, exercise price and assumptions used for the periods indicated:

YEAR ENDED DECEMBER 31,	2004	2003	2002
Fair value of grants issued	$ 5.47	$ 4.26	$ 3.42
Dividend yield	4.74%	5.49%	5.36%
Expected volatility	23.48%	24.26%	22.47%
Risk free rate	3.22%	3.16%	4.94%
Expected lives	6.5 years	6 years	10 years
Exercise price	$ 37.54	$ 32.40	$ 32.66

A summary of the status of our fixed stock option plans and changes is presented below for the periods indicated:

YEAR ENDED DECEMBER 31,	2004		2003		2002	
		WEIGHTED AVERAGE		WEIGHTED AVERAGE		WEIGHTED AVERAGE
FIXED OPTIONS	SHARES	EXERCISE PRICE	SHARES	EXERCISE PRICE	SHARES	EXERCISE PRICE
Outstanding at beginning of period	10,320,743	$31.39	9,524,900	$30.74	7,796,162	$29.67
Granted during the year	1,602,850	$37.54	1,650,450	$32.40	2,796,310	$32.66
Exercised	(1,150,464)	$28.05	(664,902)	$23.64	(506,794)	$24.42
Forfeited	(232,183)	$35.18	(189,705)	$34.63	(560,778)	$30.99
Outstanding at end of period	10,540,946	$32.61	10,320,743	$31.39	9,524,900	$30.74
Exercisable at end of period	5,523,259	$30.39	5,365,545	$28.76	4,105,999	$27.69

REMAINING CONTRACTUAL LIFE	OPTIONS OUTSTANDING AT DECEMBER 31, 2004	WEIGHTED AVERAGE EXERCISE PRICE	RANGE OF EXERCISE PRICE	OPTIONS EXERCISABLE AT DECEMBER 31, 2004	WEIGHTED AVERAGE EXERCISE PRICE	RANGE OF EXERCISE PRICE
1 years	1,800	$27.00	$27.00	1,800	$27.00	$27.00
2 years	167,086	$30.41	$ 20.57 – 30.50	167,086	$30.41	$ 20.57 – 30.50
3 years	236,410	$32.54	$ 19.15 – 32.63	236,410	$32.54	$ 19.15 – 32.63
4 years	1,006,679	$27.92	$ 24.73 – 29.38	1,006,679	$27.92	$ 24.73 – 29.38
5 years	541,755	$26.98	$ 21.99 – 27.06	541,754	$26.98	$ 21.99 – 27.06
6 years	1,272,983	$22.72	$ 22.50 – 32.76	1,272,983	$22.72	$ 22.50 – 32.76
7 years	1,917,889	$39.50	$39.50	1,229,789	$39.50	$39.50
8 years	2,340,508	$32.66	$32.66	834,509	$32.66	$32.66
9 years	1,492,792	$32.40	$32.40	232,249	$32.40	$32.40
10 years	1,563,044	$37.54	$37.54	—	$37.54	$37.54
	10,540,946			5,523,259		

Since 2003, KeySpan provides long-term incentive compensation for officers consisting of 50% stock options and 50% performance shares. Performance shares are awarded based upon the attainment of overall corporate performance goals and better aligns incentive compensation with overall corporate performance.

O. Recent Accounting Pronouncements

In May 2004, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position ("FSP") 106-2 "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." This guidance superseded FSP 106-1 issued in January 2004 and clarifies the accounting and disclosure requirements for employers with postretirement benefit plans that have been or will be affected by the passage of the Medicare Prescription Drug Improvement and Modernization Act of 2003 ("the Act"). The Act introduced two new features to Medicare that an employer needs to consider in measuring its obligation and net periodic postretirement benefit costs. The effective date for the new requirements was the first interim or annual period beginning after June 15, 2004.

KeySpan's retiree health benefit plan currently includes a prescription drug benefit that is provided to retired employees. KeySpan implemented the requirements of FSP 106-2 in September 2004 and determined that the savings associated with the Act reduced KeySpan's retiree health care costs by approximately $10 million in 2004. However, KEDLI and Boston Gas Company are subject to certain deferral accounting requirements mandated by the New York State Public Service Commission ("NYPSC") and the Massachusetts Department of Telecommunications and Energy ("MADTE"), respectively for pension costs and other postretirement benefit costs. Further, in accordance with our service agreements with LIPA, variations between pension costs and other postretirement benefit costs incurred by KeySpan compared to those costs recovered through rates charged to LIPA are deferred subject to recovery from or refund to LIPA. As a result of these various requirements, approximately $7 million of savings attributable to the implementation of FSP 106-2 and the Act was deferred and used to offset increases in overall pension and postretirement benefit costs, with the remaining approximately $3 million recorded as a reduction to 2004 postretirement expense. The implementation of FSP 106-2 and the Act had no immediate impact on KeySpan's cash flow.

In January 2005, the Department of Health and Human Services/Centers for Medicare and Medicaid Services (CMS) released final regulations with regard to the implementation of the major provision of the Medicare Act. We are currently evaluating the final regulations, and at this time we cannot determine the impact, if any, these regulations may have on our results of operations, financial position or cash flows.

In December 2004 the FASB issued SFAS 123 (revised 2004) "Share-Based Payment." This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. This Statement revises certain provisions of SFAS 123 "Accounting for Stock-Based Compensation" and supersedes APB Opinion 25 "Accounting for Stock Issued to Employees." The fair-value-based method in this Statement is similar to the fair-value-based method in Statement 123 in most respects. However, the following are key differences between the two: Entities are required to measure liabilities incurred to employees in share based payment transactions at fair value as compared to using the intrinsic method allowed under Statement 123. Entities are required to estimate the number of instruments for which the requisite service is expected to be rendered, as compared to accounting for forfeitures as they occur under Statement 123. Incremental compensation cost for a modification of the terms or conditions of an award are also measured differently under this Statement compared to Statement 123. This Statement also clarifies and expands Statement 123's guidance in several areas. The effective date of this Statement is the beginning of the first interim or annual reporting period that begins after June 15, 2005. As noted earlier, KeySpan adopted the prospective method of transition for stock options in accordance with SFAS 148 "Accounting for Stock-Based Compensation – Transition and Disclosure." Accordingly, compensation expense has been recognized by employing the fair value recognition provisions of SFAS 123 for grants awarded after January 1, 2003. KeySpan is currently reviewing the requirements of this Statement, and believes that implementation of this Statement will not have a material impact on its results of operations or financial position and no effect on its cash flows.

P. Impact of Cumulative Effect of Change in Accounting Principles

As noted previously, KeySpan has an arrangement with a variable interest entity through which it leases a portion of the 2,200-megawatt Ravenswood electric generation facility. On December 31, 2003, KeySpan adopted Financial Accounting Standards Board ("FASB") Interpretation No. 46 ("FIN 46"). This pronouncement required KeySpan to consolidate its variable interest entity, which had a fair market value of a $425 million at the inception of the lease, June 1999. As a result, in 2003 KeySpan recorded a $37.6 million after-tax charge, or $0.23 per share, change in accounting principle on the Consolidated Statement of Income, representing approximately four and a half years of depreciation. (See Note 7, "Contractual Obligations, Financial Guarantees and Contingencies – Variable Interest Entity" for a detailed description of the impact of the adoption of this standard.)

On January 1, 2003, KeySpan adopted SFAS 143, "Accounting for Asset Retirement Obligations." SFAS 143 requires an entity to record a liability and corresponding asset representing the present value of legal obligations associated with the retirement of tangible, long-lived assets. The 2003 cumulative effect of SFAS 143 and the change in accounting principle was a benefit to net income of $0.2 million, after-tax. (See Note 7, "Contractual Obligations, Financial Guarantees and Contingencies – Asset Retirement Obligation" for further details.)

Under Accounting Principle Board Opinion No. 20 ("APB 20"), the pro-forma impact of the retroactive application resulting from the adoption of a change in accounting principle is to be disclosed as follows:

			(In Thousands of Dollars, Except Per Share Amounts)
YEAR ENDED DECEMBER 31,	2004	2003	2002
Earnings for common stock	N/A	$380,886	$371,935
Add back: Cumulative effect of a change in accounting principle		37,451	—
Earnings for common stock before cumulative effect of a change in accounting principle:			
As reported		418,337	371,935
Less: SFAS 143 Accretion expense, net of taxes		—	(1,135)
Less: FIN 46 Depreciation expense, net of taxes		(9,538)	(8,024)
Add: SFAS 143 Costs of removal expense, net of taxes		—	471
Pro-forma earnings		$408,799	$363,247
Earnings per share before cumulative change in accounting principle:			
Basic – as reported		$ 2.64	$ 2.63
Basic – pro-forma		$ 2.58	$ 2.57
Diluted – as reported		$ 2.62	$ 2.61
Diluted – pro-forma		$ 2.57	$ 2.55
Earnings per share for common stock:			
Basic – as reported		$ 2.41	$ 2.63
Basic – pro-forma		$ 2.58	$ 2.57
Diluted – as reported		$ 2.39	$ 2.61
Diluted – pro-forma		$ 2.57	$ 2.55

Q. Accumulated Other Comprehensive Income

As required by SFAS 130, "Reporting Comprehensive Income," the components of accumulated other comprehensive income are as follows:

		(In Thousands of Dollars)
DECEMBER 31,	2004	2003
Foreign currency translation adjustments	$ 4,987	$ 26,523
Unrealized (losses) on marketable securities	(419)	(7,530)
Premium on derivative instrument	—	(3,437)
Accrued unfunded pension obligation	(59,760)	(51,942)
Unrealized (losses) on derivative financial instruments	856	(23,546)
Accumulated other comprehensive income	$(54,336)	$(59,932)

Note 2. Business Segments

We have four reportable segments: Gas Distribution, Electric Services, Energy Services and Energy Investments.

The Gas Distribution segment consists of our six gas distribution subsidiaries. KEDNY provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Staten Island and a portion of the Borough of Queens. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. The remaining gas distribution subsidiaries, collectively doing business as KEDNE, provide gas distribution service to customers in Massachusetts and New Hampshire.

The Electric Services segment consists of subsidiaries that: operate the electric transmission and distribution system owned by LIPA; own and provide capacity to and produce energy for LIPA from our generating facilities located on Long Island; and manage fuel supplies for LIPA to fuel our Long Island generating facilities. These services are provided in accordance with long-term service contracts having remaining terms that range from four to nine years and power purchase agreements having remaining terms that range from nine to 23 years. The Electric Services segment also includes subsidiaries that own or lease and operate the 2,200 megawatt Ravenswood electric generation facility ("Ravenswood Facility") located in Queens, New York, as well as the recently completed 250 MW combined-cycle electric generating unit located at the Ravenswood site ("Ravenswood Expansion"). Collectively the Ravenswood Facility and Ravenswood Expansion are referred to as the "Ravenswood Projects". All of the energy, capacity and ancillary services related to the Ravenswood Projects are sold to the NYISO energy markets. To finance the purchase and/or construction of the Ravenswood Projects, KeySpan entered into leasing arrangement for each facility. The Electric Services segment also conducts retail marketing of electricity to commercial customers. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for further details on the leasing arrangements.)

The Energy Services segment includes companies that provide energy-related and fiber optic services to customers located primarily within the Northeastern United States, with concentrations in the New York City and Boston metropolitan areas through the following lines of business: (i) Home Energy Services, which provides residential customers with service and maintenance of energy systems and appliances, as well as the retail marketing of electricity to commercial customers; and (ii) Business Solutions, which provides operation and maintenance, design, engineering and consulting services to commercial and industrial customers. For December 31, 2004, 2003 and 2002 we have reclassified the operations of Energy Services' mechanical contracting subsidiaries as discontinued operations on the Consolidated Statement of Income, Consolidated Balance Sheet and Consolidated Statement of Cash Flows. In 2004, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) associated with its mechanical contracting operations and certain remaining operations. In addition, an impairment charge of $100.3 million ($72.1 million after-tax or $.45 per share) was also recorded to reduce the carrying value of the remaining assets of the mechanical contracting companies. (See Note 11 "Energy Services – Discontinued Operations" for additional details regarding these charges.)

The Energy Investments segment consists of our gas exploration and production investments, as well as certain other domestic and international energy-related investments. In June 2004, KeySpan exchanged 10.8 million shares of common stock of The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company, for 100% of the stock of Seneca Upshur Petroleum, Inc. ("Seneca-Upshur"), previously a wholly owned subsidiary of Houston Exploration. This transaction reduced our interest in Houston Exploration from 55% to approximately 23.5%. As part of this transaction, Houston Exploration retired 4.6 million of its common shares and issued 6.8 million new shares in a public offering. Based on Houston Exploration's announced offering price of $48.00 per share, Seneca-Upshur's shares were valued at the equivalent of $449 million, or $41.57 per share. Seneca-Upshur's assets consisted of West Virginia gas producing properties valued at $60 million, and $389 million in cash. KeySpan follows an accounting policy of income statement recognition for Parent company gains or losses from common stock transactions initiated by its subsidiaries. As a result, this transaction resulted in a gain to KeySpan of $150.1 million and is reflected in other income and deductions on the Consolidated Statement of Income. Effective June 1, 2004, Houston Exploration's earnings and our ownership interest in Houston Exploration were accounted for on the equity basis of accounting. The deconsolidation of Houston Exploration required the recognition of certain deferred taxes on our remaining investment resulting in a net deferred tax expense of $44.1 million. Therefore, the net gain on the share exchange less the deferred tax provision was $106 million, or $0.66 per share.

In November 2004, KeySpan sold its remaining 23.5% interest in Houston Exploration (6.6 million shares) and received cash proceeds of approximately $369 million. KeySpan recorded a pre-tax gain of $179.6 million which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was $116.8 million or $0.73 per share.

Houston Exploration's revenues, which are reflected in KeySpan's Consolidated Statement of Income, were $266.4 million, $494.7 million, and $345.4 million in fiscal years 2004, 2003 and 2002, respectively. Houston Exploration's operating income, including KeySpan's share of equity earnings, were $138.5 million, $199.1 million and $109.3 million in fiscal years 2004, 2003 and 2002, respectively.

Our gas exploration and production activities now include our wholly-owned subsidiaries Seneca-Upshur and KeySpan Exploration and Production, LLC ("KeySpan Exploration and Production"), which is engaged in a joint venture with Houston Exploration. It should be noted that in the second quarter of 2004, KeySpan recorded a $48.2 million non-cash impairment charge to recognize the reduced valuation of proved reserves. (See Note 1 "Summary of Significant Accounting Policies" Item F "Gas Exploration and Production Property – Depletion" for further information on this charge.)

Asset transactions regarding our investment in Houston Exploration were also recorded in 2003. In February 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. We realized net proceeds of $79 million in connection with this repurchase. KeySpan realized a gain of $19 million on this transaction, which is reflected in other income and (deductions) on the Consolidated Statement of Income. Income taxes were not provided, since this transaction was structured as a return of capital.

For most of 2004, subsidiaries in this segment also held an ownership interest in certain midstream natural gas assets in Western Canada through KeySpan Canada. These assets included 14 processing plants and associated gathering systems that can process approximately 1.5 BCFe of natural gas daily and provide associated natural gas liquids fractionation. At the beginning of 2004, KeySpan held a 60.9% ownership interest in KeySpan Canada. In April 2004, KeySpan and KeySpan Facilities Income Fund (the "Fund"), an open-ended income fund trust which previously owned the other 39.1% interest in KeySpan Canada, consummated a transaction whereby the Fund sold 15.617 million units of the Fund at a price of CDN$12.60 per unit for gross total proceeds of approximately CDN$196.8 million. The proceeds of the offering were used by the Fund to acquire an additional 35.91% interest in KeySpan Canada from KeySpan. We received net proceeds of approximately CDN$186.3 million (or approximately US$135 million), after commissions and expenses. The Fund's ownership in KeySpan Canada increased from 39.1% to 75%, and KeySpan's ownership of KeySpan Canada decreased from 60.9% to 25%. KeySpan recorded a gain of $22.8 million ($10.1 million after-tax, or $0.06 per share) on this transaction. Effective April 1, 2004, KeySpan Canada's earnings and our ownership interest in KeySpan Canada had been accounted for on the equity basis of accounting.

In July 2004, the Fund issued an additional 10.7 million units, the proceeds of which were used to fund the acquisition of the midstream assets of Chevron Canada Midstream Inc. This transaction had the effect of further diluting KeySpan's ownership of KeySpan Canada to 17.4%. KeySpan continued to account for its investment in KeySpan Canada on the equity basis of accounting since it still exercised significant influence over this entity.

In December 2004, KeySpan sold its remaining 17.4% interest in KeySpan Canada to the Fund and received net proceeds of approximately $119 million and recorded a pre-tax gain of approximately $35.8 million, which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was approximately $24.7 million, or $0.15 per share.

KeySpan Canada's revenues, which are reflected in KeySpan's Consolidated Statement of Income, were $25.2 million, $90.3 million, and $74.9 million in fiscal years 2004, 2003 and 2002, respectively. KeySpan Canada's operating income, including KeySpan's share of equity earnings, were $16.5 million, $28.2 million and $24.5 million in fiscal years 2004, 2003 and 2002, respectively.

...ions regarding our investment in KeySpan Canada
also recorded in 2003. In 2003, we sold a portion of our interest in
pan Canada through the Fund. The Fund acquired a 39.1% owner-
interest in KeySpan Canada through an indirect subsidiary, and then
d 17 million trust units to the public through an initial public offer-
Each trust unit represented a beneficial interest in the Fund and was
tered on the Toronto Stock Exchange under the symbol KEY.UN.
tionally, we sold our 20% interest in Taylor NGL LP that owns and
ates two extraction plants in Canada to AltaGas Services, Inc. Net
eeds of $119.4 million from the two sales, plus proceeds of $45.7
n drawn under a new credit facility made available to KeySpan
da, were used to pay down existing KeySpan Canada credit facilities
60.4 million. A pre-tax loss of $30.3 million was recognized on the
actions and is included in other income and (deductions) on the
olidated Statement of Income. These transactions produced a tax
ise of $3.8 million as a result of certain United States partnership
les and resulted in an after-tax loss of $34.1 million.

This segment is also engaged in pipeline development activities.
an and Duke Energy Corporation each own a 50% interest in
er East Pipeline Company, LLC ("Islander East"). Islander East was
d to pursue the authorization and construction of an interstate
ne from Connecticut, across Long Island Sound, to a terminus near
ham, Long Island. Once in service, the pipeline is expected to trans-
p to 260,000 DTH daily to the Long Island and New York City ener-
rkets. Further, in August 2004, KeySpan acquired a 21% interest in
llennium Pipeline project which will transport up to 500,000 DTH
ural gas a day from Corning to Ramapo, New York, where it will
t to an existing pipeline.

lditionally, subsidiaries in this segment hold a 20% equity interest
oquois Gas Transmission System LP, a pipeline that transports
n gas supply to markets in the Northeastern United States and
ian LNG facility in Providence, Rhode Island, a 600,000 barrel
natural gas storage and receiving facility. Further, this segment
interest in the Premier Transmission Pipeline ("PTL") in
eland. On February 25, 2005, KeySpan entered into a Share
Sale and Purchase Agreement with BG Energy Holdings Lim
Premier Transmission Financing Public Limited Company ("P
pursuant to which all of the outstanding shares of PTL are to
chased by PTFPL. It is expected that the sale of our 50% inte
will result in proceeds of approximately $42.5 million and tha
ing of this transaction will occur before the end of the second
2005. In the fourth quarter of 2004, KeySpan recorded a pre-ta
non-cash impairment charge of $26.5 million – $18.8 million a
or $0.12 per share, reflecting the difference between the anticip
proceeds from the sale of PTL compared to its carrying value. The
sidiaries are accounted for under the equity method. Accordingly,
income from these investments is reflected as a component of ope
income in the Consolidated Statement of Income.

In the fourth quarter of 2003, we completed the sale of our 2
interest in Phoenix Natural Gas Limited for $96 million and recordec
pre-tax gain of $24.7 million in other income and (deductions) on th
Consolidated Statement of Income. The after-tax gain was $16.0 milli
or $0.10 per share.

The accounting policies of the segments are the same as those us
for the preparation of the Consolidated Financial Statements. Our seg-
ments are strategic business units that are managed separately because
of their different operating and regulatory environments. Operating
results of our segments are evaluated by management on an operating
income basis. As noted earlier, the mechanical contracting subsidiaries,
included in Energy Services, are reported as discontinued operations in
2004, 2003 and 2002. Further, due to the July 2002 sale of Midland
Enterprises LLC, an inland marine barge business, this subsidiary is
reported as discontinued operations for 2002. (See Note 9, "Discontinuec
Midland Operations" for more information on the sale of Midland).
Further, to better align the subsidiaries within our segments, we reclassi-
fied the operating results of our electric marketing subsidiary from the
Energy Services segment to the Electric Services segment in the first
quarter of 2004. As a result we reclassified the financial results for all
periods of 2003 and 2002. The revised reportable segment information
is as follows:

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31, 2004	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	GAS EXPLORATION AND PRODUCTION	OTHER INVESTMENTS	ELIMINATIONS	CONSOLIDATED
Unaffiliated revenue	4,407,292	1,738,660	182,406	279,999	42,109	—	6,650,466
Intersegment revenue	—	—	11,515	—	4,879	(16,394)	—
Depreciation, depletion and amortization	276,487	88,252	7,478	156,981	7,306	15,256	551,760
Sales of property	—	2,000	—	—	5,021	—	7,021
Income from equity investments	—	—	—	20,757	25,779	—	46,536
Operating income	579,563	289,781	(48,302)	94,455	10,238	9,535	935,270
Interest income	2,215	9,926	40	3,504	2,989	(9,202)	9,472
Interest charges	176,799	72,945	19,399	3,487	3,882	54,739	331,251
Total assets	8,908,786	2,144,275	246,609	3,379	697,924	1,363,157	13,364,130
Equity method investments	—	—	—	—	107,059	—	107,059
Construction expenditures	414,522	150,320	13,693	146,543	13,682	11,569	750,329

Eliminating items include intercompany interest income and expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.7 billion for the year ended December 31, 2004 represents approximately 25% of our consolidated revenues during that period

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31, 2003	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	GAS EXPLORATION AND PRODUCTION	OTHER INVESTMENTS	ELIMINATIONS	CONSOLIDATED
Unaffiliated revenue	4,161,272	1,605,973	158,908	501,255	108,116	—	6,535,524
Intersegment revenue	—	101	7,467	—	5,008	(12,576)	—
Depreciation, depletion and amortization	259,934	67,161	7,146	204,102	19,046	14,280	571,669
Sales of property	15,123	—	—	—	—	—	15,123
Income from equity investments	—	—	—	—	19,106	108	19,214
Operating income	574,254	269,874	(32,963)	197,209	41,345	(2,090)	1,047,629
Interest income	1,194	4,628	1,070	—	1,002	(2,235)	5,659
Interest charges	203,733	44,158	15,794	8,504	7,541	27,964	307,694
Total assets	8,457,469	2,511,125	407,485	1,530,875	915,383	817,845	14,640,182
Equity method investments	—	—	—	—	97,018	—	97,018
Construction expenditures	419,549	256,498	6,982	295,943	18,154	12,267	1,009,393

Eliminating items include intercompany interest income and expense, the elimination of certain intercompany accounts, as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.5 billion for the year ended December 31, 2003, represents approximately 22% of our consolidated revenues during that period.

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31, 2002	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	GAS EXPLORATION AND PRODUCTION	OTHER INVESTMENTS	ELIMINATIONS	CONSOLIDATED
Unaffiliated revenue	3,163,761	1,645,688	208,624	357,451	89,650	—	5,465,174
Intersegment revenue	—	101	—	—	1,128	(1,229)	—
Depreciation, depletion and amortization	237,186	61,377	8,487	176,925	14,573	15,160	513,708
Sales of property	903	1,479	—	—	2,348	—	4,730
Income from equity investments	—	—	—	—	13,992	104	14,096
Operating income	531,134	289,694	(45,581)	110,259	32,335	(8,506)	909,335
Interest income	2,020	1,834	1,248	—	238	(3,768)	1,572
Interest charges	215,140	58,788	18,187	7,303	6,858	(4,772)	301,504
Total assets	7,783,011	1,848,767	423,746	1,187,425	974,409	762,692	12,980,050
Equity method investments	—	—	—	—	130,815	—	130,815
Construction expenditures	412,433	348,147	8,133	241,477	31,243	16,074	1,057,507

Eliminating items include intercompany interest income and expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.4 billion for the year ended December 31, 2002 represents approximately 25% of our consolidated revenues during that period.

Note 3. Income Tax

KeySpan files a consolidated federal income tax return. A tax sharing agreement between the holding company and its subsidiaries provides for the allocation of a realized tax liability or asset based upon separate return contributions of each subsidiary to the consolidated taxable income or loss in the consolidated income tax return. The subsidiaries record income tax payable or receivable from KeySpan resulting from the inclusion of their taxable income or loss in the consolidated return.

Income tax expense is reflected as follows in the Consolidated Statement of Income:

			(In Thousands of Dollars)
YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Current income tax	$201,909	$ (99,798)	$ (36,588)
Deferred income tax	123,631	381,079	266,253
Total income tax	$325,540	$281,281	$229,665

At December 31, the significant components of KeySpan's deferred tax assets and liabilities calculated under the provisions of SFAS No.109 "Accounting for Income Taxes" were as follows:

		(In Thousands of Dollars)
DECEMBER 31,	**2004**	**2003**
Reserves not currently deductible	$ 4,598	$ 34,342
New York corporation income tax	(19,010)	(56,188)
Property related differences	(1,080,033)	(1,049,237)
Regulatory tax asset	(21,433)	(21,222)
Property taxes	(99,106)	(98,089)
Other items – net	90,855	(85,164)
Net deferred tax liability	$(1,124,129)	$(1,275,558)

During the year ended December 31, 2002, an adjustment to deferred income taxes of $177.7 million was recorded to reflect a decrease in the tax basis of the assets acquired at the time of the KeySpan/LILCO combination. This adjustment resulted from a revised valuation study. Concurrent with this deferred tax adjustment, KeySpan reduced current income taxes payable by $183.2 million, resulting in a net $5.5 million income tax benefit. Currently, the Internal Revenue Service is auditing LILCO's tax returns for the tax years ending December 31, 1996 through March 31, 1999 and KeySpan's and The Brooklyn Union Gas Company's tax returns for the tax years ending September 30, 1997 through December 31, 1998, pertaining to the KeySpan/LILCO combination, as well as other return years. The primary issue raised in the conduct of the examination relates to the valuation of the transferred assets in the KeySpan/LILCO combination. At this time, we cannot predict the outcome of the ongoing audit. However, KeySpan has evaluated the potential outcomes which may result based on the progress of the examination to date and believes that it has adequately provided for any potential tax which may be assessed.

The federal income tax amounts included in the Consolidated Statement of Income differ from the amounts which result from applying the statutory federal income tax rate to income before income tax.

The table below sets forth the reasons for such differences:

			(In Thousands of Dollars)
YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Computed at the statutory rate	$329,089	$247,573	$212,788
Adjustments related to:			
Tax credits	(2,150)	—	(1,026)
Removal costs	(584)	(6,592)	(4,787)
Accrual to return adjustments	(10,718)	549	(9,539)
Sale of Houston Exploration	(8,445)	—	—
Sale of KeySpan Canada	(14,067)	—	—
Minority interest in Houston Exploration	12,879	19,969	9,490
State income tax, net of federal benefit	24,833	28,462	42,125
Other items – net	(5,297)	(8,680)	(19,386)
Total income tax	$325,540	$281,281	$229,665
Effective income tax rate (1)	35%	40%	38%

(1) Reflects both federal as well as state income taxes.

In December 2004, the FASB issued Staff Position ("FSP") No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004." The American Jobs Creation Act of 2004 (the "Act"), signed into law on October 22, 2004, provides for a special one-time tax deduction, or dividend received deduction ("DRD"), of 85% of qualifying foreign earnings that are repatriated in either a company's last tax year that began before the enactment date or the first tax year that begins during the one-year period beginning on the enactment date. FSP 109-2 provides entities additional time to assess the effect of repatriating foreign earnings under the Act for purposes of applying SFAS 109, "Accounting for Income Taxes," which typically requires the effect of a new tax law to be required in the period of enactment. KeySpan will elect, if applicable, to apply the DRD to qualifying dividends of foreign earnings repatriated in 2005. KeySpan is awaiting further clarifying guidance from the U.S. Treasury Department on certain provisions of the Act. Once this guidance is received, KeySpan expects to complete its evaluation of the effects of the Act during 2005. Because the evaluation is ongoing, it is not yet practical to estimate a range of possible income tax effects of potential repatriations.

Note 4. Postretirement Benefits

Pension Plans: The following information represents the consolidated results for our noncontributory defined benefit pension plans which cover substantially all employees. Benefits are typically based on age, years of service and compensation. Funding for pensions is in accordance with requirements of federal law and regulations. KEDLI and Boston Gas Company are subject to certain deferral accounting requirements mandated by the NYPSC and MADTE, respectively for pension costs and other postretirement benefit costs.

The calculation of net periodic pension cost is as follows:

		(In Thousands of Dollars)	
YEAR ENDED DECEMBER 31,	2004	2003	2002
Service cost, benefits earned during the period	$ 52,908	$ 47,531	$ 42,423
Interest cost on projected benefit obligation	144,241	138,270	132,424
Expected return on plan assets	(158,267)	(130,556)	(157,958)
Net amortization and deferral	63,307	66,949	(4,247)
Total pension cost	$102,189	$122,194	$ 12,642

The following table sets forth the pension plans' funded status at December 31, 2004 and December 31, 2003.

	(In Thousands of Dollars)	
YEAR ENDED DECEMBER 31,	2004	2003
Change in benefit obligation:		
Benefit obligation at beginning of period	$(2,343,196)	$(2,080,193)
Service cost	(52,908)	(47,531)
Interest cost	(144,241)	(138,270)
Amendments	(2,316)	(3,079)
Actuarial loss	(114,597)	(192,617)
Benefits paid	137,142	118,494
Benefit obligation at end of period	(2,520,116)	(2,343,196)
Change in plan assets:		
Fair value of plan assets at beginning of period	1,855,239	1,544,518
ctual return on plan assets	164,225	335,757
mployer contribution	146,565	93,458
enefits paid	(137,142)	(118,494)
air value of plan assets at end of period	2,028,887	1,855,239
unded status	(491,229)	(487,957)
nrecognized net loss from past experience different from that assumed and from changes in assumptions	612,145	557,204
recognized prior service cost	57,653	64,925
t prepaid pension cost reflected on consolidated balance sheet	$ 178,569	$ 134,172

YEAR ENDED DECEMBER 31,	2004	2003	2002
Assumptions:			
Obligation discount	6.00%	6.25%	6.75%
Asset return	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	4.00%

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years indicated:

	(In Thousands of Dollars)
	PENSION BENEFITS
2005	$127,287
2006	$128,708
2007	$131,000
2008	$134,934
2009	$139,048
Years 2010 – 2014	$796,286

Unfunded Pension Obligation: At December 31, 2004 the accumulated benefit obligation was in excess of pension assets. As prescribed by SFAS 87 "Employers' Accounting for Pensions," KeySpan had a $255.9 million minimum liability at December 31, 2004, for this unfunded pension obligation. As permitted under current accounting guidelines, these accruals can be offset by a corresponding debit to a long-term asset up to the amount of accumulated unrecognized prior service costs. Any remaining amount is to be recorded in Accumulated Other Comprehensive Income on the Consolidated Balance Sheet.

Therefore, at year-end, we had a long-term asset in deferred charges other of $49.7 million, representing the amount of unrecognized prior service cost and a debit to other comprehensive income of $91.9 million, or $59.8 million after-tax. The remaining amount of $114.3 million was recorded as a contractual receivable from LIPA of $100.1 million and a regulatory asset of $14.2 million, representing the amounts that could be recovered from LIPA and the Boston Gas ratepayer in accordance with our service and rate agreements if the underlying assumptions giving rise to this minimum liability were realized and recorded as pension expense. The Boston Gas Company has received approval from the MADTE to defer as a regulatory asset the amount of its current and future minimum pension liability to reflect its ability to recover in rates its actual pension liability.

At December 31, 2004 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in excess of plan assets were $1.3 billion, $1.2 billion and $881 million, respectively.

At December 31, 2003, the accumulated benefit obligation was also in excess of pension assets. As a result, we had a minimum liability of $244.4 million, a long-term asset in deferred charges other of $55.3 million, and a debit to other comprehensive income of $79.9 million, or $51.9 million after-tax. The remaining amount of $109.2 million was recorded as a contractual receivable from LIPA of $95.8 million and a regulatory asset of $13.4 million.

At December 31, 2003 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in excess of plan assets were $1.2 billion, $1.1 billion and $794 million, respectively.

At the end of each year, we will re-measure the accumulated benefit obligation and pension assets, and adjust the accrual and deferrals as appropriate.

Other Postretirement Benefits: The following information represents the consolidated results for our contributory medical and prescription drug programs and non-contributory life insurance programs for retired employees. We have 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.

Net periodic other postretirement benefit cost included the following components:

			(In Thousands of Dollars)
YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Service cost, benefits earned during the period	$19,656	$18,825	$16,566
Interest cost on accumulated postretirement benefit obligation	70,225	69,803	65,486
Expected return on plan assets	(33,892)	(27,530)	(36,839)
Net amortization and deferral	40,981	35,815	17,527
Other postretirement cost	$96,970	$96,913	$62,740

The following table sets forth the plans' funded status at December 31, 2004 and December 31, 2003.

		(In Thousands of Dollars)
YEAR ENDED DECEMBER 31,	**2004**	**2003**
Change in benefit obligation:		
Benefit obligation at beginning of period	$(1,267,624)	$(1,056,944)
Impact due to new Medicare subsidy	60,578	—
Service cost	(19,656)	(18,825)
Interest cost	(70,225)	(69,803)
Plan participants' contributions	(1,933)	(1,757)
Amendments	27,392	35,458
Actuarial (loss)	(119,914)	(209,446)
Benefits paid	54,644	53,693
Benefit obligation at end of period	(1,336,738)	(1,267,624)
Change in plan assets:		
Fair value of plan assets at beginning of period	438,434	361,166
Actual return on plan assets	38,765	85,625
Employer contribution	39,510	43,578
Plan participants' contributions	1,932	1,757
Benefits paid	(54,644)	(53,693)
Fair value of plan assets at end of period	463,997	438,433
Funded status	(872,741)	(829,191)
Unrecognized net loss from past experience different from that assumed and from changes in assumptions	576,856	573,277
Unrecognized prior service cost	(106,523)	(89,034)
Accrued postretirement cost reflected on consolidated balance sheet	$ (402,408)	$ (344,948)

YEAR ENDED DECEMBER 31,	**2004**	**2003**	**2002**
Assumptions:			
Obligation discount	6.00%	6.25%	6.75%
Asset return	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	4.00%

The measurement of plan liabilities also assumes a health care cost trend rate of 11.0% grading down to 5.0% over five years, and 5.0% thereafter. A 1% increase in the health care cost trend rate would have the effect of increasing the accumulated postretirement benefit obligation as of December 31, 2004 by $158.0 million and the net periodic health care expense by $12.6 million. A 1% decrease in the health care cost trend rate would have the effect of decreasing the accumulated postretirement benefit obligation as of December 31, 2004 by $138.4 million and the net periodic health care expense by $10.7 million.

The reduction in the APBO for the subsidy related to the benefits attributed to past service is $60.6 million. The effect of the subsidy on the measurement of net periodic postretirement benefit cost for the current period is $10.1 million. That effect includes amortization of the actuarial experience gain in the reduction in the APBO, for the subsidy

related to benefits attributed to past service, as a component of the net amortization called for by paragraph 59 of SFAS 106 of $5.8 million. The reduction in the current period service cost due to the subsidy is $0.5 million. The resulting reduction in interest cost on the APBO as a result of the subsidy is $3.8 million.

At December 31, 2004, KeySpan had a contractual receivable from LIPA of $256.9 million representing the postretirement benefits associated with the electric business unit employees recorded in deferred charges other on the Consolidated Balance Sheet. LIPA has been reimbursing us for costs related to the postretirement benefits of the electric business unit employees in accordance with the LIPA Agreements.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years indicated:

	(In Thousands of Dollars)	
	GROSS BENEFIT PAYMENTS	**SUBSIDIARY RECEIPTS EXPECTED***
2005	$ 63,563	$ —
2006	$ 67,257	$ 3,530
2007	$ 70,605	$ 3,843
2008	$ 73,417	$ 4,145
2009	$ 76,368	$ 4,408
Years 2010 – 2014	$418,664	$24,631

* *Rebates are based on calendar year in which prescription drug costs are incurred. Actual receipt of rebates may occur in the following year.*

Pension/Other Post Retirement Benefit Plan Assets: Keyspan's weighted average asset allocations at December 31, 2004 and 2003, by asset category, for both the pension and other postretirement benefit plans are as follows:

	PENSION		OPEB	
ASSET CATEGORY	**2004**	**2003**	**2004**	**2003**
Equity securities	64%	61%	72%	68%
Debt securities	28%	31%	23%	26%
Cash and equivalents	3%	2%	—	2%
Venture capital	5%	6%	5%	4%
Total	100%	100%	100%	100%

The long-term rate of return on assets (pre-tax) is assumed to be 8.5% which management believes is an appropriate long-term expected rate of return on assets based on our investment strategy, asset allocation mix and the historical performance of equity and fixed income investments over long periods of time. The actual ten-year compound rate of return for our Plans is greater than 8.5%.

Our master trust investment allocation policy target for the assets of the pension and other postretirement benefit plans is 70% equity and 30% fixed income.

During 2003, KeySpan conducted an asset and liability study projecting asset returns and expected benefit payments over a ten-year period. Based on the results of the study, KeySpan developed a multi-year funding strategy for its plans. We believe that it is reasonable to assume assets can achieve or outperform the assumed long-term rate of return with the target allocation as a result of historical performance of equity investments over long-term periods.

Cash Contributions: In 2005, KeySpan is expected to contribute approximately $82 million to its pension plans and approximately $36 million to its other postretirement benefit plans.

Defined Contribution Plan: KeySpan also offers both its union and management employees a defined contribution plan. Both the KeySpan Energy 401(k) Plan for Management Employees and the KeySpan Energy 401(k) Plan for Union Employees are available to all eligible employees. These Plans are defined contribution plans subject to Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"). All eligible employees contributing to the Plan receive a certain employer matching contribution based on a percentage of the employee contribution, as well as a 10% discount on the KeySpan Common Stock Fund. The matching contributions are in KeySpan's common stock. For the years ended December 31, 2004, 2003 and 2002, we recorded an expense of $14.7 million, $11.2 million, and $11.2 million, respectively.

Note 5. Capital Stock

Common Stock: Currently we have 450,000,000 shares of authorized common stock. In 1998, we initiated a program to repurchase a portion of our outstanding common stock on the open market. At December 31, 2004, we had 11.9 million shares, or approximately $345 million of treasury stock outstanding. We completed this repurchase plan in 1999 and have since utilized treasury stock to satisfy our common stock benefit plans. During 2004, we issued 1.2 million shares out of treasury for the dividend reinvestment feature of our Investor Program, the Employee Stock Discount Purchase Plan, the 401(k) Plan and Stock Option Plans.

Preferred Stock: We have the authority to issue 100,000,000 shares of preferred stock with the following classifications: 16,000,000 shares of preferred stock, par value $25 per share; 1,000,000 shares of preferred stock, par value $100 per share; and 83,000,000 shares of preferred stock, par value $.01 per share.

At December 31, 2004 we had 553,000 shares outstanding of 7.07% Mandatory Redeemable Preferred Stock Series B par value $100 redeemable in 2005; and 197,000 shares outstanding of 7.17% Mandatory Redeemable Preferred Stock Series C par value $100 redeemable in 2008.

In July 2004, KeySpan redeemed 83,268 shares of preferred stock 6.00% Series A par value $100 that were previously issued in a private placement. KeySpan redeemed these shares at a 2% premium and incurred a cash expenditure of $8.5 million.

Note 6. Long-Term Debt

Notes Payable: KEDLI had $125 million of Medium-Term Notes at 6.90% due January 15, 2008, and $400 million of 7.875% Medium-Term Notes due February 1, 2010, outstanding at December 31, 2004, each of which is guaranteed by KeySpan.

KeySpan had $2.66 billion of medium and long term notes outstanding at December 31, 2003 of which $1.65 billion of these notes were associated with the acquisition of Eastern and ENI. These notes were issued in three series as follows: $700 million, 7.25% Notes due 2005; $700 million, 7.625% Notes due 2010 and $250 million, 8.00% Notes due 2030. During 2004, KeySpan redeemed the $700 million, 7.25% Notes due 2005 series. We applied the provisions of SFAS 145 "Rescission of FASB Statement No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections" and recorded an expense of $48.9 million reflecting call premiums of $40.9 million and the write-off of $8.0 million of previously deferred financing costs. The call premiums are reflected in other income and (deductions) while the write-off of previously deferred financing costs have been reflected in interest expense on the Consolidated Statement of Income. Therefore, at December 31, 2004 KeySpan has $1.96 billion of notes remaining having interest rates ranging from 4.65% to 9.75% that mature in 2005-2033.

On January 14, 2005, KeySpan redeemed $500 million 6.15% Series due 2006 of outstanding debt. KeySpan incurred $20.9 million in call premiums and wrote-off $1.0 million of previously deferred financing costs.

Gas Facilities Revenue Bonds: KEDNY can issue tax-exempt bonds through the New York State Energy Research and Development Authority. Whenever bonds are issued for new gas facilities projects, proceeds are deposited in trust and subsequently withdrawn to finance qualified expenditures. There are no sinking fund requirements on any of our Gas Facilities Revenue Bonds. During 2004, KEDNY retired $8.0 million of its outstanding Gas Facilities Revenue Bonds. The funds used to retire this debt were drawn from a special deposit defeasance trust previously established by KEDNY. Therefore, at December 31, 2004 $640.5 million of Gas Facilities Revenue Bonds remain outstanding. The interest rate on the variable rate series due December 1, 2020 is reset weekly and ranged from 0.64% to 1.65% during the year ended December 31, 2004, at which time the rate was 1.65%.

Promissory Notes: In connection with the KeySpan/LILCO transaction, KeySpan and certain of its subsidiaries issued promissory notes to LIPA to support certain debt obligations assumed by LIPA. At December 31, 2004, $155.4 million of these promissory notes remained outstanding. Under these promissory notes, KeySpan is required to obtain letters of credit to secure its payment obligations if its long-term debt is not rated at least in the "A" range by at least two nationally recognized statistical rating agencies. At December 31, 2004, KeySpan was in compliance with this requirement.

MEDS Equity Units: At December 31, 2004, KeySpan had $460 million of MEDS Equity Units outstanding at 8.75% consisting of a three-year forward purchase contract for our common stock and a six-year note. The purchase contract commits us, three years from the date of issuance of the MEDS Equity Units, May 2005, to issue and the investors to purchase, a number of shares of our common stock based on a formula tied to the market price of our common stock at that time. The 8.75% coupon is composed of interest payments on the six-year note of 4.9% and premium payments on the three-year equity forward contract of 3.85%. These instruments have been recorded as long-term debt on the Consolidated Balance Sheet. Further, upon issuance of the MEDS Equity Units, we recorded a direct charge to retained earnings of $49.1 million, which represents the present value of the forward contract's premium payments.

There were 9.2 million MEDS Equity units issued which are subject to conversion upon execution of the three-year forward purchase contract. The number of shares to be issued depends on the average closing price of our common stock over the 20 day trading period ending on the third trading day prior to May 16, 2005. If the average closing price over this time frame is less than or equal to $35.30 of KeySpan's common stock, 13 million shares will be issued. If the average closing price over this time frame is greater than or equal to $42.36, 10.9 million shares will be issued. The number of shares issued at a price between $35.30 and $42.36 will be between 10.9 million and 13 million based upon a sliding scale.

These securities are currently not considered convertible instruments for purposes of applying SFAS 128 "Earnings Per Share" calculations, unless or until such time as the market value of our common stock reaches a threshold appreciation price ($42.36 per share) that is higher than the current per share market value. Interest payments do, however, reduce net income and earnings per share.

Industrial Development Revenue Bonds: At December 31, 2004 KeySpan had outstanding $128.3 million of tax-exempt bonds with a 5.25% coupon maturing in June 2027. Fifty-three million dollars of these Industrial Development Revenue Bonds were issued in its behalf 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 in its behalf by the Suffolk County Industrial Development Authority for the Port Jefferson electric-generation peaking plant. KeySpan has guaranteed all payment obligations of our subsidiaries with regard to these bonds.

First Mortgage Bonds: Colonial Gas Company ("Colonial"), Essex Gas Company ("Essex"), ENI and their respective subsidiaries, had outstanding $153.2 million of first mortgage bonds at December 31, 2003. These bonds are secured by KEDNE gas utility property. The first mortgage bond indentures include, among other provisions, limitations on: (i) the issuance of long-term debt; (ii) engaging in additional lease obligations; and (iii) the payment of dividends from retained earnings. During 2004, KeySpan redeemed $58.2 million of these bonds, representing all previously outstanding bonds of Essex and ENI. KeySpan incurred call premiums of $13.6 million associated with this redemption, of which $5.0 million was expensed. The remaining amount of the call premiums have been deferred for future regulatory recovery. Further, KeySpan wrote-off $0.2 million of previously deferred financing costs. The call premiums are reflected in other income and (deductions) while the write-off of previously deferred financing costs have been reflected in interest expense on the Consolidated Statement of Income. Therefore, at December 31, 2004, $95.0 million of first mortgage bonds remain outstanding having interest rates ranging from 6.08% to 8.80% and maturities that range from 2008-2028.

Authority Financing Notes: Certain of our electric generation subsidiaries can issue tax-exempt bonds through the New York State Energy Research and Development Authority. At December 31, 2004, $41.1 million of Authority Financing Notes 1999 Series A Pollution Control Revenue Bonds due October 1, 2028 were outstanding. The interest rate on these notes is reset based on an auction procedure. The interest rate during 2004 ranged from 0.75% to 1.50%, through December 31, 2004, at which time the rate was 1.45%.

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 ranged from 0.88% to 2.01% from January 1, 2004 through December 31, 2004, at which time the rate was 2.01%.

Ravenswood Master Lease: We have an arrangement with a variable interest unaffiliated entity through which we lease a portion of the Ravenswood Facility. We acquired the Ravenswood Facility, in part, through the variable interest entity, from Consolidated Edison on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into a lease agreement (the "Master Lease") with a variable interest, unaffiliated financing entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to a KeySpan subsidiary. The variable interest financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity. KeySpan has guaranteed all payment and performance obligations of our subsidiary under the Master Lease. Monthly lease payments are substantially equal to the monthly interest expense on the debt securities.

We have classified the Master Lease as $412.3 million of long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary as defined in Financial Accounting Standards Board Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." Further, we have an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date, or approximately $339.6 million. Under the terms of our two credit facilities, the Master Lease is considered debt in the ratio of debt-to-total capitalization. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding the leasing arrangement associated with the Master Lease Agreement.)

Registered Securities: In 2004, in accordance with its PUHCA authorization, KeySpan filed a new universal shelf registration statement on Form S-3 with the SEC for the issuance from time to time of up to $3.0 billion in securities. This authorization provides KeySpan with the necessary flexibility to finance future capital requirements for the next several years.

Commercial Paper and Revolving Credit Agreements: In 2004, KeySpan restructured its credit facilities. We entered into a new $640 million five year revolving credit facility to replace the $450 million, 364 day facility which expired in June 2004. We also amended our existing three year $850 million facility due June 2006 to reduce commitments thereunder by $190 million to $660 million. The two credit facilities total $1.3 billion and are each syndicated among sixteen banks. These facilities continue to support KeySpan's commercial paper program for working capital needs.

The fees for these facilities are subject to a ratings-based grid, with an annual fee of 0.08% on the new five-year facility and 0.125% on the existing three-year facility. Both credit agreements allow for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans in the five-year facility are based on the Eurodollar rate plus a margin of 0.40% for loans up to 33% of the facility, and an additional 0.125% for loans over 33% of the facility. In the three-year facility Eurodollar loans are based on the Eurodollar rate plus a margin of 0.625% for loans up to 33% of the facility, and an additional 0.125% for loans over 33% of the facility. ABR loans are based on the highest of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders. We do not anticipate borrowing against these facilities; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The facilities contain certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its property to any lien, as well as certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 64% until the expiration of the existing three-year facility in 2006, at which time it will be lowered to 62%. Violation of this covenant could result in the termination of the facilities and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements.

Under the terms of the credit facility, the calculation of KeySpan's debt-to-total capitalization ratio reflects 80% equity treatment for the MEDS Equity Units. At December 31, 2004, consolidated indebtedness, as calculated under the terms of the credit facility, was 53.4% of consolidated capitalization. Violation of this covenant could result in the termination of the credit facility and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements.

At December 31, 2004, we had cash and temporary cash investments of $922.0 million. During 2004, we borrowed $430.3 million of commercial paper and, at December 31, 2004, $912.2 million of commercial paper was outstanding at a weighted average annualized interest rate of 2.4%. We had the ability to borrow up to an additional $387.8 million at December 31, 2004, under the commercial paper program.

As a result of the sale of Houston Exploration and KeySpan Canada, the credit facilities of these previous subsidiaries are no longer reflected on KeySpan's Consolidated Balance Sheet. However, the borrowings and repayments through these credit facilities are reflected on KeySpan's Consolidated Cash Flow Statement for the period that these subsidiaries were consolidated. During the time period that Houston Exploration's results were consolidated with KeySpan's (the five months ended May 31, 2004) Houston Exploration borrowed $49 million under its credit facility and repaid $136 million. KeySpan Canada repaid $17.7 million under its facility during the first three months of 2004 (the time period in which its results were consolidated with KeySpan's).

Capital Leases: Our subsidiaries lease certain facilities and equipment under long-term leases, which expire on various dates through 2022. The weighted average interest rate on these obligations was 6.07%.

Debt Maturity: The following table reflects the maturity schedule for our debt repayment requirements, including capitalized leases and related maturities, at December 31, 2004:

			(In Thousands of Dollars)
	LONG-TERM DEBT	CAPITAL LEASES	TOTAL
Repayments:			
2005	$ 15,000	$ 1,103	$ 16,103
2006	512,000	1,006	513,006
2007	—	1,063	1,063
2008	605,000	1,129	606,129
2009	412,250	1,197	413,447
Thereafter	2,898,200	6,335	2,904,535
	$4,442,450	$11,833	$4,454,283

Note 7. Contractual Obligations, Financial Guarantees and Contingencies

Lease Obligations: Lease costs included in operation expense were $67.7 million in 2004 reflecting, primarily, the lease of KeySpan's Brooklyn headquarters of $14.4 million. Further, in May 2004 KeySpan entered into a leveraged lease financing arrangement associated with the Ravenswood Expansion. The yearly operating lease expense is expected to be approximately $17 million per year. For the period May 2004 through December 31, 2004 lease expense associated with this lease was $10.5 million. (See the caption below "Sale/Leaseback Transaction" for further details of this lease.) Lease costs also include leases for other buildings, office equipment, vehicles and power operated equipment. Lease costs for the year ended December 31, 2003 and 2002 were $82.1 million and $71.1 million, respectively. As previously mentioned, the Master Lease has been consolidated and, as a result, lease payments in 2004 have been reflected as interest expense on the Consolidated Statement of Income. The future minimum cash lease payments under various leases, excluding the Master Lease, but including the Ravenswood Expansion lease, all of which are operating leases, are $91.5 million per year over the next five years and $552.7 million, in the aggregate, for all years thereafter. (See discussion below for further information regarding the Master Lease and the Ravenswood Expansion sale/leaseback transaction.)

Variable Interest Entity: As mentioned, KeySpan has an arrangement with a variable interest entity through which we lease a portion of the Ravenswood Facility. We acquired the Ravenswood Facility, a 2,200-megawatt electric generating facility located in Queens, New York, in part, through the variable interest entity from Consolidated Edison on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into the Master Lease with a variable interest, unaffiliated financing entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to our subsidiary. The variable interest unaffiliated financing

entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity. KeySpan has guaranteed all payment and performance obligations of our subsidiary under the Master Lease. Monthly lease payments substantially equal the monthly interest expense on such debt securities. Interest expense for the year ended December 31, 2004 was $29.9 million.

The initial term of the Master Lease expired on June 20, 2004 and was extended until June 20, 2009 pursuant to the terms of the Master Lease. On all future semi-annual payment dates, we have the right to: (i) either purchase the facility for the original acquisition cost of $425 million, plus the present value of the lease payments that would otherwise have been paid through June 2009; or (ii) terminate the Master Lease and dispose of the facility. In June 2009, when the Master Lease terminates, we may purchase the facility in an amount equal to the original acquisition cost, subject to adjustment, or surrender the facility to the lessor. If we elect not to purchase the property, the Ravenswood Facility will be sold by the lessor. We have guaranteed to the lessor 84% of the residual value of the original cost of the property.

We have classified the Master Lease as $412.3 million of long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary. Further, we have an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date, or approximately $339.6 million.

If our subsidiary that leases the Ravenswood Facility was not able to fulfill its payment obligations with respect to the Master Lease payments, then the maximum amount KeySpan would be exposed to under its current guarantees would be $425 million plus the present value of the remaining lease payments through June 20, 2009.

Sale/leaseback Transaction: KeySpan also has a leveraged lease financing arrangement associated with the Ravenswood Expansion. In May 2004, the unit was acquired by a lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to that subsidiary. All the obligations of KeySpan Ravenswood, LLC have been unconditionally guaranteed by KeySpan. This lease transaction generated cash proceeds of $385 million, before transaction costs, which approximates the fair market value of the facility, as determined by a third-party appraiser. This lease transaction qualifies as an operating lease under SFAS 98 "Accounting for Leases: Sale/Leaseback Transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; an Initial Direct Costs of Direct Financing Leases, an amendment of FASB Statements No.13, 66, 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11." The lease has an initial term of 36 years and the yearly operating lease expense is approximately $17 million per year. Lease payments will fluctuate from year to year, but are substantially paid over the first 16 years. The future minimum cash lease payments under this lease is approximately $142 million over the next five years and $457 million, in the aggregate, for all years thereafter. The sale/leaseback transaction resulted in a pre-tax gain of approximately $6 million which has been deferred and is being amortized over the life of the lease.

Asset Retirement Obligations: In 2003, KeySpan adopted SFAS 143, "Accounting for Asset Retirement Obligations." 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 the time of implementation, KeySpan recorded an asset retirement obligation ("ARO") related to its investment in Houston Exploration and its other gas exploration and production subsidiaries. At January 1, 2003 the ARO was $57.2 million. As a result of additions from purchases and drilling during 2003 the ARO increased to $92.4 million at December 31, 2003. Since Houston Exploration's operations have been deconsolidated, Houston Exploration's liability is no longer reflected on KeySpan's Consolidated Balance Sheet at December 31, 2004. The remaining ARO, therefore, is related to our continuing gas exploration and production activities and was approximately $1.9 million at December 31, 2004.

KeySpan's largest asset base is its gas transmission and distribution system. A legal obligation exists due to certain safety requirements at final abandonment. In addition, a legal obligation may be construed to exist with respect to KeySpan's liquefied natural gas ("LNG") storage tanks due to clean up responsibilities upon cessation of use. However, mass assets such as storage, transmission and distribution assets are believed to operate in perpetuity and, therefore, have indeterminate cash flow estimates. Since that exposure is in perpetuity and cannot be measured, no liability has been recorded pursuant to SFAS 143. KeySpan's ARO will be re-evaluated in future periods until sufficient information exists to determine a reasonable estimate of such obligation.

Financial Guarantees: KeySpan has issued financial guarantees in the normal course of business, primarily on behalf of its subsidiaries, to various third party creditors. At December 31, 2004, the following amounts would have to be paid by KeySpan in the event of non-payment by the primary obligor at the time payment is due:

(In Thousands of Dollars)

		AMOUNT OF EXPOSURE	EXPIRATION DATES
Guarantees for Subsidiaries			
Medium-Term Notes – KEDLI	(i)	$ 525,000	2008 – 2010
Industrial Development Revenue Bonds	(ii)	128,000	2027
Ravenswood – Master Lease	(iii)	425,000	2009
Ravenswood – Sale/leaseback	(iv)	385,000	2040
Surety Bonds	(v)	258,000	2005 – 2008
Commodity Guarantees and Other	(vi)	74,000	2005
Letters of Credit	(vii)	74,000	2005
		$1,869,000	

The following is a description of KeySpan's outstanding subsidiary guarantees:

(i) KeySpan has fully and unconditionally guaranteed $525 million to holders of Medium-Term Notes issued by KEDLI. These notes are due to be repaid on January 15, 2008 and February 1, 2010. KEDLI is required to comply with certain financial covenants under the debt agreements. The face values of these notes are included in long-term debt on the Consolidated Balance Sheet.

(ii) KeySpan has fully and unconditionally guaranteed the payment obligations of its subsidiaries with regard to $128 million of Industrial Development Revenue Bonds issued through the Nassau County and Suffolk County Industrial Development Authorities for the construction of two electric-generation peaking plants on Long Island. The face values of these notes are included in long-term debt on the Consolidated Balance Sheet.

(iii) KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, the lessee under the Master Lease. The initial term of the lease expired on June 20, 2004 and was extended until June 20, 2009. The Master Lease is classified as $412.3 million long-term debt on the Consolidated Balance Sheet.

(iv) KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, the lessee under the sale/leaseback transaction associated with the 250 MW Ravenswood Expansion. The initial term of the lease is for 36 years. As noted previously, this lease qualifies as an operating lease and is not reflected on the Consolidated Balance Sheet.

(v) KeySpan has agreed to indemnify the issuers of various surety and performance bonds associated with certain construction projects currently being performed by certain current and former subsidiaries within the Energy Services segment. In the event that the operating companies in the Energy Services segment fail to perform their obligations under contracts, the injured party may demand that the surety make payments or provide services under the bond. KeySpan would then be obligated to reimburse the surety for any expenses or cash outlays it incurs. KeySpan will continue to provide this guarantee for the mechanical contracting companies throughout the construction period of the currently outstanding projects. It is contemplated that the majority of the current contracts will be completed by the end of 2005. In addition, as discussed in Note 11 "Energy Services – Discontinued Operations," a performance and payment bond issued for the benefit of a former subsidiary with respect to a pending project, which bond had been supported by a $150 million indemnity obligation included in the table above, has been replaced. KeySpan has also received from a former subsidiary an indemnity bond issued by a third party insurance company, the purpose of which is to reimburse KeySpan in an amount up to $80 million in the event it is required to perform under all other indemnity obligations previously incurred by KeySpan to support such company's bonded projects existing prior to divestiture.

(vi) KeySpan has guaranteed commodity-related payments for subsidiaries within the Energy Services segment, as well as KeySpan Ravenswood, LLC. These guarantees are provided to third parties to facilitate physical and financial transactions involved in the purchase of natural gas, oil and other petroleum products for electric production and marketing activities. The guarantees cover actual purchases by these subsidiaries that are still outstanding as of December 31, 2004.

(vii) KeySpan has arranged for stand-by letters of credit to be issued to third parties that have extended credit to certain subsidiaries. Certain vendors require us to post letters of credit to guarantee subsidiary performance under our contracts and to ensure payment to our subsidiary subcontractors and vendors under those contracts. Certain of our vendors also require letters of credit to ensure reimbursement for amounts they are disbursing on behalf of our subsidiaries, such as to beneficiaries under our self-funded insurance programs. Such letters of credit are generally issued by a bank or similar financial institution. The letters of credit commit the issuer to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, KeySpan would be required to reimburse the issuer of the letter of credit.

To date, KeySpan has not had a claim made against it for any of the above guarantees or letters of credit and we have no reason to believe that our subsidiaries or former subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact such defaults may have on our consolidated results of operations, financial condition or cash flows.

Fixed Charges Under Firm Contracts: Our utility subsidiaries and the Ravenswood Facility have entered into various contracts for gas delivery, storage and supply services. Certain of these contracts require payment of annual demand charges in the aggregate amount of approximately $485 million. We are liable for these payments regardless of the level of service we require from third parties. Such charges associated with gas distribution operations are currently recovered from utility customers through the gas adjustment clause.

Legal Matters: From time to time we are subject to various legal proceedings arising out of the ordinary course of our business. Except as described below, 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, financial condition or cash flows.

KeySpan and certain of its current and former officers and directors are defendants in a consolidated class action lawsuit filed in the United States District Court for the Eastern District of New York. This lawsuit alleges, among other things, violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), in connection with disclosures relating to or following the acquisition of the Roy Kay companies. In June 2004, the parties reached an agreement in principle to settle the consolidated class action lawsuit for $13.8 million. The proposed settlement provides for KeySpan to make certain payments to plaintiffs, all of which is to be funded by the insurance carrier providing liability coverage for KeySpan's directors and officers. While KeySpan continues to deny any wrongdoing, we believe the proposed settlement is in the best interest of KeySpan and its shareholders. The settlement is subject to court approval, the timing of which cannot be determined.

On February 9, 2005, KeySpan was served with a shareholder derivative action asserting claims on behalf of KeySpan based upon breach of fiduciary duty. The complaint, which was filed in the New York State Supreme Court for the County of Kings, relates to the 2001 Roy Kay related losses and alleges that KeySpan's directors and certain senior officers breached their fiduciary duties when they placed their own personal interests above the interests of KeySpan by using material non-public information (the fraud at Roy Kay) to sell securities at artificially inflated prices.

This new complaint asserts essentially the same allegations as contained in two prior federal shareholder derivative actions which were commenced in October 2001 and June 2002. On March 15, 2004, KeySpan and the individual defendants filed a motion to dismiss those earlier federal complaints. On April 14, 2004, the plaintiffs filed a notice of voluntary withdrawal of their actions. On April 23, 2004, the federal court dismissed both actions without prejudice. KeySpan intends to file a motion to dismiss this new complaint. While KeySpan denies any wrongdoing, the outcome of this proceeding cannot be determined as yet.

In late 2001, KeySpan received inquires from the U.S. Attorney's Office, Southern District of New York and the SEC regarding trading in KeySpan Corporation stock by individual officers of KeySpan prior to the July 17, 2001 announcement that KeySpan was taking a special charge in its Energy Services business and otherwise reducing its 2001 earnings forecast.

In March 2002, the SEC issued a formal order of investigation pursuant to which it indicated that it would review the trading activity of certain company insiders as well as KeySpan's compliance with reporting rules and regulations, generally during the period following the acquisition of the Roy Kay companies through the July 17, 2001 announcement. Since mid 2002, KeySpan has not received any further notifications or inquires concerning any of these matters.

KeySpan subsidiaries, along with several other parties, have been named as defendants in numerous proceedings filed by plaintiffs claiming various degrees of injury from asbestos exposure at generating facilities formerly owned by Long Island Lighting Company ("LILCO") and others. In connection with the May 1998 transaction with LIPA, costs incurred by KeySpan for liabilities for asbestos exposure arising from the activities of the generating facilities previously owned by LILCO are recoverable from LIPA through the Power Supply Agreement ("PSA") between LIPA and KeySpan.

KeySpan is unable to determine the outcome of the outstanding asbestos proceedings, but does not believe that such outcome, if adverse, will have a material effect on its financial condition, results of operation or cash flows. KeySpan believes that its cost recovery rights under the PSA, its indemnification rights against third parties and its insurance coverage (above applicable deductible limits) cover its exposure for asbestos liabilities generally.

Other Contingencies: We derive a substantial portion of our revenues in our Electric Services segment from a series of agreements with LIPA pursuant to which we manage LIPA's transmission and distribution system and supply the majority of LIPA's customers' electricity needs. The agreements terminate at various dates between May 29, 2006 and May 28, 2013, and at this time we can provide no assurance that any of the agreements will be renewed or extended, or if they were to be renewed or extended, the terms and conditions thereof. In addition, given the complexity of these agreements, disputes arise from time to time between KeySpan and LIPA concerning the rights and obligations of each party to make and receive payments as required pursuant to the terms of these agreements. As a result, KeySpan is unable to determine what effect, if any, the ultimate resolution of these disputes will have on its financial condition, results of operations or cash flows.

In addition, LIPA is in the process of performing a long-term strategic review initiative regarding its future direction. It has engaged a team of advisors and consultants and is conducting public hearings to develop recommendations to be submitted to the LIPA Trustees. Some of the strategic options that LIPA is considering include whether LIPA should continue its operations as they presently exist, fully municipalize or privatize, sell some, but not all of their assets and become a regulator of rates and services. In the near term, LIPA must make a determination by May 2005 as to whether they will exercise its option to purchase our Long Island generating plants pursuant to the terms of the Generation Purchase Rights Agreement. Until LIPA makes a determination on its future direction, we are unable to determine what the outcome of this strategic review will have on our financial condition, results of operations or cash flows. Any action that may be taken will have to take into consideration the long-term nature of our existing contracts.

Environmental Matters

Air: With respect to NOx emissions reduction requirements for our existing power plants, our investments in low NOx boiler combustion modifications and the use of natural gas firing systems at our steam electric generating stations have enabled us to achieve the emission reductions required by May 1, 2003 under Phase I, II and III of the Ozone Transport Commission memorandum in a cost-effective manner. We have achieved and expect to continue to achieve such emission reductions through the use of low NOx combustion control systems, the use of natural gas fuel and/or the purchases of emission allowances when necessary. Capital expenditures were incurred between $10 million and $15 million for combustion control systems and natural gas fuel capability additions over the last several years to enhance compliance options.

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. It is not possible at this time to predict the extent of such capital investments since they will depend upon the outcome of the ongoing studies and the subsequent determination by the DEC to apply the standards set forth in recently promulgated federal regulations under Section 316 of the Clean Water Act designed to mitigate such impacts.

Land, Manufactured Gas Plants and Related Facilities

New York Sites: Within the State of New York we have identified 43 historical manufactured gas plant ("MGP") sites and related facilities, which were owned or operated by KeySpan subsidiaries or such companies' predecessors. These former sites, some of which are no longer owned by us, have been identified to the NYPSC and the DEC for inclusion on appropriate site inventories. Administrative Orders on Consent ("ACO") or Voluntary Cleanup Agreements ("VCA") have been executed with the DEC to address the investigation and remediation activities associated with certain sites. KeySpan submitted applications to the DEC for each of the remaining sites in August 2004 under the DEC's Brownfield Cleanup Program ("BCP"). As a result of a recent United States Supreme Court decision, KeySpan is currently reevaluating its continued participation in the DEC's BCP and VCA programs. Under the Supreme Court's ruling in Cooper Industries v. Aviall, KeySpan would be prohibited from bringing a contribution action against other responsible parties under the Comprehensive Environmental Response, Compensation and Liability Act unless KeySpan had been sued by the DEC and received a verdict against it or reached a settlement of the action with the DEC.

We have identified 28 of these sites as being associated with the historical operations of KEDNY. One site has been fully remediated. Subject to the issues described in the preceding paragraph, the remaining 27 sites will be investigated and, if necessary, remediated under the terms and conditions of ACOs, VCAs or Brownfield Cleanup Agreements ("BCA"). Expenditures incurred to date by us with respect to KEDNY MGP-related activities total $47.8 million.

The remaining 15 sites have been identified as being associated with the historical operations of KEDLI. Expenditures incurred to date by us with respect to KEDLI MGP-related activities total $42.7 million. One site has been fully investigated and requires no further action. The remaining sites will be investigated and, if necessary, remediated under the conditions of ACOs, VCAs or BCAs.

We presently estimate the remaining cost of our KEDNY and KEDLI MGP-related environmental remediation activities will be $206.6 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites however, remediation costs for each site may be materially higher than noted, depending upon changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered and as a result, it is possible that remediation costs could be up to $258 million higher. Expenditures incurred to date by us with respect to these MGP-related activities total $90.5 million.

With respect to remediation costs, the KEDNY rate plan provides, among other things, that if the total cost of investigation and remediation varies from that which is specifically estimated for a site under investigation and/or remediation, then KEDNY will retain or absorb up to 10% of the variation. The KEDLI rate plan also provides for the recovery of investigation and remediation costs but with no consideration of the difference between estimated and actual costs. At December 31, 2004, we have reflected a regulatory asset of $228.7 million for our KEDNY/KEDLI MGP sites. In accordance with NYPSC policy, KeySpan records a reduction to regulatory liabilities as costs are incurred for environmental clean-up activities. At December 31, 2004, these previously deferred regulatory liabilities totaled $37 million. In October 2003, KEDNY and KEDLI filed a joint petition with the NYPSC seeking rate treatment for additional environmental costs that may be incurred in the future. That petition is still pending.

We are also responsible for environmental obligations associated with the Ravenswood Facility, purchased from Consolidated Edison in 1999, including remediation activities associated with its historical operations and those of the MGP facilities that formerly operated at the site. We are not responsible for liabilities arising from disposal of waste at off-site locations prior to the acquisition closing and any monetary fines arising from Consolidated Edison's pre-closing conduct. We presently estimate the remaining environmental clean up activities for this site will be $3.1 million, which amount has been accrued by us. Expenditures incurred to date total $1.9 million.

New England Sites: Within the Commonwealth of Massachusetts and the State of New Hampshire, we are aware of 77 former MGP sites and related facilities within the existing or former service territories of KEDNE.

Boston Gas Company, Colonial Gas Company and Essex Gas Company may have or share responsibility under applicable environmental laws for the remediation of 67 of these sites. A subsidiary of National Grid USA ("National Grid"), formerly New England Electric System, has assumed responsibility for remediating 11 of these sites, subject to a limited contribution from Boston Gas Company, and has provided full indemnification to Boston Gas Company with respect to eight other sites.

ı Gas Company, Colonial Gas Company, and Essex Gas
sumed responsibility for remediating three sites each. At
.ertain as to whether Boston Gas Company, Colonial
Essex Gas Company have or share responsibility for
of the other sites. No notice of responsibility has been
any of these sites from any governmental environmental

tly estimate the remaining cost of these Massachusetts
lated environmental cleanup activities will be $14.9 mil-
ount has been accrued by us as a reasonable estimate
st for known sites, however remediation costs for each
aterially higher than noted, depending upon changing
and regulatory standards, selected end use for each site,
vironmental conditions encountered and as a result, it is
remediation costs could be up to $73 million higher.
incurred since November 8, 2000, the date KeySpan
.tern Enterprises, with respect to these MGP-related activities
million.

ı Gas Company reached settlements with certain insurance
recovery of a portion of previously incurred environmental
es. Under a previously issued MADTE rate order, insurance and
recoveries, after deducting legal fees, are shared between
.s and its firm gas customers. As a result of these settlements,
oston Gas Company recorded a $5 million benefit to operations
tenance expense.

may have or share responsibility under applicable environmental
he remediation of 10 MGP sites and related facilities associated
historical operations of EnergyNorth. At four of these sites we
ered into cost sharing agreements with other parties who share
bility for remediation of these sites. EnergyNorth also has entered
greement with the United States Environmental Protection
"EPA") for the contamination from the Nashua site that was
commingled with asbestos at the so-called Nashua River
Site, adjacent to the Nashua MGP site.

presently estimate the remaining cost of EnergyNorth MGP-
nvironmental cleanup activities will be $12.5 million, which
has been accrued by us as a reasonable estimate of probable
known sites however, remediation costs for each site may be
y higher than noted, depending upon changing technologies and
ry standards, selected end use for each site, and actual environ-
conditions encountered and as a result, it is possible that remedi-
sts could be up to $13 million higher. Expenditures incurred since
er 8, 2000, with respect to these MGP-related activities total
illion.

rate orders, the MADTE and the NHPUC provide for the recovery
nvestigation and remediation costs and, accordingly, at December
4, we have reflected a regulatory asset of $43.8 million for the
MGP sites. As previously mentioned, Colonial Gas Company and
as Company are not subject to the provisions of SFAS 71 and
e have recorded no regulatory asset. However, rate orders cur-
n effect for these subsidiaries provide for the recovery of investiga-

KeySpan New England LLC Sites: We are aware of three non-utility sites associated with KeySpan New England, LLC, a successor company to Eastern Enterprises, for which we may have or share environmental remediation or ongoing maintenance responsibility. These three sites, located in Philadelphia, Pennsylvania, New Haven, Connecticut and Everett, Massachusetts, were associated with historical operations involving the production of coke and related industrial processes. Honeywell International, Inc. and Beazer East, Inc. (both former owners and/or operators of certain facilities at Everett ("the Everett Facility") together with KeySpan, have entered into an ACO with the Massachusetts Department of Environmental Protection for the investigation and development of a remedial response plan for a portion of that site. KeySpan, Honeywell and Beazer East have entered into a cost-sharing agreement under which each company has agreed to pay one-third of the costs of compliance with the consent order, while preserving any claims it may have against the other companies for, among other things, reallocation of proportionate liability. In 2002, Beazer East commenced an action in the U.S. District Court for the Southern District of New York, which seeks a judicial determination on the allocation of liability for the Everett Facility. The outcome of this proceeding cannot yet be determined.

In 2004, KeySpan reached a settlement with insurance carriers regarding cost recovery for expenses at one of the above noted sites and recorded an $11.6 million reduction to operating expenses. We presently estimate the remaining cost of our environmental cleanup activities for the three non-utility sites will be approximately $19.7 million, which amount has been accrued by us as a reasonable estimate of probable costs for known sites however, remediation costs for each site may be materially higher than noted, depending upon changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered and as a result, it is possible that remediation costs could be up to $57 million higher. Expenditures incurred since November 8, 2000, with respect to these sites total $13.1 million.

We believe that in the aggregate, the accrued liability for these MGP sites and related facilities identified above are reasonable estimates of the probable cost for the investigation and remediation of these sites and facilities. As circumstances warrant, we periodically re-evaluate the accrued liabilities associated with MGP sites and related facilities. We may be required to investigate and, if necessary, remediate each site pre viously noted, or other currently unknown former sites and related facili' sites, the cost of which is not presently determinable but may be materi to our financial position, results of operations or cash flows.

Insurance Reimbursement of MGP Response Costs: We have instit ed lawsuits in New York, Massachusetts and New Hampshire against numerous insurance carriers for reimbursement of costs incurred for tl investigation and remediation of these MGP sites.

In January 1998 and July 2001, KEDLI and KEDNY, respectively, complaints for the recovery of its remediation costs in the New York Supreme Court against the various insurance companies that issued eral comprehensive liability policies to KEDLI and KEDNY. The outcor these proceedings cannot yet be determined.

In March 1999, Boston Gas Company and a subsidiary of National Grid filed a complaint for the recovery of remediation costs in the Massachusetts Superior Court against various insurance companies that issued comprehensive general liability policies to National Grid and its predecessors with respect to, among other things, the 11 sites for which Boston Gas Company has agreed to make a limited contribution. And in October 2002, Boston Gas Company filed a complaint in the United States District Court – Massachusetts District against one of the insurance companies that issued comprehensive general liability policies to Boston Gas Company for its remaining sites. The outcome of these proceedings cannot yet be determined.

EnergyNorth has filed a number of lawsuits in both the New Hampshire Superior Court and the United States District Court for the District of New Hampshire for recovery of its remediation costs against the various insurance companies that issued comprehensive general liability and excess liability insurance policies to EnergyNorth and its predecessors. The outcome of these proceedings cannot yet be determined.

In 1993 KeySpan New England LLC filed a declaratory judgment action against the Hanover and Travelers insurance companies in the Superior Court for Middlesex County for the Everett Facility ("the Eastern Action"). Eastern sought to have the court compel the Insurers to defend Eastern in connection with the Massachusetts DEP's Notice of Responsibility ("NOR"). In 2004, the Court granted KeySpan's unopposed motion for leave to file a Second Amended Complaint in the Eastern Action to seek a declaratory ruling that the insurers have a duty to indemnify KeySpan for the costs associated with the Everett NOR and certain other related private actions. The Second Amended Complaint also adds certain excess insurance carriers as defendants in the Eastern Action. The outcome of this proceeding cannot yet be determined.

Settlement negotiations have been ongoing while the litigation of these cases have been proceeding. Over the past four years KeySpan has achieved settlements with various insurance carriers in excess of $50 million for reimbursement of MGP response costs incurred in New York, Massachusetts and New Hampshire.

Note 8. Hedging, Derivative Financial Instruments and Fair Values

Financially-Settled Commodity Derivative Instruments – Hedging Activities: From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas distribution operations, gas exploration and production activities and its electric generating facilities at the Ravenswood site.

Derivative financial instruments are employed by our gas distribution operations to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases for our regulated firm gas sales customers. The accounting for these derivative instruments is subject to SFAS 71. See the caption below "Firm Gas Sales Derivative Instruments – Regulated Utilities" for a further discussion of these derivatives. Certain derivative instruments employed by our gas distribution operations are not subject to SFAS 71. Utility tariffs applicable to certain large-volume customers permit gas to be sold at prices established monthly relative to a prevailing alternate fuel price but limited to the cost of gas plus the tail block rate. KEDNY uses over-the-counter ("OTC") natural gas swaps, with offsetting positions in OTC fuel oil swaps of equivalent energy value, to hedge the cash-flow variability of specified portions of gas purchases and sales associated with these customers. The maximum length of time over which we have hedged cash flow variability associated with forecasted purchases and sales of natural gas is through October 2005. We use standard New York Mercantile Exchange ("NYMEX") futures prices to value the gas and heating oil positions. At December 31, 2004, the fair value of gas swap contracts was a liability of $6.2 million; the fair value of the oil swap contracts was an asset of $7.5 million. These derivative positions are expected to be reclassified from other comprehensive income into earnings over the next twelve months.

Seneca-Upshur utilizes OTC natural gas swaps to hedge the cash flow variability associated with forecasted sales of a portion of its natural gas production. At December 31, 2004, Seneca-Upshur has hedge positions in place for approximately 85% of its estimated 2005 through 2007 gas production, net of gathering costs. We use market quoted forward prices to value these swap positions. The maximum length of time over which Seneca-Upshur has hedged such cash flow variability is through December 2007. The fair value of these derivative instruments at December 31, 2004 was a liability of $0.7 million. The estimated amount of gains associated with such derivative instruments that are reported in other comprehensive income and that are expected to be reclassified into earnings over the next twelve months is $0.2 million, or approximately $0.1 million after-tax.

The Ravenswood Projects use derivative financial instruments to hedge the cash flow variability associated with the purchase of natural gas and oil that will be consumed during the generation of electricity. The Ravenswood Projects also hedge the cash flow variability associated with a portion of electric energy sales.

With respect to price exposure associated with fuel purchases for the Ravenswood Projects, KeySpan employs natural gas futures contracts to hedge the cash flow variability for a portion of forecasted purchases of natural gas. KeySpan also employs the use of financially-settled oil swap contracts to hedge the cash flow variability for a portion of forecasted purchases of fuel oil that will be consumed by the Ravenswood Projects. We use standard NYMEX futures prices to value the gas futures contracts and market quoted forward prices to value oil swap contracts. The maximum length of time over which we have hedged cash flow variability associated with forecasted purchases of natural gas is through September 2005. The fair value of these derivative instruments at December 31, 2004 was negligible. The maximum length of time over which we have hedged cash flow variability associated with forecasted purchases of fuel oil is through April 2006. The fair value of these derivative instruments at December 31, 2004 was $0.3 million. A substantial portion of these

derivative instruments, which are reported in other comprehensive income, are expected to be reclassified into earnings over the next twelve months.

We have also engaged in the use of cash-settled swap instruments to hedge the cash flow variability associated with a portion of forecasted electric energy sales from the Ravenswood Projects. Our hedging strategy is to hedge at least 50% of forecasted on-peak summer season electric energy sales and a portion of forecasted electric energy sales for the remainder of the year. The maximum length of time over which we have hedged cash flow variability is through December 2005. We use market quoted forward prices to value these outstanding derivatives. The fair market value of these derivative instruments at December 31, 2004 was $0.4 million all of which is expected to be reclassified into earnings over the next twelve months. The after-tax benefit is anticipated to be $0.2 million.

The above noted derivative financial instruments are cash flow hedges that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," collectively SFAS 133, and are not considered held for trading purposes as defined by current accounting literature. Accordingly, we carry the fair value of our derivative instruments on the Consolidated Balance Sheet as either a current or deferred asset or liability, as appropriate, and defer the effective portion of unrealized gains or losses in accumulated other comprehensive income. Gains and losses are reclassified from accumulated other comprehensive income to the Consolidated Statement of Income in the period the hedged transaction affects earnings. Gains and losses are reflected as a component of either revenue or fuel and purchased power depending on the hedged transaction. Hedge ineffectiveness, which was negligible in 2004, results from changes during the period in the price differentials between the index price of the derivative contract and the price of the purchase or sale for the cash flow that is being hedged, and is recorded directly to earnings.

The table below summarizes the fair value of outstanding financially-settled commodity derivative instruments that qualify for hedge accounting at December 31, 2004 and the related line item on the Consolidated Balance Sheet. Fair value is the amount at which derivative instruments could be exchanged in a current transaction between willing parties, other than in a forced liquidation sale. It should be noted that in the table below, December 31, 2003 balances include outstanding derivatives of Houston Exploration; no such derivative instruments are included in the December 2004 balances since Houston Exploration was sold during the year.

	(In Thousands of Dollars)	
DECEMBER 31,	**2004**	**2003**
Gas Contracts:		
Other current assets	$ 215	$ 3,458
Accounts payable and other liabilities	(6,149)	(35,592)
Other deferred liabilities	(879)	(4,734)
Oil Contracts:		
Other current assets	7,719	—
Other deferred charges	—	385
Electric Contracts:		
Other current assets	353	—
Other deferred charges	—	259
	$ 1,259	$(36,224)

Financially-Settled Commodity Derivative Instruments that Do Not Qualify for Hedge Accounting: KeySpan subsidiaries also have employed a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133. In 2004, we purchased a series of call options on the spread between the price of heating oil and the price of natural gas. The options cover the period February 2005 through October 2005 and further complement our hedging strategy noted above regarding sales to certain large-volume customers. As stated, we sell gas to certain large-volume customers at prices established monthly relative to a prevailing alternate fuel price but limited to the cost of gas plus the tail block rate. Utility tariffs, however, establish an upper limit on the price KeySpan can charge for the sale of natural gas to these customers. These options are intended to limit KeySpan's exposure to heating oil price spikes. These options do not qualify for hedge accounting treatment under SFAS 133. We recorded a $2.5 million charge in other income and deductions on the Consolidated Statement of Income to reflect the change in the market value associated with this derivative instrument.

Firm Gas Sales Derivative Instruments – Regulated Utilities: We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. The accounting for these derivative instruments is subject to SFAS 71. Therefore, changes in the fair value of these derivatives have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements. At December 31, 2004, these derivatives had a negative fair value of $10.4 million and are reflected as a regulatory asset on the Consolidated Balance Sheet.

Physically-Settled Commodity Derivative Instruments: SFAS 133 establishes criteria that must be satisfied in order for option contracts, forward contracts with optionality features, or contracts that combine a forward contract and a purchase option contract to be exempted as normal purchases and sales. Based upon a continuing review of our physical gas contracts, we determined that certain contracts for the physical purchase of natural gas associated with our regulated gas utilities are not exempt as normal purchases from the requirements of SFAS 133. Since these contracts are for the purchase of natural gas sold to regulated firm gas sales customers, the accounting for these contracts is subject to SFAS 71. Therefore, changes in the market value of these contracts have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. At December 31, 2004, these derivatives had a negative fair market value of $16.5 million and are reflected as a regulatory liability of $7.4 million and a regulatory asset of $23.9 on the Consolidated Balance Sheet.

Interest Rate Derivative Instruments: In 2003, we entered into interest rate swap agreements in which we swapped $250 million of 7.25% fixed rate debt to floating rate debt. Under the terms of the agreements, we received the fixed coupon rate associated with these bonds and paid our swap counterparties a variable interest rate based on LIBOR, that was reset on a semi-annual basis. These swaps were designated as fair-value hedges and qualified for "short-cut" hedge accounting treatment under SFAS 133. In the first quarter of 2004, we paid our counterparty an average interest rate of 6.44%, and as a result, we realized interest savings of $0.5 million.

On April 7, 2004 we terminated these swap agreements and received $1.2 million from our swap counterparties, of which $0.7 million represented accrued swap interest. The difference between the termination settlement amount and the amount of accrued interest, $0.5 million, was being recorded as a reduction to interest expense over the remaining life of the bonds. In August 2004, we redeemed these bonds and recorded the remaining benefit.

KeySpan has a leveraged lease financing arrangement associated with the Ravenswood Expansion. In May 2004, the facility was acquired by a lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to that subsidiary. In connection with this sale/leaseback transaction, KeySpan utilized a $275 million treasury lock (at 4.2%) to hedge the 10-year US Treasury component of the underlying notes issued by the lessor to purchase the facility. The treasury lock was in effect for a five-week period during which time the 10-year US Treasury increased 70 basis points. KeySpan did not designate this derivative instrument as a hedge for accounting purposes. The treasury lock settled in May 2004 and KeySpan received cash proceeds of $12.6 million which was recorded in other income and (deductions) in the Consolidated Statement of Income. (See Note 7. "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding the sale/leaseback transaction.)

Weather Derivatives: The utility tariffs associated with KEDNE's operations do not contain weather normalization adjustments. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations.

In 2003, KEDNE entered into heating-degree day call and put options for the 2003/2004 winter heating season – November 2003 through March 2004. With respect to sold call options, KeySpan was required to make a payment of $27,500 per heating degree day to its counterparties when actual weather experienced during this time frame was above 4,440 heating degree days, which equates to approximately 2% colder than normal weather, based on the then most recent 20-year average for normal weather. The maximum amount KeySpan was required to pay on its sold call options was $5.5 million. With respect to purchased put options, KeySpan would have received a $27,500 per heating degree day payment from its counterparties when actual weather was below 4,266 heating degree days, or approximately 2% warmer than normal. The maximum amount KeySpan would have received on its purchased put options was $11 million. The net premium cost for these options was $0.4 million. During the first quarter of 2004, weather, as measured in heating degree-days, was 9.4% colder than normal and, as a result $4.1 million was recorded as a reduction to revenues.

In 2004, we entered into heating-degree day put options to mitigate the effect of fluctuations from normal weather on KEDNE's financial position and cash flows for the 2004/2005 winter heating season – November 2004 through March 2005. These put options will pay KeySpan up to $40,000 per heating degree day when the actual temperature is below 4,130 heating degree days, or approximately 5% warmer than normal, based on the most recent 20-year average for normal weather. The maximum amount KeySpan may receive on these purchased put options is $16 million. The net premium cost for these options was $1.6 million and is being amortized over the heating season. Unlike previous years if weather is colder than normal KeySpan will have no financial obligation. Since weather was colder than normal during the fourth quarter, there was no earnings impact associated with these derivative instruments. We account for these derivatives pursuant to the requirements of EITF 99-2, "Accounting for Weather Derivatives." In this regard, such instruments are accounted for using the "intrinsic value method" as set forth in such guidance.

Derivative contracts are primarily used to manage exposure to market risk arising from changes in commodity prices and interest rates. In the event of non-performance by a counterparty to a derivative contract, the desired impact may not be achieved. The risk of counterparty non-performance is generally considered a credit risk and is actively managed by assessing each counterparty credit profile and negotiating appropriate levels of collateral and credit support. We believe that our credit risk related to the above mentioned derivative financial instruments is no greater than the risk associated with the primary contracts which they hedge and that the elimination of a portion of the price risk reduces volatility in our reported results of operations, financial position and cash flows and lowers overall business risk.

Long-term Debt: The following tables depict the fair values and carrying values of KeySpan's long-term debt at December 31, 2004 and 2003.

Fair Values of Long-Term Debt

	(In Thousands of Dollars)	
DECEMBER 31,	**2004**	**2003**
First Mortgage Bonds	$ 115,820	$ 178,438
Notes	2,571,847	3,893,158
Gas Facilities Revenue Bonds	666,941	683,354
Authority Financing Notes	66,005	66,005
Promissory Notes	159,791	158,837
MEDS Equity Units	479,964	495,880
Master Lease	460,896	474,912
Tax Exempt Bonds	134,949	129,558
	$4,656,213	$6,080,142

Carrying Values of Long-Term Debt

	(In Thousands of Dollars)	
DECEMBER 31,	**2004**	**2003**
First Mortgage Bonds	$ 95,000	$ 153,186
Notes	2,485,000	3,456,425
Gas Facilities Revenue Bonds	640,500	648,500
Authority Financing Notes	66,005	66,005
Promissory Notes	155,420	155,422
MEDS Equity Units	460,000	460,000
Master Lease	412,250	412,250
Tax Exempt Bonds	128,275	128,275
	$4,442,450	$5,480,063

Our subsidiary debt was carried at an amount approximating fair value because interest rates are based on current market rates. All other financial instruments included in the Consolidated Balance Sheet such as cash, commercial paper, accounts receivable and accounts payable, are also stated at amounts that approximate fair value.

Note 9. Discontinued Midland Operations

On November 8, 2000, KeySpan acquired Midland Enterprises LLC ("Midland"), an inland marine transportation subsidiary, as part of the Eastern acquisition. In its order approving the acquisition, the SEC required KeySpan to sell this subsidiary by November 8, 2003 because Midland's operations were not functionally related to KeySpan's core utility operations. On July 2, 2002, the sale of Midland to Ingram Industries Inc. was completed and net proceeds of $175.1 million were received from the sale.

In 2001 we recorded a discontinued operations loss on disposal. As a result of a change in the tax structuring strategy related to the sale of Midland, in the second quarter of 2002 we recorded an additional provision for city and state taxes and made adjustments to the estimates used in the 2001 loss provision. These changes resulted in an additional after tax loss on disposal of $19.7 million.

The following is selected financial information for Midland for the period January 1, 2002 through July 2, 2002:

	(In Thousands of Dollars)
	2002
Revenues	$116,149
Pre-tax income (loss)	(4,624)
Income tax (expense) benefit	1,268
Income (loss) from discontinued operations	(3,356)
Estimated book gain on disposal	5,980
Tax expense associated with disposal	(22,286)
Estimated loss on disposal	(16,306)
Loss from discontinued operations	$ (19,662)

Note 10. Gas Exploration and Production Property – Depletion

As described in Note 2 "Business Segments," during much of 2004 KeySpan's investments in gas exploration and production activities consisted of its ownership interest in Houston Exploration, as well as KeySpan's wholly-owned subsidiary KeySpan Exploration and Production, which is still engaged in a joint drilling program with Houston Exploration. Further, KeySpan's investments in these activities also includes its wholly-owned subsidiary Seneca-Upshur. These assets were accounted for under the full cost method of accounting. After the sale of Houston Exploration, Seneca-Upshur and KeySpan Exploration have remained on full cost accounting. Under the full cost method, costs of acquisition, exploration and development of natural gas and oil reserves plus asset retirement obligations are capitalized into a "full cost pool" as incurred. Unproved properties and related costs are excluded from the depletion and amortization base until a determination as to the existence of proved reserves. Properties are depleted and charged to operations using the unit of production method.

To the extent that such capitalized costs (net of accumulated depletion) less deferred taxes exceed the present value (using a 10% discount rate) of estimated future net cash flows from proved natural gas and oil reserves and the lower of cost or fair value of unproved properties, less deferred taxes, such excess costs are charged to operations, but would not have an impact on cash flows. Once incurred, such impairment of gas properties is not reversible at a later date even if prices increase. The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, adjusted for outstanding derivative instruments, held flat over the life of the reserves.

As a result of the June 2004 stock transaction discussed in Note 2 "Business Segments", KeySpan accounted for its investment in Houston Exploration on the equity method from June 2004 through November 19, 2004, i.e. Houston Exploration's operations were not consolidated with KeySpan's other subsidiaries. Therefore, we were required to calculate a ceiling test on KeySpan Exploration and Production's and Seneca-Uphsur's assets independently of Houston Exploration's assets in the second quar-

ter of 2004. Based on a report furnished by an independent reservoir engineer at that time, it was determined that the remaining proved undeveloped oil reserves held in the joint venture required a substantial investment in order to develop. Therefore, KeySpan and Houston Exploration elected not to develop these oil reserves. As a result, in the second quarter of 2004, KeySpan recorded a $48.2 million non-cash impairment charge to write down its wholly-owned gas exploration and production subsidiaries' assets. This charge was recorded in depreciation, depletion and amortization on the Consolidated Statement of Income.

Note 11. Energy Services – Discontinued Operations

The Energy Services segment has experienced significantly lower operating profits and cash flows than originally projected. As previously reported, management has reviewed the operating performance of this segment. At a meeting held on November 2, 2004, KeySpan's Board of Directors authorized management to begin the process of disposing of a significant portion of its ownership interests in certain companies within the Energy Services segment – specifically those companies engaged in mechanical contracting activities. In January and February of 2005, KeySpan sold its mechanical contracting investments. The operating results and financial position of these companies, which were previously consolidated within the Energy Services segment, have been reflected as discontinued operations on the Consolidated Statement of Income, Consolidated Balance Sheet and Consolidated Statement of Cash Flows.

In regard to the January 2005 transactions, KeySpan received proceeds of approximately $16 million, approximately $5 million of which is to be paid within a three year period. In addition, KeySpan retained its previously incurred indemnity support obligations related to certain surety, performance and payment bonds issued for the benefit of KeySpan's former subsidiaries prior to closing. The current estimated cost to complete projects supported by such indemnity obligations is approximately $25 million. The buyers have agreed to cooperate with KeySpan to seek a release of KeySpan's indemnity obligation with respect to all or a portion of such outstanding bonds after closing. Any costs incurred to obtain such release will be borne by KeySpan.

In connection with the February 2005 transaction, KeySpan paid or contributed approximately $26 million to its former subsidiary prior to closing the sale transaction in exchange for, among other things, the disposition of outstanding shares in the former subsidiary and the settlement of intercompany advances and replacement of a performance and payment bond issued for the benefit of its former subsidiary with respect to a pending project, which bond had been supported by a $150 million indemnity obligation of KeySpan. In addition, KeySpan received from its former subsidiary an indemnity bond issued by a third party insurance company, the purpose of which is to reimburse KeySpan in an amount up to $80 million in the event it is required to perform under all other indemnity obligations previously incurred by KeySpan to support the remaining bonded projects of its former subsidiary as of the closing. As of February 11, 2005, the total cost to complete such remaining bonded projects is estimated to be approximately $70 million. The aforementioned guarantees are reflected in Note 7 "Contractual Obligations, Financial Guarantees and Contingencies".

In anticipation of these sales and in connection with the preparation of the third quarter and fourth quarter financial statements, KeySpan conducted an evaluation of the carrying value of these investments, including recorded goodwill. Further, we evaluated the carrying value of goodwill for the entire Energy Services segment. As noted in prior SEC filings, KeySpan records goodwill on purchased transactions, representing the excess of acquisition cost over the fair value of net assets acquired.

As a result of these evaluations, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on Energy Services segment's continuing operations; and (ii) $93.9 million ($67.8 million after-tax) as discontinued operations reflecting the impairment on the mechanical contracting companies.

In addition, an impairment charge of $100.3 million ($72.1 million after-tax or $0.45 per share) was also recorded to reduce the carrying value of the remaining assets of the mechanical contracting companies. This charge is reflected in discontinued operations on the Consolidated Statement of Income.

KeySpan employed a combination of two methodologies in determining the estimated fair value for its investment in the Energy Services segment, a market valuation approach and an income valuation approach. Under the market valuation approach, KeySpan utilized a range of near-term potential realizable values for the mechanical contracting businesses. Under the income valuation approach, the fair value was obtained by discounting the sum of (i) the expected future cash flows and (ii) the terminal value. KeySpan utilized certain significant assumptions in this valuation, specifically the weighted-average cost of capital, short and long-term growth rates and expected future cash flows. Approximately $65 million of goodwill remains in this segment.

The information below highlights the major classes of assets and liabilities of the discontinued mechanical contracting companies, as well as major income and expense captions.

	(In Thousands of Dollars)	
DECEMBER 31,	**2004**	**2003**
Property	$ 8,743	$ 8,588
Current assets	$42,923	$181,823
Goodwill	—	$ 92,702
Current liabilities	$64,245	$ 81,956

ENDED DECEMBER 31,	2004	2003	2002
			(In Thousands of Dollars)
ıues	$ 338,666	$379,637	$ 505,492
ating expenses	364,879	385,496	472,629
lwill impairment	108,289	—	—
	(134,502)	(5,859)	32,863
me taxes (benefit)	(55,542)	(3,971)	13,815
rating income (loss)	(78,960)	(1,888)	19,048
on disposal,			
ıet of tax of $28,174	(72,088)	—	—
Income (Loss)	$ (151,048)	$ (1,888)	$ 19,048

Note 12. KeySpan Gas East Corporation Summary Financial Data

KEDLI is a wholly owned subsidiary of KeySpan. KEDLI was formed on May 7, 1998 and on May 28, 1998 acquired substantially all of the assets related to the gas distribution business of LILCO. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway peninsula of Queens county. KEDLI established a program for the issuance, from time to time, of up to $600 million aggregate principal amount of Medium-Term Notes, which will be fully and unconditionally guaranteed by the parent, KeySpan Corporation. On February 1, 2000, KEDLI issued $400 million of 7.875% Medium-Term Notes due 2010. In January 2001, KEDLI issued an additional $125 million of Medium-Term Notes at 6.9% due January 2008. The following condensed financial statements are required to be disclosed by SEC regulations and set forth those of KEDLI, KeySpan Corporation as guarantor of the Medium-Term Notes and our other subsidiaries on a combined basis.

tatement of Income

EAR ENDED DECEMBER 31, 2004	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
					(In Thousands of Dollars)
evenues	$ 619	$1,124,417	$5,526,049	$ (619)	$6,650,466
)perating Expenses					
Purchased gas	—	664,857	1,999,635	—	2,664,492
Fuel and purchased power	—	—	540,302	—	540,302
Operations and maintenance	5,287	137,847	1,423,888	—	1,567,022
Intercompany expense	—	5,391	(5,391)	—	—
Depreciation and amortization	—	79,856	471,904	—	551,760
Operating taxes	—	65,722	338,490	—	404,212
Goodwill Impairment	—	—	40,965	—	40,965
otal Operating Expenses	5,287	953,673	4,809,793	—	5,768,753
ɜain on sale of property	—	—	7,021	—	7,021
ncome from equity investments	—	—	46,536	—	46,536
Operating Income (Loss)	(4,668)	170,744	769,813	(619)	935,270
nterest charges	(204,508)	(61,503)	(267,605)	202,365	(331,251)
Other income and (deductions)	635,450	836	423,895	(723,946)	336,235
Total Other Income and (Deductions)	430,942	(60,667)	156,290	(521,581)	4,984
Income Taxes (Benefit)	(45,459)	35,827	335,173	—	325,541
Earnings from Continuing Operations	471,733	74,250	590,930	(522,200)	614,713
Discontinued Operations	—	—	(151,048)	—	(151,048)
Net Income	$471,733	$ 74,250	$ 439,882	$(522,200)	$ 463,665

Statement of Income

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31, 2003	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Revenues	$ 507	$1,046,931	$5,488,593	$ (507)	$6,535,524
Operating Expenses					
Purchased gas	—	574,009	1,921,093	—	2,495,102
Fuel and purchased power	—	—	414,633	—	414,633
Operations and maintenance	11,340	137,223	1,474,029	—	1,622,592
Intercompany expense	5,282	3,570	(3,570)	(5,282)	—
Depreciation and amortization	(53)	77,603	494,119	—	571,669
Operating taxes	—	77,503	340,733	—	418,236
Total Operating Expenses	16,569	869,908	4,641,037	(5,282)	5,522,232
Gain on sale of property	—	13,974	1,149	—	15,123
Income from equity investments	108	—	19,106	—	19,214
Operating Income (Loss)	(15,954)	190,997	867,811	4,775	1,047,629
Interest charges	(209,505)	(62,992)	(299,399)	264,202	(307,694)
Other income and (deductions)	621,151	(8,636)	54,315	(699,415)	(32,585)
Total Other Income and (Deductions)	411,646	(71,628)	(245,084)	(435,213)	(340,279)
Income Taxes (Benefit)	(28,663)	40,796	269,148	—	281,281
Earnings from Continuing Operations	424,355	78,573	353,579	(430,438)	426,069
Discontinued Operations	—	—	(1,888)	—	(1,888)
Cumulative Change in Accounting Principle	—	—	(37,451)	—	(37,451)
Net Income	$424,355	$ 78,573	$ 314,240	$(430,438)	$ 386,730

Statement of Income

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31, 2002	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Revenues	$ 463	$810,601	$4,654,573	$ (463)	$5,465,174
Operating Expenses					
Purchased gas	—	379,742	1,273,531	—	1,653,273
Fuel and purchased power	—	—	395,860	—	395,860
Operations and maintenance	13,325	45,357	1,572,615	—	1,631,297
Intercompany expense	2,772	79,826	(79,826)	(2,772)	—
Depreciation and amortization	(44)	65,911	447,841	—	513,708
Operating taxes	(2,149)	80,056	302,620	—	380,527
Total Operating Expenses	13,904	650,892	3,912,641	(2,772)	4,574,665
Gain on sale of property	—	317	4,413	—	4,730
Income from equity investments	104	—	13,992	—	14,096
Operating Income (Loss)	(13,337)	160,026	760,337	2,309	909,335
Interest charges	(200,920)	(62,520)	(295,209)	257,145	(301,504)
Other income and (deductions)	565,262	7,835	60,106	(633,068)	135
Total Other Income and (Deductions)	364,342	(54,685)	(235,103)	(375,923)	(301,369)
Income Taxes (Benefit)	(26,683)	36,746	219,601	—	229,664
Earnings from Continuing Operations	377,688	68,595	305,633	(373,614)	378,302
Discontinued Operations	—	—	(614)	—	(614)
Net Income	$ 377,688	$ 68,595	$ 305,019	$(373,614)	$ 377,688

Balance Sheet

(In Thousands of Dollars)

DECEMBER 31, 2004	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Assets					
Current Assets					
Cash and temporary cash investments	$ 580,712	$ (894)	$ 342,155	$ —	$ 921,973
Accounts receivable, net	757	223,616	1,087,679	—	1,312,052
Other current assets	4,496	146,453	650,725	—	801,674
Assets of discontinued operations	—	—	42,923	—	42,923
	585,965	369,175	2,123,482	—	3,078,622
Investments and Other	4,567,314	2,039	169,063	(4,465,523)	272,893
Property					
Gas	—	1,998,525	4,872,696	—	6,871,221
Other	13	—	2,987,720	—	2,987,733
Accumulated depreciation and depletion	—	(334,468)	(2,465,305)	—	(2,799,773)
Property of discontinued operations	—	—	8,743	—	8,743
	13	1,664,057	5,403,854	—	7,067,924
Intercompany Accounts Receivable	2,485,740	—	1,292,198	(3,777,938)	—
Deferred Charges	381,300	221,393	2,341,998	—	2,944,691
Total Assets	$8,020,332	$2,256,664	$11,330,595	$(8,243,461)	$13,364,130
Liabilites and Capitalization					
Current Liabilities					
Accounts payable	$ 48,393	$ 111,551	$ 746,706	$ —	$ 906,650
Commercial paper	912,246	—	—	—	912,246
Other current liabilities	294,642	167,201	(62,668)	—	399,175
Liabilities of discontinued operations	—	—	64,245	—	64,245
	1,255,281	278,752	748,283	—	2,282,316
Intercompany Accounts Payable	—	101,345	2,147,777	(2,249,122)	—
Deferred Credits and Other Liabilities					
Deferred income tax	(83,214)	298,062	909,281	—	1,124,129
Other deferred credits and liabilities	534,521	112,004	964,387	—	1,610,912
	451,307	410,066	1,873,668	—	2,735,041
Capitalization					
Common shareholders' equity	3,940,497	815,597	3,604,139	(4,465,523)	3,894,710
Preferred stock	19,700	—	—	—	19,700
Long-term debt	2,353,547	650,904	2,943,094	(1,528,816)	4,418,729
Total Capitalization	6,313,744	1,466,501	6,547,233	(5,994,339)	8,333,139
Minority Interest in Consolidated Companies	—	—	13,634	—	13,634
Total Liabilities and Capitalization	$8,020,332	$2,256,664	$11,330,595	$(8,243,461)	$13,364,130

Balance Sheet

(In Thousands of Dollars)

DECEMBER 31, 2003	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Assets					
Current Assets					
Cash and temporary cash investments	$ 97,567	$ 1,554	$ 104,237	$ —	$ 203,358
Accounts receivable, net	3,298	209,151	1,068,066	—	1,280,515
Other current assets	3,250	136,018	649,988	—	789,256
Assets of discontinued operations	—	—	114,196	—	114,196
	104,115	346,723	1,936,487	—	2,387,325
Investments and Other	4,475,949	1,123	153,520	(4,382,027)	248,565
Property					
Gas	—	1,899,375	4,622,876	—	6,522,251
Other	—	—	6,132,592	—	6,132,592
Accumulated depreciation and depletion	—	(355,376)	(3,413,752)	—	(3,769,128)
Property of discontinued operations	—	—	8,588	—	8,588
	—	1,543,999	7,350,304	—	8,894,303
Intercompany Accounts Receivable	3,105,571	—	1,274,283	(4,379,854)	—
Deferred Charges	374,076	237,870	2,498,043	—	3,109,989
Total Assets	$8,059,711	$2,129,715	$13,212,637	$(8,761,881)	$14,640,182
Liabilites and Capitalization					
Current Liabilities					
Accounts payable	$ 125,892	$ 165,613	$ 773,989	$ —	$ 1,065,494
Commercial paper	481,900	—	—	—	481,900
Other current liabilities	129,168	21,149	72,365	—	222,682
Liabilities of discontinued operations	—	—	82,204	—	82,204
	736,960	186,762	928,558	—	1,852,280
Intercompany Accounts Payable	—	116,197	2,679,091	(2,795,288)	—
Deferred Credits and Other Liabilities					
Deferred income tax	(48,059)	256,882	1,066,735	—	1,275,558
Other deferred credits and liabilities	532,062	136,747	968,814	—	1,637,623
	484,003	393,629	2,035,549	—	2,913,181
Capitalization					
Common shareholders' equity	3,707,785	782,223	3,562,675	(4,382,027)	3,670,656
Preferred stock	83,568	—	—	—	83,568
Long-term debt	3,047,395	650,904	3,497,215	(1,584,566)	5,610,948
Total Capitalization	6,838,748	1,433,127	7,059,890	(5,966,593)	9,365,172
Minority Interest in Consolidated Companies	—	—	509,549	—	509,549
Total Liabilities and Capitalization	$8,059,711	$2,129,715	$13,212,637	$(8,761,881)	$14,640,182

Statement of Cash Flows

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31, 2004	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	CONSOLIDATED
Operating Activities				
Net Cash (Used in) Provided by Operating Activities	$ (88,676)	$ 169,549	$ 669,196	$ 750,069
Investing Activities				
Capital expenditures	—	(108,658)	(641,671)	(750,329)
Cost of removal	—	(7,140)	(29,147)	(36,287)
Proceeds from sale of property	—	—	20,159	20,159
Proceeds from sale of subsidiary stock	—	—	1,001,142	1,001,142
Net Cash (Used in) Provided by Investing Activities	—	(115,798)	350,483	234,685
Financing Activities				
Treasury stock issued	33,406	—	—	33,406
Issuance (payment) of debt, net	(269,654)	—	(170,745)	(440,399)
Redemption of preferred stock	(8,483)	—	—	(8,483)
Net proceeds from sale/leaseback transaction	—	—	382,049	382,049
Common and preferred stock dividends paid	(291,148)	—	—	(291,148)
Gain on interest rate swap	12,656	—	—	12,656
Dividend paid to parent	447,590	(40,000)	(407,590)	—
Other	27,623	—	8,564	36,187
Net intercompany accounts	619,831	(16,199)	(603,632)	—
Net Cash Provided by (Used in) Financing Activities	571,821	(56,199)	(791,354)	(275,732)
Net Increase in Cash and Cash Equivalents	$ 483,145	$ (2,448)	$ 228,325	$ 709,022
Net Cash Flow from Discontinued Operations	—	—	9,593	9,593
Cash and Cash Equivalents at Beginning of Period	97,567	1,554	104,237	203,358
Cash and Cash Equivalents at End of Period	$ 580,712	$ (894)	$ 342,155	$ 921,973

Statement of Cash Flows

(In Thousands of Dollars)

YEAR ENDED DECEMBER 31, 2003	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	CONSOLIDATED
Operating Activities				
Net Cash (Used in) Provided by Operating Activities	$(547,516)	$164,496	$1,606,376	$1,223,356
Investing Activities				
Capital expenditures	—	(130,275)	(879,118)	(1,009,393)
Cost of removal	—	(1,710)	(29,393)	(31,103)
Proceeds from the sale of property and subsidiary stock	—	15,123	294,573	309,696
Investments in subsidiaries	—	—	(211,370)	(211,370)
Issuance of note receiveable	(55,000)	—	—	(55,000)
Net Cash (Used in) Investing Activities	(55,000)	(116,862)	(825,308)	(997,170)
Financing Activities				
Proceeds from equity issuance	473,573	—	—	473,573
Treasury stock issued	96,687	—	—	96,687
Redemption of LIPA promissory notes	(447,005)	—	—	(447,005)
(Payment) issuance of debt	(133,797)	—	120,222	(13,575)
Redemption of preferred stock	—	—	(14,293)	(14,293)
Common and preferred stock dividends paid	(280,560)	—	—	(280,560)
Other	28,933	—	(23,944)	4,989
Net intercompany accounts	873,944	(52,552)	(821,392)	—
Net Cash Provided by (Used in) Financing Activities	611,775	(52,552)	(739,407)	(180,184)
Net (Decrease) Increase in Cash and Cash Equivalents	$ 9,259	$ (4,918)	$ 41,661	$ 46,002
Net Cash from Discontinued Operations	—	—	(13,261)	(13,261)
Cash and Cash Equivalents at Beginning of Period	88,308	6,472	75,837	170,617
Cash and Cash Equivalents at End of Period	$ 97,567	$ 1,554	$ 104,237	$ 203,358

Statement of Cash Flows

				(In Thousands of Dollars)
YEAR ENDED DECEMBER 31, 2002	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	CONSOLIDATED
Operating Activities				
Net Cash (Used in) Provided by Operating Activities	$(97,981)	$189,838	$655,806	$ 747,663
Investing Activities				
Capital expenditures	—	(146,450)	(911,057)	(1,057,507)
Other	—	903	151,358	152,261
Cost of removal	—	(883)	(26,548)	(27,431)
Net Cash (Used in) Investing Activities	—	(146,430)	(786,247)	(932,677)
Financing Activities				
Treasury stock issued	86,710	—	—	86,710
Issuance (payment) of debt, net	327,247	—	(35,603)	291,644
Common and preferred stock dividends paid	(256,656)	—	—	(256,656)
Other	70,299	—	(3,255)	67,044
Net intercompany accounts	(41,311)	(36,936)	78,247	—
Net Cash Provided by (Used in) Financing Activities	186,289	(36,936)	39,389	188,742
Net (Decrease) Increase in Cash and Cash Equivalents	$ 88,308	$ 6,472	$ (91,052)	$ 3,728
Net Cash Flow from Discontinued Operations	—	—	14,166	14,166
Cash and Cash Equivalents at Beginning of Period	—	—	152,723	152,723
Cash and Cash Equivalents at End of Period	$ 88,308	$ 6,472	$ 75,837	$ 170,617

Note 13. Supplemental Gas and Oil Disclosures (Unaudited)

For December 31, 2003 and 2002 the following information includes amounts attributable to 100% of Houston Exploration and KeySpan Exploration and Production, LLC. Shareholders other than KeySpan had a minority interest of approximately 45% in Houston Exploration at December 31, 2003 and 34% in 2002. Gas and oil operations, and reserves, were located in the United States in all years. As a result of the disposition of Houston Exploration and the immateriality of KeySpan's ongoing gas exploration and production activities supplemental gas and oil disclosures are not required for 2004.

Capitalized Costs Relating to Gas and Oil Producing Activities

		(In Thousands of Dollars)
AT DECEMBER 31,	2003	2002
Unproved properties not being amortized	$ 142,905	$ 110,623
Properties being amortized –		
productive and nonproductive	2,429,891	1,917,287
Total capitalized costs	2,572,796	2,027,910
Accumulated depletion	(1,159,509)	(968,713)
Net capitalized costs	$1,413,287	$1,059,197

Costs Incurred in Property Acquisition, Exploration and Development Activities

		(In Thousands of Dollars)
AT DECEMBER 31,	2003	2002
Acquisition of properties –		
Unproved properties	$ 61,484	$ 14,600
Proved properties	171,297	90,004
Exploration	66,259	28,343
Development	170,493	139,108
Asset retirement obligation	31,858	—
Total costs incurred	$501,391	$272,055

Costs included in development costs to develop proved undeveloped reserves for the years ended December 31, 2003 and 2002 were $49.4 million, and $11.0 million, respectively.

Results of Operations from Gas and Oil Producing Activities*

	(In Thousands of Dollars)	
AT DECEMBER 31,	2003	2002
Revenues	$497,948	$356,233
Production and lifting costs	63,591	44,822
Shipping and handling costs	10,388	9,450
Depletion	205,118	177,548
Total expenses	279,097	231,820
Income before taxes	218,851	124,414
Income taxes	76,598	42,519
Results of operations	$142,253	$ 81,895

* *Excluding corporate overhead and interest costs*

Summary of Production and Lifting Costs

	(In Thousands of Dollars)	
AT DECEMBER 31,	2003	2002
Pumping, gauging and other labor	$10,975	$7,846
Compressors and other rental equipment	5,136	4,135
Property taxes and insurance	7,155	6,801
Transportation	2,329	2,131
Processing fees	2,354	3,078
Workover and well stimulation	5,225	2,348
Repairs, maintenance and supplies	3,735	2,972
Fuel and chemicals	3,109	2,582
Environmental, regulatory and other	7,614	3,307
Severance taxes	15,959	9,622
Total production and lifting costs	$63,591	$44,822

For December 31, 2003 and 2002 the gas and oil reserves information reflects Houston Exploration and KeySpan Exploration and Production, LLC. These estimates principally were prepared by independent petroleum consultants. Proved reserves are estimated quantities of natural gas and crude oil which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions.

Reserve Quantity Information Natural Gas (MMcf)

AT DECEMBER 31,	2003	2002
Proved Reserves		
Beginning of year	614,734	585,659
Revisions of previous estimates	(32,433)	(15,324)
Extensions and discoveries	140,632	105,798
Production	(100,130)	(107,507)
Purchases of reserves in place	89,380	48,777
Sales of reserves in place	—	(2,669)
Proved reserves – End of year (1)	712,183	614,734
Proved developed reserves		
Beginning of year	435,629	448,921
End of Year (2)	488,012	435,629

(1) Includes minority interest of 318,417, and 208,516, in 2003 and 2002, respectively.

(2) Includes minority interest of 218,190, and 148,811 in 2003 and 2002, respectively.

Crude Oil, Condensate and Natural Gas Liquids (MBbls)

AT DECEMBER 31,	2003	2002
Proved reserves		
Beginning of Year	9,548	10,234
Revisions of previous estimates	(3,542)	(5)
Extension and discoveries	117	342
Production	(1,514)	(1,025)
Purchases of reserves in place	3,753	483
Sales of reserves in place	—	(481)
Proved reserves – End of year (1)	8,362	9,548
Proved developed reserves		
Beginning of year	2,413	2,479
End of year (2)	4,273	2,413

(1) Includes minority interest of 3,739 and 2,256 in 2003 and 2002, respectively.

(2) Includes minority interest of 1,910 and 824 in 2003 and 2002, respectively.

The standardized measure of discounted future net cash flows was prepared by applying year-end prices of gas and oil adjusted for the effects of KeySpan's hedging program to the proved reserves. The standardized measure does not purport, nor should it be interpreted, to present the fair value of gas and oil reserves of KeySpan Exploration and Production LLC or Houston Exploration. An estimate of fair value would also take into account, among other things, the recovery of reserves not presently classified as proved, anticipated future changes in prices and costs, and a discount factor more representative of the time value of money and the risks inherent in reserve estimates.

Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Gas and Oil Reserves

	(In Thousands of Dollars)	
AT DECEMBER 31,	**2003**	**2002**
Future cash flows	$4,375,781	$2,951,622
Future costs-		
Production	(769,892)	(495,097)
Development	(378,547)	(263,926)
Future net inflows before income tax	3,227,342	2,192,599
Future income taxes	(853,425)	(559,853)
Future net cash flows	2,373,917	1,632,746
10% discount factor	(853,403)	(528,829)
Standardized measure of discounted future net cash flows (1)	$1,520,514	$1,103,917

(1) Includes minority interest of $672,620 and $361,435 in 2003 and 2002, respectively

Changes in Standardized Measure of Discounted Future Net Cash Flows from Proved Reserve Quantities

	(In Thousands of Dollars)	
AT DECEMBER 31,	**2003**	**2002**
Standardized measure – beginning of year	$1,103,917	$586,186
Sales and transfers, net of production costs	(492,328)	(285,603)
Net change in sales and transfer prices, net of production costs	384,299	589,632
Extensions and discoveries and improved recovery, net of related costs	434,311	242,055
Changes in estimated future development costs	(9,352)	(6,453)
Development costs incurred during the period that reduced future development costs	81,025	42,075
Revisions of quantity estimates	(123,954)	(36,368)
Accretion of discount	142,296	68,986
Net change in income taxes	(236,551)	(215,369)
Net purchases of reserves in place	254,030	99,741
Sales of reserves in place	—	(31,488)
Changes in production rates (timing) and other	(17,179)	50,523
Standardized measure – end of year	$1,520,514	$1,103,917

Average Sales Prices and Production Costs Per Unit

YEAR ENDED DECEMBER 31,	**2003**	**2002**
Average Sales Price*		
Natural gas ($/Mcf)	5.23	3.16
Oil, condensate and natural gas liquid ($/Bbl)	28.26	24.06
Production cost per equivalent Mcf ($)	0.58	0.42

**Represents the cash price received which excludes the effect of any hedging transactions.*

Note 14. Summary of Quarterly Information (Unaudited)

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2004

			(In Thousands of Dollars, Except Per Share Amounts)	
QUARTER ENDED	**3/31/04**	**6/30/04**	**9/30/04**	**12/31/04**
Operating Revenue	2,510,592	1,277,806	975,544	1,886,524
Operating Income	487,627	122,158 (a)	87,613 (c)	237,872 (e)
Earnings (loss) from continuing operations,less preferred stock dividends	246,636	128,485 (a)(b)	(30,133) (c)(d)	264,113 (e)(f)
Earnings (loss) from discontinued operations (g)	(401)	793	(87,006)	(64,434)
Earnings (loss) for common stock	246,235	129,278	(117,139)	199,679
Basic earnings per common share from continuing operations less preferred stock dividends	1.54	0.81	(0.19)	1.64
Basic earnings per common share from discontinued operations	—	—	(0.54)	(0.40)
Basic earnings per common share	1.54	0.81	(0.73)	1.24
Diluted earnings per common share	1.53	0.80	(0.73)	1.23
Dividends declared	0.445	0.445	0.445	0.445

(a) KeySpan's wholly owned gas exploration and production subsidiaries recorded a non-cash impairment charge of $48.2 million ($31.1 million after-tax) or $0.19 per share to recognize the reduced valuation of proved reserves.

(b) In June 2004, KeySpan exchanged 10.8 million shares of common stock of Houston Exploration for 100% of the stock of Seneca Upshur Petroleum, Inc. We recorded a gain of $150.1 million and were required to record deferred tax expense of $44.1 million. The net gain on the share exchange less the deferred tax provision was $106 million or $0.66 per share. In April 2004, KeySpan recorded a gain of $22.8 million ($10.1 million after-tax) or $0.06 per share, resulting from the sale of 35.9% of our ownership interest in KeySpan Canada.

(c) KeySpan recorded a $14.4 million ($12.6 million after-tax) or $0.08 per share non-cash goodwill impairment charge associated with our continuing investments in the Energy Services segment.

(d) In August 2004, we redeemed approximately $758 million of outstanding debt and recorded a charge of $45.9 million ($29.3 million after-tax) or $0.18 per share representing call premiums incurred on this redemption.

(e) In December 2004, we recorded a $26.5 million ($18.8 million after-tax) or $0.12 per share non-cash impairment charge related to our 50% ownership interest in Premier Transmission Pipeline.

(f) In November 2004, KeySpan decided to sell its remaining 6.6 million shares in Houston Exploration and recorded a gain of $179.6 million ($116.8 million after-tax) or $0.73 per share. In December 2004, KeySpan sold its remaining interest in KeySpan Canada and recorded a gain of $35.8 million ($24.7 million after tax) or $0.15 per share.

(g) At December 31, 2004, KeySpan intended to sell a significant portion of its ownership interest in certain companies within the Energy Services segment, specifically those companies engaged in mechanical contracting activities. As a result, KeySpan recorded a loss in discontinued operations of $151.1 million, or $0.94 per share. This loss reflects $139.9 million after-tax impairment charges, which were recorded in the third and fourth quarters, and operating losses of $11.2 million.

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2003.

(In Thousands of Dollars, Except Per Share Amounts)

QUARTER ENDED	3/31/03	6/30/03	9/30/03	12/31/03
Operating Revenue	2,423,482	1,307,366	1,032,532	1,772,144
Operating income	455,082	139,087	112,205	341,255
Earnings (loss) from continuing operations, less preferred stock dividends	240,684 (a)	(7,089) (b)	13,407	173,223 (c)
Earnings (loss) from discontinued operations (e)	946	(310)	(2,283)	(241)
Cumulative change in accounting principle	174	—	—	(37,625) (d)
Earnings (loss) for common stock	241,804	(7,399)	11,124	135,357
Basic earnings per common share from continuing operations less preferred stock dividends	1.54	(0.05)	0.08	1.09
Basic earnings per common share from discontinued operations (a)	—		(0.01)	—
Cumulative change in accounting principle	—	—	—	(0.24)
Basic earnings per common share	1.54	(0.05)	0.07	0.85
Diluted earnings per common share	1.53	(0.05)	0.07	0.84
Dividends declared	0.445	0.445	0.445	0.445

(a) In February 2003, we reduced our ownership interest in Houston Exploration from 66% to 56% following the repurchase, by Houston Exploration, of 3 million shares of stock owned by KeySpan. This transaction resulted in an after-tax gain of $19.0 million or $0.12 per share.

(b) In May 2003, we monetized 39% of our interest in KeySpan Canada, and sold our 20% interest in Taylor NGL LP, a company that owns and operates extraction plants in Canada. The transactions resulted in an after-tax loss of $34.1 million or $0.22 per share.

(c) In December 2003, we sold our 24.5% interest in Phoenix Natural Gas, a natural gas distribution business in Northern Ireland. KeySpan recognized an after-tax gain on the sale of $16.0 million or $0.10 per share.

(d) As a result of the implementation of FASB Interpretation No. 46 "Consolidation of Variable Interest Entities," in December 2003 KeySpan consolidated the Ravenswood Master Lease. KeySpan recorded a cumulative effect change in accounting principle of $37.6 million or $0.23 per share, related to "catch-up" depreciation of the facility since its acquisition in June 1999.

(e) In December 2004, KeySpan reflected certain Energy Services companies as discontinued. Amounts for each of the quarters in the year 2003 have been restated to reflect this presentation.

(In Thousands of Dollars, Except Per Share Amounts)

YEAR ENDED DECEMBER 31,	2004	2003	2002	2001	2000
Income Summary					
Revenues					
Gas Distribution	$ 4,407,292	$ 4,161,272	$ 3,163,761	$ 3,613,551	$ 2,555,785
Electric Services	1,738,660	1,605,973	1,645,688	1,850,381	1,702,908
Energy Services	182,406	158,908	208,624	243,553	245,775
Energy Investments	322,108	609,371	447,101	498,318	310,096
Total revenues	6,650,466	6,535,524	5,465,174	6,205,803	4,814,564
Operating expenses					
Purchased gas for resale	2,664,492	2,495,102	1,653,273	2,171,113	1,408,680
Fuel and purchased power	540,302	414,633	395,860	538,532	460,841
Operations and maintenance	1,567,022	1,622,592	1,631,297	1,704,370	1,418,164
Depreciation, depletion and amortization	551,760	571,669	513,708	564,039	326,748
Early retirement and severance charges	—	—	—	—	65,175
Operating taxes	404,212	418,236	380,527	448,914	421,936
Impairment Charges	40,965	—	—	—	—
Total operating expenses	5,768,753	5,522,232	4,574,665	5,426,968	4,101,544
Gain on sale of property	7,021	15,123	4,730	—	—
Income from equity investments	46,536	19,214	14,096	13,129	20,010
Operating income	935,270	1,047,629	909,335	791,964	733,030
Other income and (deductions)	4,983	(340,279)	(301,368)	(359,525)	(233,322)
Income taxes	325,540	281,281	229,665	200,472	208,549
Earnings from continuing operations	614,713	426,069	378,302	231,967	291,159
Discontinued Operations					
Income (loss) from operations, net of tax	(78,960)	(1,888)	15,692	22,643	9,648
Loss on disposal, net of tax	(72,088)	—	(16,306)	(30,356)	—
Loss from discontinued operations	(151,048)	(1,888)	(614)	(7,713)	9,648
Cumulative change in accounting principles	—	(37,451)	—	—	—
Net income	463,665	386,730	377,688	224,254	300,807
Preferred stock dividend requirements	5,612	5,844	5,753	5,904	18,113
Earnings for common stock	$ 458,053	$ 380,886	$ 371,935	$ 218,350	$ 282,694
Financial Summary					
Earnings per share ($)	2.86	2.41	2.63	1.58	2.10
Cash dividends declared per share ($)	1.78	1.78	1.78	1.78	1.78
Book value per share, year-end ($)	24.22	22.99	20.67	20.73	20.65
Market value per share, year-end ($)	39.45	36.80	35.24	34.65	42.38
Shareholders, year-end	72,549	75,067	78,281	82,300	86,900
Capital expenditures ($)	750,329	1,009,393	1,057,507	1,059,759	925,257
Total assets ($)	13,364,130	14,640,182	12,980,050	11,789,606	11,307,465
Common shareholders' equity ($)	3,894,710	3,670,656	2,944,592	2,890,602	2,815,816
Preferred stock redemption required ($)	75,000	75,000	75,000	75,000	75,000
Preferred stock no redemption required ($)	—	8,568	8,849	9,077	9,205
Long-term debt ($)	4,418,729	5,610,948	5,224,081	4,697,649	4,116,441
Total capitalization ($)	8,333,139	9,365,172	8,252,522	7,672,328	7,016,462

KEYSPAN CORPORATION DIRECTORS AND OFFICERS

BOARD OF DIRECTORS

Robert B. Catell
Chairman and
Chief Executive Officer
KeySpan Corporation

Andrea S. Christensen
Special Counsel
Kaye Scholer LLP

Robert J. Fani
President and
Chief Operating Officer
KeySpan Corporation

Alan H. Fishman
President and
Chief Executive Officer
Independence Community Bank

James R. Jones
Co-Chairman and
Chief Executive Officer
Manatt Jones Global Strategies, LLC

Dean James L. Larocca
Distinguished Professor
of Government and
Public Policy
Long Island University

Gloria C. Larson
Partner
Foley Hoag LLP

Stephen W. McKessy
Retired Vice Chairman
PricewaterhouseCoopers

Edward D. Miller
Former President and
Chief Executive Officer
AXA Financial, Inc.

Vikki L. Pryor
President and
Chief Executive Officer
SBLI USA Mutual Life Insurance Company, Inc.

COMMITTEES OF THE BOARD

Executive Committee

Robert B. Catell, *Chairman*

Alan H. Fishman
James R. Jones
Stephen W. McKessy
Edward D. Miller

Audit Committee

Alan H. Fishman, *Chairman*

Andrea S. Christensen
James L. Larocca
Stephen W. McKessy
Vikki L. Pryor

Compensation and Management Development Committee

Edward D. Miller, *Chairman*

James R. Jones
James L. Larocca
Gloria C. Larson
Stephen W. McKessy

Corporate Governance and Nominating Committee

James R. Jones, *Chairman*

Andrea S. Christensen
James L. Larocca
Gloria C. Larson
Vikki L. Pryor

PRINCIPAL OFFICERS

Office of the Chairman

Robert B. Catell
Chairman and
Chief Executive Officer

Robert J. Fani
President and
Chief Operating Officer

Wallace P. Parker Jr.
President
Energy Delivery and
Customer Relationship Group

Steven L. Zelkowitz
President
Energy Assets
and Supply Group

Executive Vice Presidents

John J. Bishar, Jr.
Executive Vice President
General Counsel and
Chief Governance Officer

John A. Caroselli
Executive Vice President
and Chief Strategy Officer

Gerald Luterman
Executive Vice President
and Chief Financial Officer

David J. Manning
Executive Vice President
Corporate Affairs and
Chief Environmental Officer

Anthony Nozzolillo
Executive Vice President
Electric Operations

Lenore F. Puleo
Executive Vice President
Shared Services

Nickolas Stavropoulos
Executive Vice President
KeySpan Energy Delivery

Senior Vice Presidents

Joseph F. Bodanza, Jr.
Senior Vice President
Regulatory Affairs and
Asset Optimization

Coleen A. Ceriello
Senior Vice President
Shared Service

John F. Haran
Senior Vice President
and Chief Engineer
KeySpan Energy Delivery

Michael J. Taunton
Senior Vice President
Treasurer and
Chief Risk Officer

Anthony J. Sartor
Senior Vice President
KeySpan Services

Elaine Weinstein
Senior Vice President
Human Resources and
Chief Diversity Officer

Other Officers

Theresa A. Balog
Vice President and
Chief Accounting Officer

Lawrence S. Dryer
Vice President and
General Auditor

Joseph E. Hajjar
Vice President and
Controller

Michael A. Walker
Vice President and
Deputy General Counsel

General Office
KeySpan Corporation
One MetroTech Center
Brooklyn, NY 11201-3850

Annual Meeting of Shareholders
The Annual Meeting of Shareholders of KeySpan Corporation will be held at 10:00 a.m. Eastern Time, on Friday, May 20, 2005, at the Tilles Center on the C.W. Post Campus of Long Island University in Brookville, New York.

Stock Listings
KeySpan common stock is traded primarily on the New York Stock Exchange (NYSE) under the trading symbol "KSE." KeySpan "MEDS" Convertible securities are primarily traded on the NYSE under the ticker KSE PRA. Daily stock quotes are listed in most major newspapers under the heading "KeySpan".

KeySpan Investor Program ("Dividend Reinvestment Plan")
The KeySpan Investor Program is an Open Enrollment/Dividend Reinvestment Plan. The Plan offers individuals a convenient and cost-effective way of purchasing KeySpan common stock. This Plan is open to everyone (NOT just existing shareholders). There is no enrollment fee for joining the Plan.

We welcome your participation in the KeySpan Investor Program. If you are interested in receiving Program material, please contact KeySpan's Stock Transfer Agent, EquiServe (electronic request line) at 1-866-238-5345 (1-866-2-FUUFK).

To enroll in the Plan, individuals must complete an application and mail in an initial investment of at least $250, or authorize electronic deductions of at least $25. Individuals may also enroll in the Plan via our web site http://investor.keyspanenergy.com.

Parameters
Eligibility: Open Enrollment

Investment Features

Initial Investment	Ongoing Investment
Minimum: $250	Minimum: [illegible]
Maximum: $150,000	Maximum: [illegible]

Investment Frequency: Weekly on Thursday
Source of Shares: Open Market (as of January 2004)
Sales Frequency: Daily
Sales Fee: $5.00 + 5 cents per share
Full or Partial Reinvestment: Yes
Electronic Debits/Credits: Yes
Safekeeping of Shares: Yes

Dividends
KeySpan paid an annual dividend of $1.78 in 2004. All of the dividends paid during the calendar year 2004 are considered to be ordinary dividend income and are therefore taxable (subject to review by the IRS). Tax forms 1099-Div were mailed by January 31, 2005. Please consult your tax advisor for further information.

In November 2004, the Company announced [illegible] dividend increase to $1.82 to take effect with the [illegible] payment.

Proposed Common Stock Dividend Dates

Declaration Date	Record Date	Payment Date
Dec. 15, 2004	Jan. 12, 2005	Feb. 1, 2005
Mar. 24, 2005	Apr. 13, 2005	May 1, 2005
Jun. 23, 2005	Jul. 13, 2005	Aug. 1, 2005
Sept. 21, 2005	Oct. 12, 2005	Nov. 1, 2005
Dec. 14, 2005	Jan. 11, 2006	Feb. 1, 2006

Stock Plans Group
Please direct inquiries to:
KeySpan Corporation
Stock Plans Group
One MetroTech Center
22nd Floor
Brooklyn, NY 11201-3850
Or call: 1-718-403-2196 E-mail: financial@keyspanenergy.com

Investor Relations
Inquiries from security analysts, stockbrokers, investment managers and other members of the financial community should be addressed to George Laskaris, Director of Investor Relations, at 1-718-403-[illegible], or by e-mail: glaskaris@keyspanenergy.com. Company information, including financial reports, is available at http://investor.keyspanenergy.com.

Stock Transfer Agent and Registrar
EquiServe Trust Company, N.A.
Investment Plan Services
P.O. Box 43069
Providence, RI 02940-3069
Call: 1-800-482-3638

Annual Report – Form 10-K
The New York Stock Exchange (NYSE) Section 303A.12(a) Chief Executive Officer Certification was filed with the NYSE on June 30, 2004.

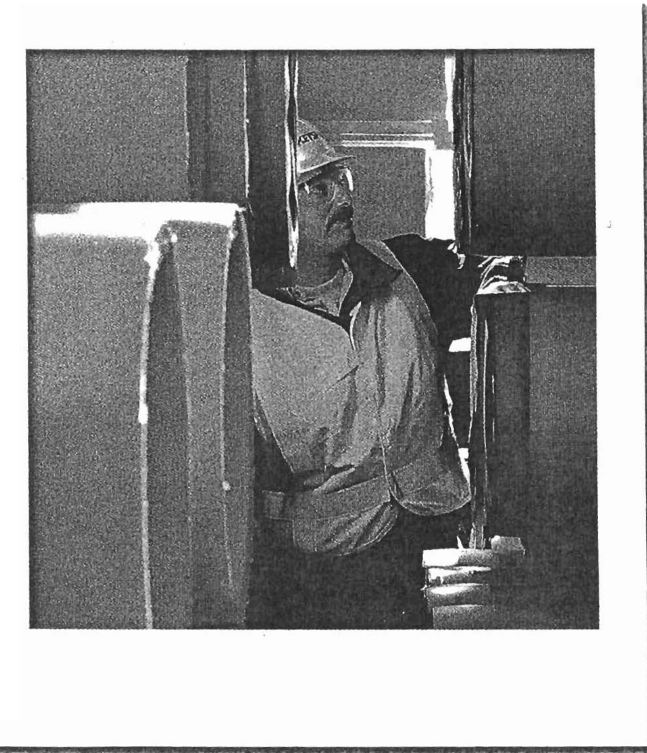
KeySpan files reports with the Securities and Exchange Commission (SEC), including annual reports on Form 10-K, quarterly reports on Form 10-Q and any other filings required by the SEC. The most recent certifications by KeySpan's Chief Executive Officer and Chief Financial Officer pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, were filed as exhibits to KeySpan's 2004 Form 10-K.

Independent Registered Public Accountants
Deloitte & Touche LLP
2 World Financial Center
New York, NY 10281
1-212-436-2000

Web Address
For more information on KeySpan, or for copies of our press releases and quarterly reports, please visit our web site at http://investor.keyspanenergy.com.

This Annual Report is Printed on Recycled Paper

KEYSPAN
Climate is everything™
One MetroTech Center
Brooklyn, New York 11201
www.keyspanenergy.com



2005 Annual Report

WHO WE ARE

A member of the Standard & Poor's 500 Index, KeySpan Corporation (NYSE: KSE) is the fifth largest distributor of natural gas in the United States and the largest in the Northeast, operating regulated gas utilities in New York, Massachusetts and New Hampshire, serving 2.6 million customers. These customer-focused businesses are complemented by a portfolio of service companies that offer energy-related products, services and solutions to homes and businesses. KeySpan is also the largest electric generator in New York State. We own approximately 6,600 megawatts of generating capacity, providing power to 1.1 million customers of the Long Island Power Authority on Long Island and supplying approximately 25 percent of New York City's capacity needs. In addition to these assets, KeySpan has strategic investments in natural gas pipeline transportation, distribution, storage and production. KeySpan has headquarters in Brooklyn, New England and Long Island. For more information, visit KeySpan's web site at www.keyspanenergy.com.

OUR BUSINESS SEGMENTS

GAS DISTRIBUTION

KeySpan is the largest gas distribution company in the Northeast serving 2.6 million customers. Its subsidiaries include a number of companies providing gas distribution services under the KeySpan brand. KeySpan Energy Delivery New York serves the New York City boroughs of Brooklyn, Staten Island and most of Queens. KeySpan Energy Delivery Long Island provides services on Long Island and the Rockaway Peninsula in Queens. Other subsidiaries, doing business as KeySpan Energy Delivery New England, provide services in Massachusetts and New Hampshire.

ELECTRIC SERVICES

KeySpan's electric services segment is the largest electric generator in New York State. We own and operate electric generation in New York City and Long Island with total capacity of approximately 6,600 megawatts. This segment also manages Long Island's electric transmission and distribution system for 1.1 million customers under long-term contracts with the Long Island Power Authority.

ENERGY SERVICES

The energy services segment includes companies that provide energy-related services to customers located primarily within the Northeastern United States. Subsidiaries in this segment provide residential and small commercial customers with service and maintenance of energy systems and appliances, as well as operation and maintenance, design, engineering, consulting and fiber optic services to commercial, institutional and industrial customers.

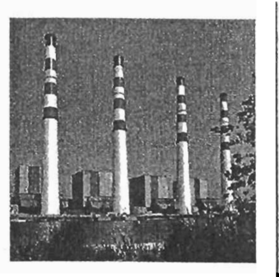
ENERGY INVESTMENTS

The energy investments segment consists of strategic investments in natural gas exploration and production, pipeline development, transportation, distribution and storage. These investments primarily include ownership of an interstate liquefied natural gas (LNG) storage facility in Providence, Rhode Island; a 20 percent interest in the Iroquois gas pipeline in the Northeast United States; and a 50 percent and 21 percent interest, respectively, in the Islander East and Millennium pipeline projects.

- Core earnings were up 5 percent to $403 million.

- Gas business added approximately $50 million in new gross profit margin.

- Electric business operating income increased 18 percent over 2004.



- Annual dividend increased to $1.86 per share.

- Debt-to-capitalization ratio reduced from more than 53 percent to less than 51 percent.

DEAR FELLOW SHAREHOLDER,

For KeySpan, 2005 was a year defined by strong operational and financial performance in an increasingly complex environment. It was this performance – and indeed our sustained performance over the last eight years – that set the stage for us to take a bold, exciting and decisive step into the future on February 27, 2006.

On that date, KeySpan announced a definitive agreement with National Grid in which National Grid will acquire all the outstanding shares of KeySpan for $7.3 billion in cash or $42 per share. While both companies' boards unanimously approved the agreement, shareholder and certain other regulatory approvals are necessary to achieve a targeted completion date of early 2007. Upon approval, KeySpan will become a wholly owned subsidiary of National Grid. As a shareholder, you will be receiving materials in the near future concerning this transaction.

At a time when energy costs and industry consolidation are defining the future of our industry, this agreement provides a premium return on your investment. It provides the platform that will create a stronger company that can better compete and win in a progressive, deregulated marketplace – one where size, scale and balance are important strategic differentiators for long-term, sustainable growth. Upon approval, KeySpan will join National Grid to establish the third largest energy delivery company in terms of customers in the United States.

As part of this larger company, we'll have access to greater resources to better tackle the tough issues – like high-priced, volatile energy markets and the ability to meet customers' demand for energy through enhanced supply, natural gas pipelines and infrastructure. And because National Grid's U.S. business is focused on the Northeast, where our combined service areas are contiguous in many places, there are many opportunities to achieve economies of scale and reduce costs for customers.

In short, KeySpan will become an important part of one of the most efficient, reliable and growth-focused energy delivery companies in the world.

BUILDING THE PLATFORM

KeySpan's excellent financial performance, core expertise in gas and electric operations, and our strong record in customer and community service all played a large role in why National Grid found KeySpan so valuable and attractive. And it provides the foundation for what promises to be a fruitful relationship for the new, combined company and its customers and shareholders.

In 2005, we delivered solid core earnings per share of $2.37, in line with analysts' estimates and an increase of 5 percent as compared to 2004. We reduced our debt-to-capitalization ratio from more than 53 percent to less than 51 percent, further improving our balance sheet. And in December, your board approved an annual dividend increase of four cents to $1.86 per share, the second consecutive year we were able to raise the dividend. KeySpan shareholders will continue to receive quarterly dividend payments until completion of the transaction.

Despite the challenge of higher gas commodity prices, which resulted in increased uncollectible accounts and less usage per customer, KeySpan's gas business completed 46,000 gas installations in 2005, adding almost $50 million in new gross profit margin. Net revenues were higher than 2004 by $48 million. Overall, KeySpan realized another year of organic growth, which helped offset the impact of higher costs.

The electric business also performed exceptionally. The Ravenswood facility and all of the Long Island generating units were close to 100 percent available and operating at top performance during the very hot summer. This combination of availability and efficiency helped earn $342 million in operating income, 18 percent higher than 2004.

And our new, enhanced agreement with the Long Island Power Authority (LIPA) was a case study in managing complexity. With no archetype to follow, we had to produce our own working, flexible model for this unique relationship – one that would provide benefit for shareholders, employees and Long Island consumers. We worked in partnership with LIPA to diligently achieve these objectives and create certainty in our Long Island electric operations through 2013. Now, we look forward to bringing the benefits of our combined company to LIPA and all its customers.

We bring these strengths – and more – to the table. Combining with National Grid, of course, also gives us a myriad of benefits that we wouldn't have on our own. It gives us the opportunity to lower risk and compete as a stronger player in the midst of a changing marketplace. And it allows us to drive growth to new heights, as part of a bigger company that will have the scale and resources necessary to enhance customer service and grow in today's complex environment.

AN IDEAL COMBINATION

Beyond the numbers, it's also an excellent fit for both companies. Both National Grid and KeySpan are dedicated to supply diversity and delivering energy in the most efficient, cost-effective way to customers. Both look to achieve outstanding operational performance in the most economical manner possible. Both have a substantial commitment to the local communities we serve, the natural environment we operate in, and the principles of sound fiscal and corporate accountability. And both boast a core of excellent employees who are technological leaders.

AN EXCITING FUTURE

Clearly, this is a bold step for KeySpan. But one that I feel is both necessary and evolutionary. And while employees may naturally feel some uncertainty, both companies are committed to achieve any staff reductions sensitively – through attrition and voluntary programs. Overall, I see much upside potential for our excellent employees to develop their talents and expand their opportunities as part of a global company.

Upon completion of the transaction, I will become executive chairman of National Grid's U.S. operation for two years. I will also serve as deputy chairman on National Grid's 14-member board in the United Kingdom, where one member of KeySpan's current board will join me, ensuring a strong role in the combined company. I especially look forward to working with Mike Jesanis, who will serve as president and chief executive officer of the combined company, and Steve Holliday, chief executive designate of National Grid plc. I have come to better know these two talented and experienced men over the last several months – and I assure you we share a common philosophy and vision.

I've enjoyed a highly satisfying 48 years in this business; the last eight have been especially fulfilling. My thanks to our loyal shareholders who've invested their hard-earned dollars with us, and to our employees, who've made our success possible. I also want to thank KeySpan's board of directors; they were instrumental in making KeySpan the company we are today – and making us part of the company we will be tomorrow.

As I conclude this letter, I'm confident and excited about the future. The KeySpan Corporation is poised to build on our successful history as a vital part of a larger, stronger company that can lay claim to the title we've relentlessly pursued since KeySpan was formed: the premier energy company in the Northeast.

Robert B. Catell

Robert B. Catell
Chairman and Chief Executive Officer
March 21, 2006

Financial Review

CONTENTS

5 Financial Review and Analysis

40 Consolidated Financial Statements

46 Notes to Consolidated Financial Statements

87 Selected Financial Data

88 Directors and Officers

89 Shareholder Information

ADDITIONAL INFORMATION REGARDING THE KEYSPAN/NATIONAL GRID TRANSACTION AND WHERE TO FIND IT

KeySpan intends to file with the Securities and Exchange Commission ("SEC") a proxy statement and other relevant documents in connection with the proposed acquisition of KeySpan by National Grid. Investors and security holders of KeySpan are advised to read the proxy statement and other relevant documents when they become available, as they will contain important information about the transaction. Investors and security holders may obtain a free copy of the proxy statement and other documents filed by KeySpan with the SEC, when they become available, at the SEC's web site at http:/www.sec.gov.

KeySpan and its directors, executive officers and other members of its management and employees may be deemed to be participants in the solicitation of proxies from its security holders in connection with the proposed acquisition. Information concerning the interests of KeySpan's participants in the solicitation is set forth in KeySpan's most recent proxy statement and Annual Report on Form 10-K filed (filed with the Securities and Exchange Commission on March 30, 2005 and March 2, 2006, respectively) and will be set forth in the proxy statement relating to the merger when it becomes available.

KeySpan Corporation (referred to in the Notes to the Financial Statements as "KeySpan," "we," "us" and "our") is a holding company that operates six regulated utilities that distribute natural gas to approximately 2.6 million customers in New York City, Long Island, Massachusetts and New Hampshire, making KeySpan the fifth largest gas distribution company in the United States and the largest in the Northeast. We also own, lease and operate electric generating plants in Nassau and Suffolk Counties on Long Island and in Queens County in New York City and are the largest electric generation operator in New York State. Under contractual arrangements, we provide power, electric transmission and distribution services, billing and other customer services for approximately 1.1 million electric customers of the Long Island Power Authority ("LIPA"). KeySpan's other operating subsidiaries are primarily involved in gas exploration and production; underground gas storage; liquefied natural gas storage; retail electric marketing; large energy-system ownership, installation and management; service and maintenance of energy systems; and engineering and consulting services. We also invest and participate in the development of natural gas pipelines, electric generation and other energy-related projects. (See Note 2" Business Segments" for additional information on each operating segment.)

Recent Developments

On February 25, 2006, KeySpan entered into an Agreement and Plan of Merger (the "Merger Agreement"), with National Grid PLC, a public limited company incorporated under the laws of England and Wales ("Parent") and National Grid USA, Inc., a New York Corporation ("Merger Sub"), pursuant to which Merger Sub will merge with and into KeySpan (the "Merger"), with KeySpan continuing as the surviving company. Pursuant to the Merger Agreement, at the effective time of the Merger, each outstanding share of common stock, par value $0.01 per share of KeySpan (the "Shares"), other than shares owned by KeySpan, shall be canceled and shall be converted into the right to receive $42.00 in cash, without interest.

Consummation of the Merger is subject to various closing conditions, including but not limited to the satisfaction or waiver of conditions regarding the receipt of requisite regulatory approvals and the adoption of the Merger Agreement by the stockholders of KeySpan and the Parent. Assuming receipt or waiver of the foregoing, it is currently anticipated that the Merger will be consummated in early 2007. Accordingly, any statements contained herein concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions are "forward-looking statements" and do not take into account the occurrence or impact of any potential strategic transaction on the future operations, financial condition and cash flows of KeySpan. However, no assurance can be given that the Merger will occur, or, the timing of its completion.

At December 31, 2005, KeySpan was a holding company under the Public Utility Holding Company Act of 1935, as amended ("PUHCA 1935"). In August 2005, the Energy Policy Act of 2005 (the "Energy Act") was enacted. The Energy Act is a broad energy bill that places an increased emphasis on the production of energy and promotes the development of new technologies and alternative energy sources and provides tax credits to companies that produce natural gas, oil, coal, electricity and renewable energy. For KeySpan, one of the more significant provisions of the Energy Act is the repeal of PUHCA 1935, which became effective on February 8, 2006. Since that time, the jurisdiction of the Securities and Exchange Commission ("SEC") over certain holding company activities, including the regulation of our affiliate transactions and service companies, has been transferred to the jurisdiction of the Federal Energy Regulatory Commission ("FERC") pursuant to the Public Utility Holding Company Act of 2005 ("PUHCA 2005"). See "Regulation and Rate Matters" for additional information on the Energy Act and PUHCA 2005.

Executive Summary

Below is a table comparing the more significant items impacting earnings from continuing operations and earnings available for common stock for the periods indicated.

(In Millions of Dollars, Except per Share Amounts)

YEAR ENDED DECEMBER 31,	2005		2004		2003	
	EARNINGS	E.P.S.	EARNINGS	E.P.S.	EARNINGS	E.P.S.
Earnings from continuing operations, less preferred stock dividends	$ 396.4	$ 2.33	$ 609.1	$ 3.80	$ 420.2	$ 2.65
Discontinued operations	(1.8)	(0.01)	(151.0)	(0.94)	(1.9)	(0.01)
Cumulative change in accounting principle	(6.6)	(0.04)	—	—	(37.4)	(0.23)
Earnings for Common Stock	$ 388.0	$ 2.28	$ 458.1	$ 2.86	$ 380.9	$ 2.41
Components of Continuing Operations:						
Core operations	$ 403.2	$ 2.37	$ 359.4	$ 2.25	$ 334.2	$ 2.11
Asset sales	—	—	257.5	1.60	0.9	—
Non core operations	—	—	83.9	0.52	98.7	0.62
Impairment charges	—	—	(62.4)	(0.39)	—	—
Debt redemption costs	(6.8)	(0.04)	(29.3)	(0.18)	(13.6)	(0.08)
Earnings from continuing operations, less preferred stock dividends	$ 396.4	$ 2.33	$ 609.1	$ 3.80	$ 420.2	$ 2.65

Earnings from Continuing Operations 2005 vs 2004

KeySpan's earnings from continuing operations, less preferred stock dividends, for the year ended December 31, 2005 were $396.4 million or $2.33 per share, a decrease of $212.7 million, or $1.47 per share compared to $609.1 million, or $3.80 per share realized in 2004. KeySpan's financial results for the year ended December 31, 2005 and 2004, reflect the following items that had a significant impact on comparative results: (i) earnings from core operations; (ii) asset sales of non-core subsidiaries recorded in 2004 and their respective results for 2004; (iii) impairment charges recorded in 2004; and (iv) debt redemption charges recorded in both 2005 and 2004.

As indicated in the above table, KeySpan's earnings from core operations increased $43.8 million or $0.12 per share in 2005, primarily reflecting higher earnings from the Electric Services segment, improved results from the Energy Services segment, and a decrease in interest charges. KeySpan's electric services operations benefited from an increase in net electric revenues principally as a result of improved pricing due, in part, to the warm weather during the 2005 summer. Lower operating losses were incurred at the Energy Services segment as a result of lower operating expenses.

The decrease in interest expense resulted from the benefits attributable to lower outstanding debt resulting from debt redemptions in 2004 and the first quarter of 2005, as well as from the sale of Houston Exploration and KeySpan Canada. These favorable results were somewhat offset by a decrease in operating income from KeySpan's gas distribution operations as a result of higher operating expenses, primarily due to an increase in the provision for uncollectible accounts receivable as a result of increasing gas costs and the adverse impact from recent collection experience.

The full benefit to earnings per share from the favorable operating results of the Electric Services and Energy Services segments, as well as the decrease in interest charges was offset by the higher level of common shares outstanding. On May 16, 2005, KeySpan issued 12.1 million shares of common stock upon the scheduled conversion of the MEDS Equity Units. The dilutive effect of this issuance on earnings per share for the year ended December 31, 2005, was approximately $0.12 per share. (See Note 6 to the Consolidated Financial Statements "Long-term Debt and Commercial Paper" for additional details on the MEDS Equity Units.)

The remaining items impacting comparative earnings from continuing operations – asset sales, impairment charges and debt redemption charges – are discussed below.

During 2004, KeySpan sold its remaining 55% equity interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company based in Houston, Texas. We received cash proceeds of approximately $758 million in two stock transactions that resulted in after-tax gains of $222.7 million, or $1.39 per share. The first transaction occurred in June 2004 and the second transaction was completed in November 2004. The operations of Houston Exploration were fully consolidated in KeySpan's Consolidated Financial Statements during the first five months of 2004, but were then accounted for on the equity method of accounting after the first transaction reduced our ownership interest below 50%.

Also in 2004, KeySpan sold its remaining 60.9% investment in KeySpan Energy Canada Partnership ("KeySpan Canada"), a company that owned certain midstream natural gas assets in Western Canada. We received cash proceeds of approximately $255 million in two transactions that resulted in a total after-tax gain of $34.8 million, or $0.21 per share. The first transaction took place in April 2004 and the second transaction was completed in December 2004. The operations of KeySpan Canada were fully consolidated in KeySpan's Consolidated Financial Statements during the first three months of 2004, but then were accounted for on the equity method of accounting after the first transaction reduced our ownership interest below 50%.

Combined, these asset sales provided KeySpan with approximately $1 billion in case proceeds and after-tax earnings of $257.5 million, or $1.60 per share.Further, during 2004, KeySpan's share of the after-tax operating earnings of Houston Exploration and KeySpan Canada was $83.9 million or $0.52 per share.

See Note 2 to the Consolidated Financial Statements "Business Segments" and the discussions under the caption "Review of Operating Segments" for a more detailed discussion of each of the above noted non-core transactions.

KeySpan recorded three significant impairment charges during 2004: (i) a goodwill impairment charge recorded in the Energy Services segment; (ii) a ceiling test write-down recorded in the Energy Investments segment; and (iii) a carrying value impairment charge also recorded in the Energy Investments segment. These impairment charges resulted in after-tax charges to continuing operations of $62.4 million, or $0.39 per share.

Specifically, the Energy Services segment recorded an after-tax non-cash goodwill impairment charge of $12.6 million, or $0.08 per share in continuing operations as a result of an evaluation of the carrying value of goodwill recorded in this segment. That evaluation resulted in a total impairment charge of $152.4 million after-tax, or $0.95 per share – $12.6 million of this charge was attributable to continuing operations, while the remaining $139.9 million,or $0.87 per share, was reflected in discontinued operations. (See Note 10 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for additional details on this charge.)

KeySpan's remaining wholly owned gas exploration and production subsidiaries recorded a non-cash impairment charge of $48.2 million ($31.1 million after-tax,or $0.19 per share) in 2004 to recognize the reduced valuation of proved reserves. (See Note 9 to the Consolidated Financial Statements "Gas exploration and Production Property – Depletion," for additional details on this charge.)

In addition to the asset sales noted previously, in the fourth quarter of 2004,KeySpan anticipated selling its previous 50% ownership interest in Premier Transmission Limited ("Premier"), a gas pipeline from southwest Scotland to Northern Ireland. In the fourth quarter of 2004, KeySpan recorded a non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share,reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying

value. This investment was accounted for under the equity method of accounting in the Energy Investments segment. The sale of Premier was completed in the first quarter of 2005 and resulted in cash proceeds of approximately $48.1 million and a pre-tax gain of $4.1 million reflecting the difference from earlier estimates. (See Note 2 to the Consolidated Financial Statements "Business Segments" and the discussions under the caption "Review of Operating Segments" for a more detailed discussion of the sale.)

The remaining significant item impacting comparative results, as noted above,was debt redemption costs incurred in both 2005 and 2004. In 2005, KeySpan redeemed $500 million of 6.15% Notes due in 2006. KeySpan incurred $20.9 million in call premiums, which were expensed and recorded in other income and deductions on the Consolidated Statement of Income, and wrote-off $1.3 million of previously deferred financing costs. Further, KeySpan accelerated the amortization of approximately $11.2 million of previously unamortized benefits associated with an interest rate swap on these Notes. The accelerated amortization was recorded as a reduction to interest expense. The net after-tax expense of this debt redemption was $6.8 million or $0.04 per share. (See Note 6 to the Consolidated Financial Statements "Long-Term Debt and Commercial Paper" as well as the discussion under the caption "Financing" for additional details on this transaction.) In 2004, KeySpan redeemed approximately $758 million of various series of outstanding long-term debt. KeySpan incurred $54.5 million in call premiums associated with these redemptions, of which $45.9 was expensed and recorded in other income and deductions on the Consolidated Statement of Income. The remaining amount of the call premiums have been deferred for future rate recovery. Further, KeySpan wrote-off $8.2 million of previously deferred financing costs which have been reflected in interest expense on the Consolidated Statement of Income. The total after-tax expense of the 2004 debt redemption was $29.3 million or $0.18 per share.

The net impact of the above mentioned items resulted in a decrease to earnings from continuing operations of $6.8 million or $0.04 per share for the year ended December 31, 2005, compared to a gain of $249.7 million, or $1.55 per share, in 2004.

Earnings Available for Common Stock 2005 vs 2004

Earnings available for common stock also include losses from discontinued operations associated with KeySpan's former mechanical contracting subsidiaries; these companies were discontinued in the fourth quarter of 2004 and sold in early 2005. In the fourth quarter of 2004, KeySpan's investment in its mechanical contracting subsidiaries was written-down to fair value. During 2005, operating losses amounting to $4.1 million after-tax were incurred through the dates of sale of these companies, including, but not limited to, costs incurred for employee related benefits. Partially offsetting these losses was an after-tax gain of $2.3 million associated with the related divestitures, reflecting the difference between the fair value estimates and the financial impact of the actual sale transactions. The net income impact of the operating losses and the disposal gain was a loss of $1.8 million, or $0.01 per share for the year ended December 31, 2005.

Further, earnings available for common stock for 2005 include a $6.6 million, or $0.04 per share, cumulative change in accounting principle charge as a result of implementing the accounting requirements of FASB Interpretation No. 47 ("FIN 47") "Accounting for Conditional Asset Retirement Obligations." This pronouncement required KeySpan to record a liability for the estimated future cost associated with the legal obligation to dispose of long-lived assets at the time of their retirement or disposal date. Upon initial implementation, December 31, 2005, a cumulative change in accounting principle charge was recorded on KeySpan's Consolidated Statement of Income, representing the present value of KeySpan's future retirement obligation. See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for further information on this charge.

As previously noted, in 2004 KeySpan conducted an evaluation of the carrying value of its investments in the Energy Services segment. As a result of this evaluation, KeySpan recorded a loss in discontinued operations of $151.0 million, or $0.94 per share. This loss reflects a $139.9 million after-tax impairment charge to reflect a reduction to the carrying value of assets associated with our mechanical contracting activities and operating losses of $11.1 million. (See Note 10 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for additional details on these items.)

Earnings from Continuing Operations 2004 vs 2003

KeySpan's earnings from continuing operations, less preferred stock dividends, for the year ended December 31, 2004, were $609.1 million or $3.80 per share, an increase of $188.9 million, or $1.15 per share compared to $420.2 million, or $2.65 per share realized in 2003. KeySpan's financial results for the year ended December 31, 2004 and 2003 reflect the following items that had a significant impact on comparative results: (i) earnings from core operations; (ii) non-core asset sales recorded in both 2004 and 2003; (iii) impairment charges recorded in 2004; and (iv) debt redemption charges recorded in both 2004 and 2003.

As indicated in the table above, KeySpan's earnings from core operations increased $25.2 million or $0.14 per share for the twelve months ended December 31, 2004 compared to 2003, primarily reflecting an increase in net electric revenues associated with KeySpan's Electric Services segment, as well as from higher earnings from the Gas Distribution segment, primarily due to a Boston Gas Company rate increase resulting from a rate proceeding concluded in November 2003.

The remaining items impacting comparative earnings from continuing operations – asset sales, impairment charges and debt redemption charges – are discussed below.

As noted previously, during 2004 KeySpan sold its ownership interests in Houston Exploration and KeySpan Canada. Combined, these asset sales provided KeySpan with approximately $1 billion of cash proceeds and after-tax earnings of $257.5 million, or $1.60 per share. Further, during 2004, KeySpan's share of the after-tax operating earnings of Houston Exploration and KeySpan Canada was $83.9 million or $0.52 per share.

During 2003, KeySpan completed two non-core asset sales. KeySpan sold a 39.09% interest in KeySpan Canada and a 20% interest in Taylor

NGL LP which owned and operated two extraction plants in Canada. We recorded an after-tax loss of $34.1 million, or $0.22 per share, associated with these sales. Additionally, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. We recorded a gain of $19.0 million, or $0.12 per share, on this transaction. Income taxes were not provided on this transaction since the transaction was structured as a return of capital. KeySpan's share of the after-tax operating earnings of Houston Exploration and KeySpan Canada was $98.7 million or $0.62 per share for the twelve months ended December 31, 2003.

Further, in the fourth quarter of 2003, we completed the sale of a 24.5% interest in Phoenix Natural Gas, a natural gas distribution company located in Northern Ireland, and recorded an after-tax gain of $16.0 million, or $0.10 per share. In total, KeySpan recorded a pre-tax gain of $13.3 million from the monetization of non-core assets. The combined after-tax gain from these asset sales was minimal due to the tax treatment associated with each transaction.

See Note 2 to the Consolidated Financial Statements "Business Segments" and the discussions under the caption "Review of Operating Segments" for a more detailed discussion of each of the above noted non-core transactions.

As previously noted, KeySpan recorded three significant impairment charges during 2004: (i) a goodwill impairment charge recorded in the Energy Services segment of $152.4 million after-tax, or $0.95 per share, – $12.6 million of which was attributable to continuing operations, while the remaining $139.9 million, or $0.87 per share, was reflected in discontinued operations; (ii) an after-tax ceiling test write-down of $31.1 million, or $0.19 per share, to recognize the reduced valuation of proved reserves associated with KeySpan's wholly-owned gas exploration and production subsidiaries; and (iii) a non-cash impairment charge of $26.5 million, – $18.8 million after-tax or $0.12 per share, recorded in the Energy Investments segment reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value.

The remaining significant item noted above is debt redemption costs incurred in 2004 and 2003. As noted previously, in 2004, KeySpan redeemed approximately $758 million of outstanding long-term debt. The total after-tax expense of this debt redemption was $29.3 million or $0.18 per share. In 2003, KeySpan incurred $18.2 million in debt redemption costs associated with the redemption of approximately $447 million of outstanding promissory notes that were issued to LIPA in connection with the KeySpan/Long Island Lighting Company ("LILCO") business combination completed in May 1998. Further, Houston Exploration, then a consolidated subsidiary, incurred debt redemption costs of $5.9 million, to retire $100 million 8.625% Notes. The total after-tax expense of the debt redemptions in 2003 was $13.6 million or $0.08 per share.

The net impact of the above mentioned items resulted in an increase to earnings from continuing operations of $249.7 million, or $1.55 per share for the year ended December 31, 2004, compared to $86.0 million or $0.54 per share in 2003.

Earnings Available for Common Stock 2004 vs 2003

Earnings available for common stock for the year ended December 31, 2004 also include losses from discontinued operations of $151.0 million, or $0.94 per share. This loss includes $139.9 million of after-tax impairment charges to reflect a reduction to the carrying value of assets associated with KeySpan's former mechanical contracting subsidiaries and operating losses of $11.1 million.

Earnings available for common stock for the year ended December 31, 2003, also reflect an operating loss from discontinued operations associated with KeySpan's former mechanical contracting subsidiaries of $1.9 million, or $0.01 per share and a charge for a cumulative change in accounting principle. In January 2003, the Financial Accounting Standards Board ("FASB") issued Financial Interpretation Number 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." This Interpretation required KeySpan to, among other things, consolidate the Ravenswood Master Lease (the lease under which KeySpan leases and operates a portion of the Ravenswood electric generating facility (the "Ravenswood Facility") and classify the lease obligation as long-term debt on the Consolidated Balance Sheet starting December 31, 2003. As a result of implementing FIN 46, we recognized a non-cash, after-tax charge of $37.4 million, or $0.23 per share related to "catch-up" depreciation of the facility since its acquisition in June 1999 and recorded the charge as a cumulative change in accounting principle. (See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for an explanation of the leasing arrangement for the Ravenswood Facility, as well as an explanation of the implementation of FIN 46.)

Consolidated Summary of Results

Operating income by segment, as well as consolidated earnings available for common stock is set forth in the following table for the periods indicated.

	(In Millions of Dollars, Except Per Share Amounts)		
YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Gas Distribution	$ 565.7	$ 579.6	$ 574.3
Electric Services	342.3	289.8	269.9
Energy Services			
Operations	(2.7)	(33.9)	(33.0)
Goodwill impairment charge	—	(14.4)	—
Energy Investments			
Operations of continuing companies	20.6	24.4	12.5
Operations of sold companies	—	155.0	226.0
Ceiling test write-down and impairment charge	—	(74.7)	—
Eliminations and other	(18.1)	9.5	(2.1)
Operating Income	907.8	935.3	1,047.6
Other Income and (Deductions)			
Interest charges	(269.3)	(331.3)	(307.7)
Gain on sale of assets	4.1	388.3	13.3
Cost of debt redemption	(20.9)	(45.9)	(24.1)
Minority interest	(0.4)	(36.8)	(63.9)
Other income and (deductions)	16.6	30.6	42.1
	(269.9)	4.9	(340.3)
Income taxes	(239.3)	(325.5)	(281.3)
Income from Continuing Operations	398.6	614.7	426.0
Loss from discontinued operations	(1.8)	(151.0)	(1.9)
Cumulative change in accounting principles	(6.6)	—	(37.4)
Net Income	390.2	463.7	386.7
Preferred stock dividend requirements	2.2	5.6	5.8
Earnings for Common Stock	$ 388.0	$ 458.1	$ 380.9
Basic Earnings per Share:			
Continuing operations, less preferred stock dividends	$ 2.33	$ 3.80	$ 2.65
Discontinued operations	(0.01)	(0.94)	(0.01)
Cumulative change in accounting principles	(0.04)	—	(0.23)
	$ 2.28	$ 2.86	$ 2.41

Operating Income 2005 vs 2004

As indicated in the above table, operating income decreased $27.5 million, or 3%, for the twelve months ended December 31, 2005 compared to the same period of 2004. The comparative operating results reflect the following two items that had a significant impact on results: (i) operating results of non-core subsidiaries recorded in 2004; offset by (ii) impairment charges recorded in 2004. As noted earlier, during 2004 KeySpan held equity ownership interests in Houston Exploration and KeySpan Canada. For the twelve months ended December 31, 2004, KeySpan's share of the combined operating income of Houston Exploration and KeySpan Canada was $155.0 million. KeySpan sold its remaining ownership interest in these non-core operations in the fourth quarter of 2004. Offsetting this income to some extent were pre-tax non-cash impairment charges of $89.1 million recorded in 2004. As noted earlier, KeySpan recorded the following three impairment charges during 2004: (i) a goodwill impairment charge recorded in the Energy Services segment attributable to continuing operations of $14.4 million; (ii) a ceiling test write-down of $48.2 million to recognize the reduced valuation of proved reserves associated with KeySpan's wholly-owned gas exploration and production subsidiaries; and (iii) a non-cash impairment charge of $26.5 million also recorded in the Energy Investments segment reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value.

The combined impact of the non-core operating income recorded in 2004 offset by the impairment charges contributed $65.9 million to operating income for the twelve months ended December 31, 2004. KeySpan's core businesses, therefore, posted an increase in operating income of $38.4 million for the twelve months ended December 31, 2005, compared to the same period of 2004, primarily reflecting an increase of $52.5 million in the Electric Services segment, partially offset by a $13.9 million decrease in the Gas Distribution segment. The favorable results from KeySpan's electric services operations reflect an increase in net electric revenues as a result of higher electric prices that were due, in part, to the warm weather during the summer of 2005. Gas distribution results, however, were adversely impacted by higher operating expenses, primarily due to an increase in the provision for uncollectible accounts receivable as a result of higher gas costs and by higher property taxes. For the most part, the beneficial impact on comparative operating income from lower net operating losses incurred at the Energy Services segment, was offset by an increase in expenses residing at the holding company level. Further, in 2004 KeySpan reached a settlement with certain of its insurance carriers regarding cost recovery for expenses incurred at a non-utility environmental site and recorded an $11.6 million gain from the settlement as a reduction to expense.

Other income and (deductions) reflects interest charges, costs associated with debt redemptions, income from subsidiary stock transactions, minority interest charges and other miscellaneous items. For the twelve months ended December 31, 2005, other income and (deductions) reflects a net expense of $269.9 million compared to income of $4.9 million for the twelve months ended December 31, 2004. This unfavorable variation of $274.8 million is due to higher gains from asset sales recorded in 2004 compared to 2005 of $384.2 million, offset by a decrease in interest charges of $62.0 million, lower debt redemption costs of $25.0 million and the absence of minority interest expenses of $36.4 million. The following is a discussion of these items.

As noted earlier, in the first quarter of 2005, KeySpan finalized its sale of Premier. The final sale of Premier resulted in a pre-tax gain of $4.1 million reflecting the difference from earlier estimates and what was recorded in the first quarter of 2005. For the twelve months ended December 31, 2004, KeySpan realized pre-tax income of $388.3 million from subsidiary stock transactions associated with Houston Exploration and KeySpan Canada, as discussed earlier.

Interest expense decreased $62.0 million, or 19%, for the twelve months ended December 31, 2005, compared to the same period of 2004, reflecting the benefits attributable to recent debt redemptions, as well as the sale of Houston Exploration and KeySpan Canada. In addition, as noted earlier, in 2005 KeySpan redeemed $500 million 6.15% Series Notes due 2006. KeySpan incurred $20.9 million in call premiums, wrote-off $1.3 million of previously deferred financing costs and accelerated the amortization of approximately $11.2 million of previously unamortized benefits associated with an interest rate swap on these bonds. The accelerated amortization of the interest rate swap and the write-off of previously deferred financing costs reduced interest expense in 2005 by $9.9 million.

In 2004, KeySpan redeemed approximately $758 million of various series of outstanding debt and incurred $45.9 million in call premiums and wrote-off $8.2 million of previously deferred financing costs. The net impact of the 2005 and 2004 debt redemptions lowered comparative interest expense by $18.1 million.

For the year ended December 31, 2004 other income and (deductions) also includes the effects of minority interest of $36.8 million related to our previous majority ownership interests in Houston Exploration and KeySpan Canada. Finally, other income and (deductions) for the year ended December 31, 2004 reflects a $12.6 million gain recorded on the settlement of a derivative financial instrument entered into in connection with the sale/leaseback transaction associated with the Ravenswood Expansion, a 250 MW combined cycle generating facility located at the Ravenswood site, as well as a $5.5 million foreign currency gain.

Income taxes decreased $86.2 million for the year ended December 31, 2005 compared to last year due, for the most part, to lower pre-tax earnings. In addition, tax expense for 2004 reflects: (i) a $6.0 million benefit resulting from a revised appraisal associated with property that was disposed of in 2003; (ii) a tax benefit of $12 million related to the repatriation of earnings from KeySpan's foreign investments; and (iii) the beneficial tax treatment afforded the stock transaction with Houston Exploration.

As noted earlier, earnings available for common stock for the year ended December 31, 2005, also includes losses of $1.8 million, or $0.01 per share, from discontinued operations, as well as a $6.6 million, or $0.04 per share cumulative change in accounting principles charge. Earnings available for common stock for the year ended December 31, 2004, includes losses of $151.0 million, or $0.94 per share, from discontinued operations.

As a result of the items discussed above, earnings available for common stock were $388.0 million, or $2.28 per share for the year ended December 31, 2005, compared to $458.1 million, or $2.86 per share realized in 2004.

Operating Income 2004 vs 2003

Operating income decreased $112.3 million, or 11%, for the twelve months ended December 31, 2004, compared to the same period of 2003. Comparative operating income was adversely impacted by lower operating income from the Energy Investments segment as a result of KeySpan's reduced ownership interest in Houston Exploration and KeySpan Canada during the latter half of 2004. KeySpan's lower ownership level in these former subsidiaries reduced comparative operating income by $71.0 million. In addition, operating income in the Energy Investments segment was adversely impacted by the $48.2 million non-cash impairment charge to recognize the reduced valuation of proved reserves, as well as the $26.5 million non-cash impairment charge associated with our previous investment in Premier. Further, the decrease in operating income reflects the $14.4 million non-cash goodwill impairment charge recorded in the Energy Services segment. The combined impact of the decrease in non-core operating income and the impairment charges recorded in 2004 reduced operating income for the twelve months ended December 31, 2004, by $160.1 million. KeySpan's core businesses, therefore, posted an increase in operating income of $47.8 million for the twelve months ended December 31, 2004 compared to the same period of 2003, primarily reflecting increases of $19.9 million in the Electric Services segment, $5.3 million in the Gas Distribution segment and $11.9 million from the continuing operations in the Energy Investments segment.

The increase in comparative operating income in the Electric Services segment in 2004 primarily reflects higher net electric margins associated with the Ravenswood Expansion. The Gas Distribution segment benefited from customer additions and oil-to-gas conversions throughout our service territories, as well as from the full effect of the rate increase resulting from the Boston Gas Company rate proceeding concluded in November 2003. In 2003, we recorded $15.1 million in gains from property sales, primarily the sale of 550 acres of real property located on Long Island, that were recorded in the Gas Distribution segment. The continuing operations in the Energy Investments segment realized higher earnings from the sale of property, as well as from an increase in earnings from gas pipeline investments and generally lower administrative costs. (See the discussion under the caption "Review of Operating Segments" for further details on each segment.)

Other income and (deductions) reflects interest charges, costs associated with debt redemptions, income from subsidiary stock transactions, minority interest charges and other miscellaneous items. For the twelve months ended December 31, 2004, other income and (deductions) reflects a net gain of $4.9 million compared to a net expense of $340.3 million for the twelve months ended December 31, 2003. This favorable variation of $345.2 million is due to higher gains from asset sales recorded in 2004 compared to 2003 of $375.0 million and a lower minority interest adjustment of $27.1 million, offset by an increase in interest charges of $23.6 million and higher debt redemption costs of $21.8 million. The following is a discussion of these items.

As noted earlier, for the twelve months ended December 31, 2004, KeySpan realized pre-tax income of $388.3 million from subsidiary stock transactions associated with Houston Exploration and KeySpan Canada. During 2003, we monetized a portion of our Canadian and Northern Ireland investments, as well as a portion of our ownership interest in Houston Exploration and recorded a net gain of $13.3 million associated with these transactions. Further, the lower ownership level in Houston Exploration and KeySpan Canada in 2004 resulted in an associated decrease in the minority interest adjustment of $27.1 million.

The increase in interest expense of $23.6 million, or 8%, in 2004, compared to the prior year, reflects a number of items. As noted earlier, interest expense for 2004 includes the write-off of $8.2 million of previously deferred issuance costs as a result of the redemption of $758 million of outstanding long-term debt. In addition, interest expense in 2004 was impacted by the implementation of FIN 46, discussed earlier. Beginning January 1, 2004, lease payments associated with the Ravenswood Master Lease have been reflected as interest expense on the Consolidated Statement of Income resulting in an increase to interest expense of approximately $30 million in 2004. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies for further information on the Master Lease.")

Further, comparative interest expense also reflects the benefits realized in 2003 associated with interest rate swaps. In 2003, we terminated an interest rate swap agreement with a notional amount of $270 million. This swap was used to hedge a portion of outstanding promissory notes that were issued to LIPA in connection with the KeySpan/LILCO business combination. In March 2003, we redeemed approximately $447 million of the outstanding promissory notes, and settled the outstanding derivative instrument. The cash proceeds from the termination of the interest rate hedge were $18.4 million, of which $8.1 million represented accrued swap interest. The difference between the termination settlement amount and the amount of accrued swap interest, $10.3 million, was recorded to earnings (as an adjustment to interest expense) in 2003 and effectively offset a portion of the redemption charges.

Offsetting, to some extent, these adverse impacts to comparative interest expense are the benefits associated with a lower level of outstanding long-term debt.

As noted previously, during 2004, KeySpan redeemed approximately $758 million of outstanding long-term debt and recorded $45.9 million in debt redemption costs. In 2003, KeySpan incurred debt redemption costs of $24.1 million associated with (i) the redemption of approximately $447 million of outstanding promissory notes issued to LIPA in connection with the KeySpan/LILCO business combination; and (ii) Houston Exploration's debt redemption costs of $5.9 million to retire $100 million 8.625% Notes. The operating results for Houston Exploration were consolidated in 2003.

Other income and (deductions) for 2004 also reflects a $12.6 million gain recorded on the settlement of a derivative financial instrument entered into in connection with the sale/leaseback transaction associated with the Ravenswood Expansion, as well as a $5.5 million foreign currency gain on cash investments held off-shore. Other income and (deductions) for 2003 also reflects severance tax refunds totaling $21.6 million recorded by Houston Exploration for severance taxes paid in 2002 and earlier periods, as well as $6.5 million of realized foreign currency translation gains. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding the sale/leaseback transaction.)

Income tax expense generally reflects the level of pre-tax income. In addition, tax expense for 2004 reflects: (i) a $6.0 million benefit resulting from a revised appraisal associated with property that was disposed of in 2003; (ii) a tax benefit of $12 million related to the repatriation of earnings from KeySpan's foreign investments; and (iii) the beneficial tax treatment afforded the stock transaction with Houston Exploration.

Income tax expense for 2003 includes a number of items impacting comparative results. During 2003, the partial monetization of our Canadian investments resulted in tax expense of $3.8 million, reflecting certain United States partnership tax rules. In addition, we recorded an adjustment to income tax expense of $6.1 million due to the Commonwealth of Massachusetts disallowing the carry forward of net operating losses incurred by our regulated utilities in Massachusetts. Offsetting, to some extent, these increases to tax expense, was a tax benefit recorded in 2003 of $9.0 million associated with certain New York City general corporation tax issues. In addition, certain costs associated with employee deferred compensation plans were deducted for federal income tax purposes in 2003. These costs, however, are not expensed for "book" purposes resulting in a beneficial permanent book-to-tax difference of $6.3 million.

As noted earlier, earnings available for common stock for the year ended December 31, 2004, also included losses of $151.0 million, or $0.94 per share, from discontinued operations. Earnings available for common stock for the year ended December 31, 2003, included a charge for a cumulative change in accounting principles of $37.4 million, or $0.23 per share, associated with the implementation of FIN 46, as well as operating losses of $1.9 million, or $0.01 per share associated with discontinued operations.

As a result of the items discussed above, earnings available for common stock were $458.1 million, or $2.86 per share for the year ended December 31, 2004, compared to $380.9 million, or $2.41 per share realized in 2003.

Review of Operating Segments

KeySpan's segment results are reported on an "Operating Income" basis. Management believes that this generally accepted accounting principle ("GAAP") based measure provides a reasonable indication of KeySpan's underlying performance associated with its operations. The following is a discussion of financial results achieved by KeySpan's operating segments presented on an Operating Income basis.

Gas Distribution

KeySpan Energy Delivery New York ("KEDNY") provides gas distribution service to customers in the New York City Boroughs of Brooklyn, Staten Island and a portion of Queens. KeySpan Energy Delivery Long Island ("KEDLI") provides gas distribution service to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. Four natural gas distribution companies – Boston Gas Company, Essex Gas Company, Colonial Gas Company and EnergyNorth Natural Gas, Inc., each doing business under the name KeySpan Energy Delivery New England ("KEDNE"), provide gas distribution service to customers in Massachusetts and New Hampshire.

The table below highlights certain significant financial data and operating statistics for the Gas Distribution segment for the periods indicated.

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Revenues	$ 5,390.1	$ 4,407.3	$ 4,161.3
Cost of gas	3,607.0	2,664.7	2,444.5
Revenue taxes	65.8	73.3	90.5
Net Gas Revenues	1,717.3	1,669.3	1,626.3
Operating Expenses			
Operations and maintenance	727.0	672.5	659.9
Depreciation and amortization	276.9	276.5	259.9
Operating taxes	147.8	140.7	147.3
Total Operating Expenses	1,151.7	1,089.7	1,067.1
Gain on the sale of property	0.1	—	15.1
Operating Income	$ 565.7	$ 579.6	$ 574.3
Firm gas sales and transportation (MDTH)	323,347	324,549	328,073
Transportation – Electric Generation (MDTH)	25,076	27,656	34,778
Other Sales (MDTH)	187,805	155,992	158,722
Warmer (Colder) than Normal – New York & Long Island	(1.0%)	(1.0%)	(8.0%)
Warmer (Colder) than Normal – New England	(8.6%)	(6.8%)	(10.0%)

A MDTH is 10,000 therms and reflects the heating content of approximately one million cubic feet of gas. A therm reflects the heating content of approximately 100 cubic feet of gas. One billion cubic feet (BCF) of gas equals approximately 1,000 MDTH.

Executive Summary

Operating Income 2005 vs 2004

Operating income decreased $13.9 million, or 2%, for the twelve months ended December 31, 2005, compared to the same period last year due to higher operating expenses. Operating expenses increased $62.0 million reflecting primarily an increase in the provision for uncollectible accounts receivable and higher property taxes totaling $45.8 million. Partially offsetting the higher operating expenses was an increase of $48.0 million in net gas revenues (revenues less the cost of gas and associated revenue taxes) resulting from customer additions and oil-to-gas conversions in our firm gas sales market, as well as from higher net gas revenues in our large-volume heating markets.

Net Revenues

Net gas revenues from our gas distribution operations increased $48.0 million, or 3%, for the twelve months ended December 31, 2005, compared to the same period last year. Net gas revenues benefited from customer additions and oil-to-gas conversions in our firm gas sales market (residential, commercial and industrial customers), as well as from higher net gas revenues in our large-volume heating and interruptible (non-firm) markets. As measured in heating degree days, weather in 2005 in our New York and New England service territories was approximately 1.0% and 8.6% colder than normal, respectively. Compared to 2004, weather in 2005 was 1.2% colder in KeySpan's New England service territory, while weather was consistent between years in the New York service territory.

Net revenues from firm gas customers (residential, commercial and industrial customers) increased $24.3 million for the twelve months ended December 31, 2005, compared to the same period last year. Customer additions and oil-to-gas conversions, net of attrition and conservation, added $25.1 million to net gas revenues. Further, we realized a benefit of $3.8 million as a result of the Boston Gas Company's Performance Based Rate Plan (the "Plan") that was approved by the Massachusetts Department of Telecommunications and Energy ("MADTE") in 2003. The Plan provides for firm gas sales rates to be adjusted each year based on an inflation factor offset by a productivity factor. (See the caption under "Regulation and Rate Matters" for further information regarding the rate filing.)

Offsetting, to some extent, the beneficial impact of the customer additions and oil-to-gas conversions was the adverse impact to comparative net gas revenues from the additional billing day last year due to the leap year. In 2004, KeySpan realized $5.7 million in additional net gas revenues from the additional billing day. Further, KeySpan earned $8.7 million less in regulatory incentives for the twelve months ended December 31, 2005, compared to the same period last year.

Also included in net revenues is the recovery of certain regulatory items and certain taxes that added $6.6 million to net revenues. However, the recovery of these items through revenues does not impact net income since we expense a similar amount as amortization charges and income taxes, as appropriate on the Consolidated Statement of Income. Firm gas distribution rates for KEDNY, KEDLI and KEDNE in 2005, other than for the recovery of gas costs and as noted, have remained substantially unchanged from rates charged in 2004.

KEDNY and KEDLI each operate under a utility tariff that contains a weather normalization adjustment that significantly offsets variations in firm net revenues due to fluctuations in normal weather. However, the gas distribution operations of our New England based subsidiaries do not have a weather normalization adjustment. To mitigate the effect of fluctuations in normal weather patterns on KEDNE's results of operations and cash flows, weather derivatives were in place for the 2004/2005 and 2005/2006 winter heating seasons. These financial derivatives afforded KeySpan some protection against warmer than normal weather. As a result of the weather fluctuations and financial weather derivatives, weather had a $3.2 million favorable impact on comparative net gas revenues. (See Note 8 to the Consolidated Financial Statements "Hedging,

Derivative Financial Instruments and Fair Values" for further information on derivative transactions.)

In our large-volume heating and interruptible (non-firm) markets, which include large apartment houses, government buildings and schools, gas service is provided under rates that are designed to compete with prices of alternative fuel, including No. 2 and No. 6 grade heating oil. These "dual-fuel" customers can consume either natural gas or fuel oil for heating purposes. Net revenues in these markets increased $23.7 million during the twelve months ended December 31, 2005, compared to the same period last year, primarily reflecting higher pricing. Further, since weather during January 2004 was significantly colder than normal, KeySpan interrupted service to a segment of its dual-fuel customers for a number of days during the month, as permitted under its tariff, to ensure reliable service to firm customers. The majority of interruptible profits earned by KEDLI and KEDNE are returned to firm customers as an offset to gas costs.

Firm Sales, Transportation and Other Sales Quantities

Both actual firm gas sales and transportation quantities, as well as weather normalized sales quantities for the twelve months ended December 31, 2005, remained consistent with those quantities realized in 2004. Net revenues are not affected by customers opting to purchase their gas supply from other sources, since delivery rates charged to transportation customers generally are the same as delivery rates charged to full sales service customers. Transportation quantities related to electric generation reflect the transportation of gas to our electric generating facilities located on Long Island. Net revenues from transportation services are not material.

Other sales quantities include on-system interruptible quantities, off-system sales quantities (sales made to customers outside of our service territories) and related transportation. The increase in these sales quantities for the twelve months ended December 31, 2005 compared to the same period of 2004 reflects higher off-system sales. The majority of these profits earned are returned to firm customers as an offset to gas costs. From April 1, 2002 through March 31, 2005, we had an agreement with Coral Resources, L.P. ("Coral"), a subsidiary of Shell Oil Company, under which Coral assisted in the origination, structuring, valuation and execution of energy-related transactions on behalf of KEDNY and KEDLI. Upon the expiration of this agreement, these services are provided by KeySpan employees. We also have a portfolio management contract with Merrill Lynch Trading, under which Merrill Lynch Trading provides all of the city gate supply requirements at market prices and manages certain upstream capacity, underground storage and term supply contracts for KEDNE. A new three year agreement has been negotiated with Merrill Lynch to provide portfolio management services to KeySpan's Massachusetts gas distribution subsidiaries. This agreement is pending MADTE approval. KeySpan will provide these services internally for its New Hampshire gas distribution subsidiary, EnergyNorth.

Purchased Gas for Resale

The increase in gas costs for the twelve months ended December 31, 2005, compared to the same period of 2004, of $942.3 million, or 35%, reflects an increase of 23% in the price per dekatherm of gas purchased for firm gas sales customers, as well as an increase in the quantity of gas purchased for large-volume heating and interruptible (non-firm) customers. The current gas rate structure of each of our gas distribution utilities includes a gas adjustment clause, pursuant to which variations between actual gas costs incurred for resale to firm sales customers and gas costs billed to firm sales customers are deferred and refunded to or collected from customers in a subsequent period.

Operating Expenses

For the twelve months ended December 31, 2005, operating expenses increased $62.0 million, or 6% compared to the same period last year. Operations and maintenance expense increased $54.5 million, or 8%, in 2005 compared to 2004 primarily due to an increase of $38.7 million in the provision for uncollectible accounts as a result of increasing gas costs and the adverse impact from recent collection experience. Further, the gas distribution operations realized an increase in insurance and regulatory fees, as well as postretirement expenses in 2005 compared to 2004. In 2004, KeySpan recognized a benefit of approximately $3 million, net of amounts subject to regulatory deferral treatment, associated with the implementation of the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the "Medicare Act") and implementation of Financial Accounting Standards Board Staff Position ("FSP") 106-2. In addition, in 2004, Boston Gas reached an agreement with an insurance carrier for recovery of previously incurred environmental expenditures. Insurance and third-party recoveries, after deducting legal fees, are shared between Boston Gas and its firm gas customers as provided under a previously issued MADTE rate order. As a result of this insurance settlement, Boston Gas recorded a $5 million benefit to operations and maintenance expense.

Comparative operating taxes increased $7.1 million due to the expiration of a five-year property tax assessment agreement with New York City, as well as to a $2.5 million property tax refund received in 2004. Higher depreciation charges of $4.5 million reflecting the continued expansion of the gas distribution system were offset by lower regulatory amortization charges of $4.1 million.

In December 2005, Boston Gas received a MADTE order permitting regulatory recovery of the 2004 gas cost component of bad debt write-offs. This was approved for full recovery as an exogenous cost effective November 1, 2005. In addition, effective January 1, 2006, Boston Gas is permitted to fully recover the gas cost component of bad debt write-offs through its cost-of-gas adjustment clause rather than filing for recovery as an exogenous cost. We have reflected both of these favorable recovery mechanisms in our December 31, 2005 Allowance for Doubtful Accounts reserve requirement and related expense. Boston Gas also plans to request full recovery, as an exogenous cost, of the 2005 gas cost component of bad debt write-offs beginning November 1, 2006.

YEAR ENDED DECEMBER 31,	2005	2004	2003
			(In Millions of Dollars)
Revenues	$ 43.0	$ 58.9	$119.0
Less: Operation and			
maintenance expense	26.5	33.5	68.6
Ceiling test write-down	—	48.2	—
Impairment charge	—	26.5	—
Other operating expenses	11.1	15.3	27.3
Add: Equity earnings	15.1	25.8	19.1
Sale of assets	0.1	5.0	—
Operating Income (Loss)	$ 20.6	$ (33.8)	$ 42.2

Operating income above reflects 100% of KeySpan Canada's results from January 1, 2003 through April 1, 2004.

Operating Income 2005 vs 2004

For the twelve months ended December 31, 2005, operating income for this segment increased $54.4 million compared to the same period of 2004, reflecting non-cash impairment charges recorded last year of $74.7 million. As noted earlier, in 2004, KeySpan's wholly owned gas exploration and production subsidiaries that have remained with KeySpan after the Houston Exploration transaction, recorded a non-cash impairment charge of $48.2 million to recognize the reduced valuation of proved reserves. (See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies" Item F "Gas Exploration and Production Property – Depletion" for further information on this charge.) Further, in the fourth quarter of 2004, KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value.

Operating income for the twelve months ended December 31, 2004, also includes $16.5 million in earnings from KeySpan Canada. The remaining activities reflected a decrease in operating income of $3.8 million primarily due to the sale of real property in 2004.

Operating Income 2004 vs 2003

The decrease in comparative operating income in 2004 compared to 2003 of $76.0 million reflects the impairment charges recorded in 2004, as well as our lower ownership interest in KeySpan Canada. Operating income for the twelve months ended December 31, 2004, includes $16.5 million in earnings from KeySpan Canada compared to operating income of $29.7 million for the twelve months ended December 31, 2003. Excluding the impairment charges and KeySpan Canada, the remaining activities reflected an increase in operating income of $11.9 million primarily due to the sale of real property in 2004, higher earnings from gas pipeline investments and lower administrative costs.

During the first five months of 2004, our gas exploration and production investments also included a 55% equity interest in Houston Exploration, the operations of which were consolidated in KeySpan's Consolidated Financial Statements. On June 2, 2004, KeySpan exchanged 10.8 million shares of common stock of Houston Exploration for 100% of the stock of Seneca-Upshur, previously a wholly owned subsidiary of Houston Exploration. This transaction reduced our interest in Houston Exploration from 55% to the then current level of 23.5%. Effective June 2, 2004, Houston Exploration's earnings and our ownership interest in Houston Exploration were accounted for on the equity method of accounting. KeySpan follows an accounting policy of income statement recognition for parent company gains or losses from common stock transactions initiated by its subsidiaries. As a result, this transaction resulted in a gain to KeySpan of $150.1 million. The deconsolidation of Houston Exploration required the recognition of certain deferred taxes on our remaining investment resulting in a net deferred tax expense of $44.1 million. Therefore, the net gain on the share exchange less the deferred tax provision was $106 million, or $0.66 per share.

In November 2004, KeySpan sold its remaining 23.5% interest in Houston Exploration (6.6 million shares) and received cash proceeds of approximately $369 million. KeySpan recorded a pre-tax gain of $179.6 million which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was $116.8 million or $0.73 per share.

Asset transactions regarding our investment in Houston Exploration were also recorded in 2003. In February 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. We realized net proceeds of $79 million in connection with this repurchase. KeySpan realized a gain of $19 million on this transaction, which is reflected in other income and (deductions) on the Consolidated Statement of Income. Income taxes were not provided, since this transaction was structured as a return of capital.

Selected financial data and operating statistics for Houston Exploration for 2004 and 2003 are set forth in the following table.

YEAR ENDED DECEMBER 31,	2004	2003
		(In Millions of Dollars)
Revenues	$ 268.1	$ 495.3
Depletion and amortization expense	104.6	204.1
Other operating expenses	45.7	94.9
Add: Equity Earnings	20.7	—
Operating Income	$ 138.5	$ 196.3

Houston Exploration

Operating Income 2004 vs 2003

The decline in operating income of $57.8 million for the twelve months ended December 31, 2004, compared to the corresponding period in 2003, reflects the reduction in KeySpan's ownership interest in Houston Exploration. As noted, in 2003 KeySpan maintained a 55% ownership interest in Houston Exploration. In 2004, KeySpan maintained a 55% ownership interest for the five month period January 1, 2004 through June 2, 2004, then held an approximate 23.5% interest for the five month period June 2, 2004 through October 31, 2004. KeySpan then sold its remaining 23.5% interest in Houston Exploration in November 2004.

Other Matters

In order to serve the anticipated market requirements in our New York service territories, KeySpan and Duke Energy Corporation formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Islander East is owned 50% by KeySpan and 50% by Duke Energy, and was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Shoreham, Long Island. Applications for all necessary regulatory authorizations were filed in 2000 and 2001. Islander East has received a final certificate from the FERC and all necessary permits from the State of New York. The State of Connecticut denied Islander East's request for a consistency determination under the Coastal Zone Management Act ("CZMA") and application for a permit under Section 401 of the Clean Water Act. Islander East appealed the State of Connecticut's determination on the CZMA issue to the United States Department of Commerce. In 2004, the Department of Commerce overrode Connecticut's denial and granted the CZMA authorization. Islander East's petition for a declaratory order overriding the denial of the Clean Water Act permit is pending with Connecticut's State Superior Court. Pursuant to a provision of the Energy Act, Islander East has appealed the denial of the Clean Water Act permit directly to the United States Court of Appeals for the Second Circuit and has moved to stay the Connecticut case pending the Second Circuit's decision. The State of Connecticut has filed a motion to challenge the constitutionality of the provisions of the Energy Act providing this appeal right. The appeal was argued in January 2006 and a decision is expected within the first six months of 2006. Various options for the financing of this pipeline construction are being evaluated. As of December 31, 2005, KeySpan's total capitalized costs associated with the siting and permitting of the Islander East pipeline were approximately $24.6 million.

KeySpan also owns a 21% ownership interest in the Millennium Pipeline project. KeySpan acquired its interest in the project from Duke Energy in August 2004. The other partners in the Millennium Pipeline are Columbia Gas Transmission Corp., a unit of NiSource Incorporated and DTE Energy. It is anticipated that KeySpan will acquire an additional 5.25% ownership interest in Millennium from Columbia during the first quarter of 2006, bringing our total ownership interest in Millennium to 26.25%. The Millennium Pipeline project is anticipated to transport up to 525,000 DTH of natural gas a day from Corning to Ramapo, New York, interconnecting with the pipeline systems of various other utilities in New York. The project received a FERC certificate to construct, acquire and operate the facilities in 2002. On August 1, 2005, the project filed an amended application with FERC requesting, among other things, approval of a reduction in capacity and maximum allowable operating pressure, minor route modifications, the addition of certain facilities and the acquisition of certain facilities from Columbia Gas Transmission Corporation. Additionally, in December 2005, The Consolidated Edison Company of New York ("Con Edison"), KEDLI and Columbia Gas Transmission each entered into amended precedent agreements to purchase capacity on the pipeline. KEDLI has agreed to purchase 150,000 DTH per day from the Millennium Pipeline system, increasing to 200,000 DTH in the third year of the pipeline being in service. This will provide KEDLI with new, competitively priced supplies of natural gas from Canada. Subject to, among other things, the conditions precedent in the precedent agreements, the receipt of necessary regulatory approvals and financing, it is anticipated that the Millennium Pipeline will be in service in either 2007 or 2008. As of December 31, 2005, total capitalized costs associated with the Millennium Pipeline project were $10.4 million.

In 2005, KeySpan LNG entered into a joint development agreement with BG, LNG Services, a subsidiary of British Gas, to upgrade KeySpan LNG's liquidfied natural gas ("LNG") facility to accept marine deliveries and to triple vaporization (or regasification) capacity. In June 2005, the FERC denied KeySpan LNG's application to expand the facility citing concerns that the proposed upgraded facility would not meet current federal safety standards, which the facility is not currently subject to. KeySpan sought a rehearing with FERC, and on January 20, 2006 the FERC denied such request, although the order provided that KeySpan LNG could file an amendment to its original application addressing a revised expansion project which would differ substantially from that originally proposed by KeySpan. Any amendment application would need to include a detailed analysis of the new project scope, including upgrades to the existing facilities and alternative plans for any service disruptions that may be necessary during construction of a new expanded project. KeySpan is evaluating whether to appeal FERC's current order.

In addition to the proceeding at FERC, KeySpan LNG also is involved in seeking other required regulatory approvals and the resolution of certain litigation regarding such approvals. In February 2005, KeySpan LNG filed an action in Federal District Court in Rhode Island seeking a declaratory judgment that it is not required to obtain a "Category B Assent" from the State of Rhode Island and an injunction preventing the Rhode Island Coastal Resources Management Council ("CRMC") from enforcing the Category B assent requirements. In March 2005, the Rhode Island Attorney General answered the complaint and moved to substitute the State of Rhode Island as the defendant and filed a counterclaim seeking a declaratory judgment that the expansion requires a Category B Assent. In April, the parties filed cross motions for summary judgment with respect to all issues presented to the Court. On April 14, 2005, the Attorney General also filed on behalf of the State a complaint against KeySpan LNG in Rhode Island State Superior Court raising substantially the same issues as the federal court action. KeySpan LNG removed that action to federal court and moved for summary judgment. The Attorney General subsequently withdrew both the motion to substitute defendants and the counterclaim. Although the Court had indicated its intention to issue a decision in the pending cases by August 2005, the Court has now indicated that it will stay the litigation pending resolution of the FERC rehearing and/or appeal process discussed above. Since the FERC order is a recent development, the Court has not yet taken any action. As of December 31, 2005, our investment in this project was $15.3 million.

Allocated Costs

As previously noted, at December 31, 2005 KeySpan was a holding company under PUHCA 1935. As a result of the Energy Act, PUHCA 1935 was repealed and replaced by PUHCA 2005 as of February 8, 2006. Under PUHCA 1935, the SEC had jurisdiction over our holding company activities, including the regulation of our affiliate transactions and service companies. In accordance with those regulations and state regulatory agencies' regulations, we established service companies that provide: (i) traditional corporate and administrative services; (ii) gas and electric transmission and distribution system planning, marketing, and gas supply planning and procurement; and (iii) engineering and surveying services to subsidiaries. The SEC's jurisdiction over our holding company activities was eliminated under PUHCA 2005, although the SEC continues to have jurisdiction over the registration and issuance of our securities under the securities law. These service companies are now subject to the jurisdiction of the FERC under PUHCA 2005, as well as subject to regulations and orders of the NYPSC, MADTE and NHPUC. See "Regulation and Rate Matters" for additional information on the Energy Act.

The operating income variation as reflected in "elimination and other" is due primarily to costs residing at KeySpan's holding company level such as corporate advertising and strategic review costs. Further, in 2004 KeySpan reached a settlement with its insurance carriers regarding cost recovery for expenses incurred at a non-utility environmental site and recorded an $11.6 million gain from the settlement as a reduction to operating expenses.

Operating income variations in "eliminations and other" between 2004 and 2003 reflect, in part, allocation adjustments recorded in 2003. As required by the SEC, during 2003 we adjusted certain provisions in our allocation methodology that resulted in certain costs being allocated back to certain non-operating subsidiaries. Further, as noted, in 2004 KeySpan recorded an $11.6 million gain from the settlement with its insurance carriers regarding cost recovery for expenses incurred at a non-utility environmental site. It should be noted that in 2003 KeySpan recorded a $10 million favorable adjustment for environmental reserves associated with non-utility environmental sites based on a site investigation study concluded in the fourth quarter of 2003.

Liquidity

Cash flow from operations decreased $346.8 million, or 46%, for the twelve months ended December 31, 2005 compared to 2004, reflecting, in part, the absence of Houston Exploration and KeySpan Canada which combined contributed approximately $230 million to consolidated operating cash flow in 2004. It should be noted that in prior years, Houston Exploration funded its gas exploration and development activities, in part, from available cash flow from operations. In addition, due to the significant increase in natural gas prices in 2005, KeySpan's gas distribution utilities paid approximately $215 million more in 2005 compared to 2004 for the purchase of natural gas that is currently in inventory. As noted previously, the current gas rate structure of each of our gas distribution utilities includes a gas adjustment clause, pursuant to which variations between actual gas costs incurred for sale to firm customers and gas costs billed to firm customers are deferred and refunded to or collected from customers in a subsequent period. Further in 2005 the Internal Revenue Service ("IRS") published new regulations related to the capitalization of costs of self-constructed property for income tax purposes. As a result of these regulations, KeySpan incurred approximately $60 million in higher income tax payments for the twelve months ended December 31, 2005 compared to the same period in 2004. These adverse impacts to cash flow from operations were partially offset by lower interest payments and higher core earnings.

Cash flow from operations for the year ended December 31, 2004 decreased $473.3 million, or 39%, compared to 2003 primarily due to federal tax refunds received in 2003. During 2003, KeySpan performed an analysis of costs capitalized for self-constructed property and inventory for income tax purposes. KeySpan filed a change of accounting method for income tax purposes resulting in a cumulative deduction for costs previously capitalized. As a result of this tax method change, along with accelerated deductions resulting from bonus depreciation, KeySpan received in October 2003, a $192.3 million refund from the Internal Revenue Service for prior year taxes, as well as an additional $85 million for tax payments made in 2002. On a comparative basis, tax refunds received in 2003 compared with federal tax payments made in 2004 of $63.2 million, resulted in a comparative cash flow decrease in 2004 of approximately $340.5 million. Further, cash flow from operations for 2004 was adversely impacted by the deconsolidation of Houston Exploration in June 2004.

At December 31, 2005, we had cash and temporary cash investments of $124.5 million. During the twelve months ended December 31, 2005, we repaid $254.6 million of commercial paper and, at December 31, 2005, $658 million of commercial paper was outstanding at a weighted-average annualized interest rate of 4.38%. At December 31, 2005, KeySpan had the ability to issue up to an additional $842 million of short-term debt under its commercial paper program.

In June 2005, KeySpan closed on a $920 million revolving credit facility for five years due June 24, 2010, which was syndicated among fifteen banks, and an amended $580 million revolving credit facility due June 24, 2009. These facilities replaced an existing $660 million, 3-year facility due June 2006, and a 5-year $640 million facility due June 2009. The two credit facilities, which now total $1.5 billion – $920 million for five years through 2010, and $580 million for the amended facility through 2009, will continue to support KeySpan's commercial paper program for ongoing working capital needs.

The fees for the facilities are based on KeySpan's current credit ratings and are increased or decreased based on a downgrading or upgrading of our ratings. The current annual facility fee is 0.07% based on our credit rating of A3 by Moody's Investor Services and A by Standard & Poor's for each facility. Both credit facilities allow for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin that is tied to our applicable credit ratings. ABR loans are based on the higher of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders.

We do not anticipate borrowing against these facilities; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The facilities contain certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its utility property to any lien, as well as certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 65% as at the last day of any fiscal quarter. Violation of these covenants could result in the termination of the facilities and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements. At December 31, 2005, KeySpan's consolidated indebtedness was 50.7% of its consolidated capitalization and KeySpan was in compliance with all covenants.

Subject to certain conditions set forth in the credit facility, KeySpan has the right, at any time, to increase the commitments under the $920 million facility up to an additional $300 million. In addition, KeySpan has the right to request that the termination date be extended for an additional period of 365 days prior to each anniversary of the closing date. This extension option, however, requires the approval of lenders holding more than 50% of the total commitments to such extension request. Under the agreements, KeySpan has the ability to replace non-consenting lenders with other pre-approved banks or financial institutions. Upon effectiveness of PUHCA 2005, KeySpan's ability to issue commercial paper is no longer limited by the SEC. Accordingly, subject to compliance with the foregoing conditions, KeySpan is currently able to issue up to $1.5 billion of commercial paper.

A substantial portion of consolidated revenues are derived from the operations of businesses within the Electric Services segment, that are largely dependent upon two large customers – LIPA and the NYISO. Accordingly, our cash flows are dependent upon the timely payment of amounts owed to us by these counterparties. (See the discussion under the caption "Electric Services – LIPA Agreements" for information regarding the recent settlement between KeySpan and LIPA regarding the current contractual agreements.)

We satisfy our seasonal working capital requirements primarily through internally generated funds and the issuance of commercial paper. We believe that these sources of funds are sufficient to meet our seasonal working capital needs.

Capital Expenditures and Financing

Construction Expenditures

The table below sets forth our construction expenditures by operating segment for the periods indicated:

	(In Millions of Dollars)	
YEAR ENDED DECEMBER 31,	**2005**	**2004**
Gas Distribution	$ 410.3	$ 414.5
Electric Services	88.8	150.3
Energy Investments	23.6	160.2
Energy Services and other	16.8	25.3
	$ 539.5	$ 750.3

Construction expenditures related to the Gas Distribution segment are primarily for the renewal, replacement and expansion of the distribution system. Construction expenditures for the Electric Services segment reflect costs to maintain our generating facilities and, for 2004, expand the Ravenswood Generating Station. Construction expenditures related to the Energy Investments segment for 2004 primarily reflect costs associated with gas exploration and production activities of Houston Exploration, as well as costs related to KeySpan Canada's gas processing facilities.

Construction expenditures for 2006 are estimated to be approximately $630 million. The amount of future construction expenditures is reviewed on an ongoing basis and can be affected by timing, scope and changes in investment opportunities.

Financing

In January 2006, the NYPSC issued orders granting additional financing authority to KEDNY and KEDLI. KEDNY has the authority, through December 31, 2008, to issue up to $475 million of new securities and to refinance up to $650 million of its existing debt obligations. KEDLI has the authority, through December 31, 2008, to issue up to $450 million of new securities and to refinance up to $525 million of its existing debt obligations. KEDNY and KEDLI had sought a waiver from the requirement in the existing rate plans that KEDNY and KEDLI must raise their own long-term debt or preferred stock and may not derive such securities from KeySpan. The NYPSC declined to grant the requested waiver.

In December 2005, KEDNY converted $50 million of fixed rate Gas Facility Revenue Bonds ("GFRB") (5.64% GFRB Series D1 and D2 due 2026) into variable rate debt. The interest rate on these bonds is now reset, through an auction process, every seven days.

In November 2005, KEDNY, issued $137 million of tax-exempt GFRB through the New York State Energy Research and Development Authority ("NYSERDA") in the following series: (i) $82 million of 4.70% GFRB, 2005 Series A (the "Series A Bonds"); and (ii) $55 million GFRB, 2005 Series B (the "Series B Bonds"). The interest rate on the Series B bonds is reset every seven days through an auction process. KEDNY used the proceeds from this issuance to redeem the following three series: (i) $41 million Adjustable Rate GFRB Series 1989 A due February 2024; (ii) $41 million

Adjustable Rate GFRB Series 1989 B due February 2024; and (iii) $55 million 5.60% GFRB Series 1993 C due June 2025. KEDNY incurred $3.7 million in call premiums and financing fees, all of which have been deferred for future rate recovery.

In January 2005, KeySpan redeemed $500 million of outstanding debt – 6.15% notes due 2006. KeySpan incurred $20.9 million in call premiums and wrote-off $1.3 million of previously deferred costs. Further, we accelerated the amortization of approximately $11.2 million of previously unamortized benefits associated with an interest rate swap on these bonds. The accelerated amortization, as well as the write-off of previously deferred costs was recorded to interest expense. In addition, during the first quarter of 2005, $15 million of 8.87% notes of a KeySpan subsidiary were redeemed at maturity.

Further, $55.3 million of 7.07% Series B preferred stock was redeemed in May 2005 on its scheduled redemption date. Additionally, also in May 2005, KeySpan called for optional redemption $19.7 million of 7.17% Series C of preferred stock due 2008. KeySpan no longer has preferred stock outstanding.

In May 2002, KeySpan issued 9.2 million MEDS Equity Units which were subject to conversion to common stock upon execution of the three-year forward purchase contract. In 2005, KeySpan was required to remarket the note component of the Equity Units between February 2005 and May 2005 and reset the interest rate to the then current market rate of interest; however, the reset interest rate could not be set below 4.9%. In March 2005, KeySpan remarketed the note component of $394.9 million of the Equity Units at the reset interest rate of 4.9% through their maturity date of May 2008. The balance of the notes ($65.1 million) were held by the original MEDS Equity Unit holders in accordance with their terms and not remarketed. KeySpan then exchanged $300 million of the remarketed notes for $307.2 million of new 30 year notes bearing an interest rate of 5.8%. Therefore, KeySpan now has $160 million of 4.9% notes outstanding with a maturity date of May 2008 and $307.2 million of 5.8% notes outstanding with a maturity date of April 2035.

On May 16, 2005, KeySpan issued 12.1 million shares of common stock, at an issuance price of $37.93 per share pursuant to the terms of the forward purchase contract. KeySpan received proceeds of approximately $460 million from the equity issuance. The number of shares issued was dependent on the average closing price of our common stock over the 20 day trading period ending on the third trading day prior to May 16, 2005.

The following table represents the ratings of our long-term debt at December 31, 2005. During the fourth quarter of 2004 Standard & Poor's reaffirmed its ratings on KeySpan's and its subsidiaries' long-term debt and removed its negative outlook. Further in the second quarter of 2005, Fitch Ratings revised its ratings on KeySpan's and its subsidiaries' long-term debt to positive outlook. Moody's Investor Services, however, continues to maintain its negative outlook ratings on KeySpan's and its subsidiaries' long-term debt.

	MOODY'S INVESTOR SERVICES	STANDARD & POOR'S	FITCHRATINGS
KeySpan Corporation	A3	A	A–
KEDNY	N/A	A+	A+
KEDLI	A2	A+	A–
Boston Gas	A2	A	N/A
Colonial Gas	A2	A+	N/A
KeySpan Generation	A3	A	N/A

Off-Balance Sheet Arrangements

Guarantees

KeySpan had a number of financial guarantees with its subsidiaries at December 31, 2005. KeySpan has fully and unconditionally guaranteed: (i) $525 million of medium-term notes issued by KEDLI; (ii) the obligations of KeySpan Ravenswood, LLC, which is the lessee under the $425 million Master Lease associated with the Ravenswood Facility and the lessee under the $385 million sale/leaseback transaction for the Ravenswood Expansion including future decommission costs of $19 million; and (iii) the payment obligations of our subsidiaries related to $128 million of tax-exempt bonds issued through the Nassau County and Suffolk County Industrial Development Authorities for the construction of two electric-generation peaking facilities on Long Island. The medium-term notes, the Master Lease and the tax-exempt bonds are reflected on the Consolidated Balance Sheet; the sale/leaseback obligation is not recorded on the Consolidated Balance Sheet. Further, KeySpan has guaranteed: (i) up to $76.0 million of surety bonds associated with certain construction projects currently being performed by current and former subsidiaries; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of $83.2 million; and (iii) $73.0 million of subsidiary letters of credit. These guarantees are not recorded on the Consolidated Balance Sheet. KeySpan's guarantees on certain performance bonds relating to current construction projects of the discontinued mechanical contracting companies will remain in place throughout the construction period for these projects. KeySpan has received an indemnity bond issued by a third party to offset potential exposure related to a significant portion of the continuing guarantee. At this time, we have no reason to believe that our subsidiaries or former subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact such defaults may have on our consolidated results of operations, financial condition or cash flows. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees, as well as Note 10 "Energy Services – Discontinued Operations" for additional information on the discontinued mechanical contracting companies.)

Contractual Obligations

KeySpan has certain contractual obligations related to its outstanding long-term debt, outstanding credit facility borrowings, outstanding commercial paper borrowings, various leases, and demand charges associated with certain commodity purchases. KeySpan's outstanding short-term and

long-term debt issuances are explained in more detail in Note 6 to the Consolidated Financial Statements "Long-Term Debt and Commercial Paper." KeySpan's leases, as well as its demand charges are more fully detailed in Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies." The table below reflects maturity schedules for KeySpan's contractual obligations at December 31, 2005. Included in the table is the long-term debt that has been consolidated as part of the variable interest entity associated with the Ravenswood Master Lease.

(In Millions of Dollars)

CONTRACTUAL OBLIGATIONS	TOTAL	1 – 3 YEARS	4 – 5 YEARS	AFTER 5 YEARS
Long-term Debt	$ 3,934.7	$ 317.0	$ 1,522.3	$ 2,095.4
Capital Leases	10.8	3.2	2.5	5.1
Operating Leases	585.7	213.6	137.5	234.6
Master Lease Payments	99.7	85.5	14.2	—
Sale/Leaseback Arrangement	569.5	73.0	78.8	417.7
Interest Payments	2,873.6	663.7	380.0	1,829.9
Demand Charges	492.7	492.7	—	—
Total Contractual Cash Obligations	$ 8,566.7	$ 1,848.7	$ 2,135.3	$ 4,582.7
Commercial Paper	$ 657.6	Revolving		

For information regarding projected postretirement contributions, see Note 4 to the Consolidated Financial Statements "Postretirement Benefits." For information regarding asset retirement obligations, see Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies."

Discussion of Critical Accounting Policies and Assumptions

In preparing our financial statements, the application of certain accounting policies requires difficult, subjective and/or complex judgments. The circumstances that make these judgments difficult, subjective and/or complex have to do with the need to make estimates about the impact of matters that are inherently uncertain. Actual effects on our financial position and results of operations may vary significantly from expected results if the judgments and assumptions underlying the estimates prove to be inaccurate. The critical accounting policies requiring such subjectivity are discussed below.

KeySpan continually evaluates its critical accounting policies. Based upon current facts and circumstances KeySpan has decided that certain accounting policies that were considered "critical" at December 31, 2004 should no longer be considered as critical accounting policies. The accounting policies that are no longer considered critical are as follows: (i) Percentage-of-completion accounting is a method of accounting for long-term construction type contracts in accordance with generally accepted accounting principles. This accounting policy was used for engineering and mechanical contracting revenue recognition by the Energy Services segment. However, since KeySpan has sold its mechanical contracting subsidiaries, contracting revenue recognition is no longer a significant accounting issue; and (ii) The full cost accounting method is used by our gas exploration and production subsidiaries to account for their natural gas and oil properties. Seneca-Upshur and KeySpan Exploration continue to apply this accounting treatment. However, since KeySpan has sold its ownership interest in Houston Exploration, KeySpan's gas exploration and production activities are not a significant aspect of its overall business operations and therefore, full cost accounting is no longer a significant accounting policy.

Valuation of Goodwill

KeySpan records goodwill on purchase transactions, representing the excess of acquisition cost over the fair value of net assets acquired. In testing for goodwill impairment under SFAS 142 "Goodwill and Other Intangible Assets," significant reliance is placed upon a number of estimates regarding future performance that require broad assumptions and significant judgment by management. A change in the fair value of our investments could cause a significant change in the carrying value of goodwill. The assumptions used to measure the fair value of our investments are the same as those used by us to prepare annual operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set annual budgetary guidelines.

As prescribed in SFAS 142, KeySpan is required to compare the fair value of a reporting unit to its carrying amount, including goodwill. This evaluation is required to be performed at least annually, unless facts and circumstances indicated that the evaluation should be performed at an interim period during the year. At December 31, 2005, KeySpan had $1.7 billion of recorded goodwill and has concluded that the fair value of the business units that have recorded goodwill exceed their carrying value.

As noted previously, during 2004, KeySpan conducted an evaluation of the carrying value of goodwill recorded in its Energy Services segment. As a result of this evaluation, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on Energy Services segment's continuing operations; and (ii) $93.9 million as discontinued operations reflecting the impairment on the mechanical contracting companies. (See Note 10 to the Consolidated Financial Statements" Energy Services – Discontinued Operations" for further details.)

Also as noted previously, at the end of 2004, KeySpan anticipated selling its then 50% interest in Premier. This investment was accounted for under the equity method of accounting in the Energy Investments segment. In the fourth quarter of 2004 KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share. The impairment charge reflected the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value at that time and was recorded as a reduction to goodwill.

Accounting for the Effects of Rate Regulation on Gas Distribution Operations

The financial statements of the Gas Distribution segment reflect the ratemaking policies and orders of the New York Public Service Commission ("NYPSC"), the New Hampshire Public Utilities Commission ("NHPUC"), and the Massachusetts Department of Telecommunications and Energy ("MADTE").

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas and EnergyNorth) are subject to the provisions of SFAS 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the actions of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies.

In separate orders issued by the MADTE relating to the acquisition by Eastern Enterprises of Colonial Gas and Essex Gas, the base rates charged by these companies have been frozen at their current levels for a ten-year period ending 2009. Due to the length of these base rate freezes, Colonial Gas and Essex Gas had previously discontinued the application of SFAS 71. EnergyNorth base rates continue as set by the NHPUC in 1993.

SFAS 71 allows for the deferral of expenses and income on the Consolidated Balance Sheet as regulatory assets and liabilities when it is probable that those expenses and income will be allowed in the rate setting process in a period different from the period in which they would have been reflected in the Consolidated Statements of Income of an unregulated company. These deferred regulatory assets and liabilities are then recognized in the Consolidated Statement of Income in the period in which the amounts are reflected in rates.

In the event that regulation significantly changes the opportunity for us to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101 "Regulated Enterprises – Accounting for the Discontinuation of Application of FASB Statement No. 71." We estimate that the write-off of our net regulatory assets at December 31, 2005 could result in a charge to net income of approximately $308.0 million or $1.81 per share, which would be classified as an extraordinary item. In management's opinion, our regulated subsidiaries that currently are subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

As is further discussed under the caption "Regulation and Rate Matters," in October 2003 the MADTE rendered its decision on the Boston Gas base rate case and Performance Based Rate Plan proposal submitted to the MADTE in April 2003. The rate plans previously in effect for KEDNY and KEDLI have expired and the rates established in those plans remain in effect. The continued application of SFAS 71 to record the activities of these subsidiaries is contingent upon the actions of regulators with regard to future rate plans. We are currently evaluating various options that may be available to us including, but not limited to, proposing new rate plans for KEDNY and KEDLI. The ultimate resolution of any future rate plans could have a significant impact on the application of SFAS 71 to these entities and, accordingly, on our financial position, results of operations and cash flows.

Management believes that currently available facts support the continued application of SFAS 71 and that all regulatory assets and liabilities are recoverable or refundable in the current regulatory environment.

Pension and Other Postretirement Benefits

As discussed in Note 4 to the Consolidated Financial Statements, "Postretirement Benefits," KeySpan participates in both non-contributory defined benefit pension plans, as well as other post-retirement benefit ("OPEB") plans (collectively "postretirement plans"). KeySpan's reported costs of providing pension and OPEB benefits are dependent upon numerous factors resulting from actual plan experience and assumptions of future experience. Pension and OPEB costs (collectively "postretirement costs") are impacted by actual employee demographics, the level of contributions made to the plans, earnings on plan assets, and health care cost trends. Changes made to the provisions of these plans may also impact current and future postretirement costs. Postretirement costs may also be significantly affected by changes in key actuarial assumptions, including, anticipated rates of return on plan assets and the discount rates used in determining the postretirement costs and benefit obligations. Actual results that differ from our assumptions are accumulated and amortized over ten years.

Certain gas distribution subsidiaries are subject to SFAS 71, and, as a result, changes in postretirement expenses are deferred for future recovery from or refund to gas sales customers. However, KEDNY, although subject to SFAS 71, does not have a recovery mechanism in place for changes in postretirement costs. Further, changes in postretirement expenses associated with subsidiaries that service the LIPA agreements are also deferred for future recovery from or refund to LIPA.

For 2005, the assumed long-term rate of return on our postretirement plans' assets was 8.5% (pre-tax), net of expenses. This is an appropriate long-term expected rate of return on assets based on KeySpan's investment strategy, asset allocation and the historical performance of equity and fixed income investments over long periods of time. The actual 10 year compound annual rate of return for the KeySpan Plans is greater than 8.5%.

KeySpan's master trust investment allocation policy target is 70% equity and 30% fixed income. At December 31, 2005, the actual investment allocation was in line with the target. In an effort to maximize plan performance, actual asset allocation will fluctuate from year to year depending on the then current economic environment.

Based on the results of an asset and liability study conducted in 2003 projecting asset returns and expected benefit payments over a 10-year period, KeySpan has developed a multiyear funding strategy for its postretirement plans. KeySpan believes that it is reasonable to assume assets can achieve or outperform the assumed long-term rate of return with the target allocation as a result of historical performance of equity investments over long-term periods.

A 25 basis point increase or decrease in the assumed long-term rate of return on plan assets would have impacted 2005 expense by approximately $6 million, before deferrals.

The year-end December 31, 2005 weighted average discount rate used to determine postretirement obligations was 5.75%. Our discount

rate assumption was developed by matching our plans' cash flows to the Citigroup above-median discount curve spot rates. The resulting yield is then rounded to the nearest 25 basis points. A 25 basis point increase or decrease in the weighted average year-end discount rate would have had no impact on 2005 expense. However, a 25 basis point decrease in the weighted average year-end discount rate would result in the recording of an additional minimum pension liability. A year-end discount rate of 5.5% would have required an additional $42 million debit to other comprehensive income ("OCI") before taxes and deferrals. A year-end discount rate of 5.25% would have required an additional $338 million charge to OCI before taxes and deferrals.

At January 1, 2005, the weighted average discount rate used to determine pension and postretirement obligations was 6.0%. A 25 basis point increase or decrease in the weighted average discount rate at the beginning of the year would have impacted 2005 expense by approximately $15 million, before deferrals.

Our health care cost trend assumptions are developed based on historical cost data, the near-term outlook and an assessment of likely long-term trends. The salary growth assumptions reflect our long-term outlook.

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At December 31, 2005, we had a funding credit balance in excess of the ERISA minimum funding requirements and as a result KeySpan was not required to make any contributions to its qualified pension plans in 2005. However, although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Therefore, during 2005 KeySpan contributed $174 million to its funded and unfunded postretirement plans.

For 2006, KeySpan expects to contribute approximately $120 million to its funded and unfunded post-retirement plans. Future funding requirements are heavily dependent on actual return on plan assets and prevailing interest rates.

Dividends

In the fourth quarter of 2005 KeySpan increased its dividend to an annual rate of $1.86 per common share beginning with the quarterly dividend to be paid in February 2006. Our dividend framework is reviewed annually by the Board of Directors. The amount and timing of all dividend payments is subject to the discretion of the Board of Directors and will depend upon business conditions, results of operations, financial conditions and other factors. Based on currently foreseeable market conditions, we intend to maintain the annual dividend at the $1.86 level.

Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to KeySpan is conditioned upon maintenance of a utility capital structure with debt not exceeding 55% and 58%, respectively, of total utility capitalization. In addition, the level of dividends paid by both utilities may not be increased from current levels if a 40 basis point penalty is incurred under the customer service performance program. At the end of KEDNY's and KEDLI's most recent rate years (September 30, 2005 and November 30, 2005, respectively), each company was in compliance with the utility capital structure required by the NYPSC. Additionally, we have met the requisite customer service performance standards.

Regulation and Rate Matters

Gas Distribution

On September 30, 2002, KEDNY's rate agreement with the NYPSC expired. Under the terms of the agreement, the then current gas distribution rates and all other provisions, including the earnings sharing provision (at a 13.25% return on equity), remain in effect until changed by the NYPSC. Under the agreement, KEDNY is subject to an earnings sharing provision pursuant to which it is required to credit firm customers with 60% of any utility earnings up to 100 basis points above a 13.25% return on equity (other than any earnings associated with discrete incentives) and 50% of any utility earnings in excess of 100 basis points above such threshold level. KEDNY did not earn above a 13.25% return on equity in its rate year ended September 30, 2005.

On November 30, 2000, KEDLI's rate agreement with the NYPSC expired. Under the terms of the agreement, the gas distribution rates and all other provisions, including the earnings sharing provision, will remain in effect until changed by the NYPSC. Under the agreement, KEDLI is subject to an earnings sharing provision pursuant to which it is required to credit to firm customers 60% of any utility earnings for any rate year ended November 30, up to 100 basis points above a return on equity of 11.10% and 50% of any utility earnings in excess of a return on equity of 12.10%. KEDLI did not earn above an11.10% return on equity in its rate year ended November 30, 2005.

At this time, we are evaluating various options regarding the KEDNY and KEDLI rate plans, including but not limited to, proposing new rate plans. In the meantime, KeySpan filed a joint petition for KEDNY and KEDLI with the NYPSC seeking authority to defer certain costs associated with high gas costs. Specifically, KeySpan seeks authority to defer the following costs, each of which is directly linked to increased gas prices: (i) the portion of increased bad debt expense attributable to increased gas cost; (ii) the return requirement on the increased cost of gas in storage; and (iii) the return requirement on the increased need for working capital. KeySpan projects total combined deferrals of approximately $67 million and $65 million in 2006 and 2007, respectively. On January 25, 2006, the NYPSC noticed the joint petition in the New York State Register.

Boston Gas, Colonial Gas and Essex Gas operations are subject to Massachusetts's statutes applicable to gas utilities. Rates for gas sales and transportation service, distribution safety practices, issuance of securities and affiliate transactions are regulated by the MADTE.

Effective November 1, 2003, the MADTE approved a $25.9 million increase in base revenues for Boston Gas with an allowed return on equity of 10.2% reflecting an equal balance of debt and equity. On January 27, 2004, the MADTE issued its order on Boston Gas Company's Motion for Recalculation, Reconsideration and Clarification that granted an additional $1.1 million in base revenues, for a total of $27 million. The MADTE also approved a Performance Based Rate Plan (the "Plan") for up to ten years. On November 1, 2005, the MADTE approved a base rate increase of $7.2 million under the Plan. In addition, an increase of $7.5 million in the local distribution adjustment clause was approved to recover pension and other postretirement costs. The MADTE also approved a true-up mechanism for pension and other postretirement benefit costs under which variations

etween actual pension and other postretirement benefit costs and nounts used to establish rates are deferred and collected from or funded to customers in subsequent periods. This true-up mechanism lows for carrying charges on deferred assets and liabilities at Boston as's weighted-average cost of capital.

In connection with the Eastern Enterprises acquisition of Colonial as in 1999, the MADTE approved a merger and rate plan that resulted in ten year freeze of base rates to Colonial Gas's firm customers. The base te freeze is subject only to certain exogenous factors, such as changes in x laws, accounting changes, or regulatory, judicial, or legislative anges. Due to the length of the base rate freeze, Colonial Gas discon- ued its application of SFAS 71. Essex Gas is also under a ten-year base te freeze and has also discontinued its application of SFAS 71.

In December 2005, Boston Gas received a MADTE order permitting gulatory recovery of the 2004 gas cost component of bad debt write- fs. This was approved for full recovery as an exogenous cost effective ovember 1, 2005. In addition, effective January 1, 2006, Boston Gas is rmitted to fully recover the gas cost component of bad debt write-offs rough its cost-of-gas adjustment clause rather than filing for recovery as exogenous cost. We have reflected both of these favorable recovery echanisms in our December 31, 2005 Allowance for Doubtful Accounts serve requirement and related expense. Boston Gas also plans to request l recovery, as an exogenous cost, the 2005 gas cost component of bad bt write-offs from Boston Gas ratepayers beginning November 1, 2006.

ectric Rate Matters

ySpan sells to LIPA all of the capacity and, to the extent requested, ergy conversion services from our existing Long Island based oil and -fired generating plants. Sales of capacity and energy conversion servic- re made under rates approved by the FERC in accordance with the entered into between KeySpan and LIPA in 1998. The original FERC oved rates, which had been in effect since May 1998, expired on mber 31, 2003. On October 1, 2004 the FERC approved a settlement ed between KeySpan and LIPA to reset rates effective January 1, Under the new agreement, KeySpan's rates reflect a cost of equity % with no revenue increase in the first year. The FERC approved d operating and maintenance expense levels and recovery of other costs as agreed to by the parties. (See Electric Services – greements" for a discussion of the 2006 settlement between and LIPA regarding the current contractual agreements.)

gy Policy Act of 2005 and the Public Utility Holding Acts of 1935 and 2005

ber 31, 2005, KeySpan and certain of its subsidiaries were sub- jurisdiction of the SEC under PUHCA 1935. The rules and under PUHCA 1935, generally limited the operations of a npany to a single integrated public utility system, plus addition- lated businesses. In addition, the principal regulatory provi- CA 1935: (i) regulated certain transactions among affiliates ling company system, including the payment of dividends

and its subsidiaries; (iii) limited the entry by registered holding c and their subsidiaries into businesses other than electric and/or g businesses; and (iv) required SEC approval for certain utility merg acquisitions.

In August 2005, the Energy Act was enacted by Congress ar into law by the President. The Energy Act is a broad based energy places an increased emphasis on the production of energy and prc the development of new technologies and alternative energy sourc providing tax credits to companies that produce natural gas, oil, co tricity and renewable energy. For KeySpan, one of the more signific provisions of the Energy Act was the repeal of PUHCA 1935, effecti February 8, 2006, and the transfer of certain holding company overs from the SEC to FERC pursuant to PUHCA 2005.

Pursuant to PUHCA 2005, the SEC no longer has jurisdiction ov our holding company activities, other than those traditionally associat with the registration and issuance of our securities under the federal s rities laws. FERC now has jurisdiction over certain of our holding comp activities, including (i) regulating certain transactions among our affiliat within our holding company system; (ii) governing the issuance, acquisi- tion and disposition of securities and assets by certain of our public utili subsidiaries; and (iii) approving certain utility mergers and acquisitions.

Moreover, our affiliate transactions also remain subject to certain re ulations of the NYPSC, MADTE and NHPUC, in addition to FERC.

Electric Services – LIPA Agreements

LIPA is a corporate municipal instrumentality and a political subdivision of the State of New York. On May 28, 1998, certain of LILCO's business unit were merged with KeySpan and LILCO's common stock and remaining assets were acquired by LIPA. At the time of this transaction, KeySpan an LIPA entered into three major long-term service agreements that (i) pro- vide to LIPA all operation, maintenance and construction services and sig- nificant administrative services relating to the Long Island electric transmis sion and distribution ("T&D") system pursuant to the Management Services Agreement (the "1998 MSA"); (ii) supply LIPA with electric gener ating capacity, energy conversion and ancillary services from our Long Island generating units pursuant to the Power Supply Agreement (the "1998 PSA") and other long-term agreements through which we provide LIPA with approximately one half of its customers' energy needs; and (iii) manage all aspects of the fuel supply for our Long Island generating facili ties, as well as all aspects of the capacity and energy owned by or under contract to LIPA pursuant to the Energy Management Agreement (the "1998 EMA"). We also purchase energy, capacity and ancillary services in the open market on LIPA's behalf under the 1998 EMA. The 1998 MSA, 1998 PSA and 1998 EMA all became effective on May 28, 1998 and are collectively referred to as the 1998 LIPA Agreements.

On February 1, 2006, KeySpan and LIPA entered into (i) an amended and restated Management Services Agreement (the "2006 MSA"), pursuant to which KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island; (ii) 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 acquire substantially all of the electric generating facilities owned by KeySpan on Long Island; and (iii) a Settlement Agreement (the "2006 Settlement Agreement") resolving outstanding issues between the parties regarding the 1998 LIPA Agreements. The 2006 MSA, the 2006 Option Agreement and the 2006 Settlement Agreement are collectively referred to herein as the "2006 LIPA Agreements". Each of the 2006 Agreements will become effective as of January 1, 2006 upon all of the 2006 LIPA Agreements receiving the required governmental approvals; otherwise none of the 2006 LIPA Agreements will become effective.

2006 Settlement Agreement

Pursuant to the terms of the 2006 Settlement Agreement, KeySpan and LIPA agreed to resolve issues that have existed between the parties relating to the various 1998 LIPA Agreements. In addition to the resolution of these matters, KeySpan's entitlement to utilize LILCO's available tax credits and other tax attributes will increase from approximately $50 million to approximately $200 million. These credits and attributes may be used to satisfy KeySpan's previously incurred indemnity obligation to LIPA for any federal income tax liability that may result from the settlement of a pending Internal Revenue Service audit for LILCO's tax year ended March 31, 1999. In recognition of these items, as well as for the modification and extension of the 1998 MSA and the elimination of the GPRA, upon effectiveness of the Settlement Agreement KeySpan will record a contractual asset in the amount of approximately $160 million, of which approximately $110 million will be attributed to the right to utilize such additional credits and attributes and approximately $50 million will be amortized over the eight year term of the 2006 MSA. In order to compensate LIPA for the foregoing, KeySpan will pay LIPA $69 million in cash and will settle certain accounts receivable in the amount of approximately $90 million due from LIPA.

Generation Purchase Rights Agreement and 2006 Option Agreement

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 has the option during the period January 1, 2006 to December 31, 2006 to purchase only 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. The 2006 Option Agreement replaces the GPRA, the expiration of which has been stayed pending effectiveness of the 2006 LIPA Agreements. In the event such agreements do not become effective by reason of failure to secure the requisite governmental approvals, the GPRA will be reinstated for a period of 90 days. 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.

Management Services Agreements

Pursuant to the 1998 MSA, KeySpan manages the day-to-day operations, maintenance and capital improvements of the T&D System. LIPA exercises control over the performance of the T&D System through specific standards for performance and incentives. In exchange for providing the services, the 1998 MSA provides for a $10 million annual management fee and provides certain incentives and imposes certain penalties based upon performance. We earn certain incentives for budget under runs associated with the day-to-day operations, maintenance and capital improvements of LIPA's T&D System. These incentives provide for us to (i) retain 100% on the first $5 million in annual budget under runs, and (ii) retain 50% of additional annual under runs up to 15% of the total cost budget, thereafter all savings accrue to LIPA. With respect to cost overruns, we absorb the first $15 million of overruns, with a sharing of overruns above $15 million. There are certain limitations on the amount of cost sharing of overruns. During 2005, we performed our obligations under the 1998 MSA within the agreed upon budget and we earned $7.4 million in non-cost performance incentives.

When originally executed the 1998 MSA had a term expiring on May 28, 2006. In 2002, in connection with an extension of the GPRA term, the 1998 MSA was extended for 31 months through 2008. As a result of the recent negotiations and settlement between KeySpan and LIPA discussed above, the parties entered into the 2006 MSA.

In place of the previous compensation structure (whereby KeySpan was reimbursed for budgeted costs, and earned a management fee and certain performance and cost-based incentives), KeySpan's compensation for managing the T&D System under the 2006 MSA consists of two components: a minimum compensation component of $224 million per year and a variable component based on electric sales. The $224 million component will remain unchanged for three years and then increase annually by 1.7%, plus inflation. The variable component, which will comprise no more than 20% of KeySpan's compensation, is based on electric sales on Long Island exceeding a base amount of 16,558 gigawatt hours, increasing by 1.7% in each year. Above that level, KeySpan will receive approximately 1.34 cents per kilowatt hour for the first contract year, 1.29 cents per kilowatt hour in the second contract year (plus an annual inflation adjustment), 1.24 cents per kilowatt hour in the third contract year (plus an annual inflation adjustment), with the per kilowatt hour rate thereafter adjusted annually by inflation. Subject to certain limitations, KeySpan will be able to retain all operational efficiencies realized during the term of the 2006 MSA.

:ontinue to reimburse KeySpan for certain expenditures ınection with the operation and maintenance of the T&D ›ther payments made on behalf of LIPA, including: real prop- :r T&D System taxes, return postage, capital construction and storm costs.

06 MSA provides for a number of performance metrics meas- ıs aspects of KeySpan's performance in the operations and cus- ce areas. Poor performance in any metric may subject KeySpan l and other non-cost penalties (such financial penalties not to million in the aggregate for all performance metrics in any con-). Subject to certain limitations, superior performance in certain an be used to offset underperformance in other metrics.

nt failure to meet threshold performance levels for two metrics, Average Interruption Duration Index (two out of three consecutive ınd Customer Satisfaction Index (three consecutive years), will con- an event of default under the 2006 MSA.

hould LIPA sell the T&D System to a private entity during the term 2006 MSA, LIPA shall have the right to terminate the 2006 MSA, ded that LIPA will be required to pay KeySpan's reasonable transition and a termination fee of (a) $28 million if the termination date ırs on or before December 31, 2009, and (b) $20 million if the termi- on date occurs after December 31, 2009.

wer Supply Agreements

ySpan sells to LIPA all of the capacity and, to the extent requested, ergy conversion services from our existing Long Island based oil and s-fired generating plants. Sales of capacity and energy conversion servic- are made under rates approved by the FERC. Since October 1, 2004, ırsuant to a FERC approved settlement, the rates reflect a cost of equity 9.5% with no revenue increase. The FERC also approved updated oper- ing and maintenance expense levels and KeySpan's recovery of certain her costs as agreed to by the parties. Rates charged to LIPA include a xed and variable component. The variable component is billed to LIPA on monthly per megawatt hour basis and is dependent on the number of egawatt hours dispatched. LIPA has no obligation to purchase energy onversion services from us and is able to purchase energy or energy con- ersion services on a least-cost basis from all available sources consistent vith existing interconnection limitations of the T&D System. The 1998 SA provides incentives and penalties that can total $4 million annually for he maintenance of the output capability and the efficiency of the gener- ting facilities. In 2005, we earned $4 million in incentives under this greement.

The 1998 PSA has a term of fifteen years through May 2013, with IPA having the option to renew the 1998 PSA for an additional fifteen year term. The 1998 PSA will be terminated in the event that the GPRA is renewed and LIPA purchases at fair market value certain of KeySpan's Long Island based generating units. If the 2006 LIPA Agreements receive the requisite governmental approvals and become effective, and if LIPA exercises its rights under the 2006 Option Agreement to purchase the two generating plants, then LIPA and KeySpan will enter into an operation and

for certain costs; and the 1998 PSA will be amended to reflect that the purchased generating facilities would no longer be covered by the 1998 PSA. 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.

Energy Management Agreement

The 1998 EMA provides for KeySpan to procure and manage fuel supplies on behalf of LIPA to fuel the generating facilities under contract to it and perform off-system capacity and energy purchases on a least-cost basis to meet LIPA's needs. In exchange for these services we earn an annual fee of $1.5 million. In addition, we arrange for off-system sales on behalf of LIPA of excess output from the generating facilities and other power supplies either owned or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales. In addition, the 1998 EMA provides incentives and penalties that can total $5 million annually for performance related to fuel purchases and off-system power purchases. In 2005, we earned EMA incentives in an aggregate of $5 million.

The original term for the fuel supply service is fifteen years, expiring May 28, 2013, and the original term for the off-system purchases and sales services described is eight years, expiring May 28, 2006. In March 2005, LIPA issued a RFP for system power supply management services beginning May 29, 2006 and fuel management services for certain of its peaking generating units beginning January 1, 2006. KeySpan submitted a bid in response to this RFP in April 2005. LIPA has not yet selected a service provider.

In the event LIPA exercises its rights under the 2006 Option Agreement, KeySpan and LIPA will enter into an amendment to the 199[illegible] EMA reflecting that the facilities that LIPA acquires pursuant to the Optic Agreement are no longer covered under the 1998 EMA and as noted above, an operation and maintenance agreement, whereby KeySpan w continue to operate the newly acquired facilities for a fixed manageme fee plus reimbursement for certain costs. It is anticipated that the fees received pursuant to the operation and maintenance agreement will c the reduction in any fees earned by KeySpan pursuant to the 1998 E

Under the 1998 LIPA Agreements and the 2006 LIPA Agreemen we are required to obtain a letter of credit in the aggregate amount of $60 million supporting our obligations to provide the various ser our long-term debt is not rated in the "A" range by a nationally re nized rating agency.

Power Purchase Agreements

KeySpan-Glenwood Energy Center, LLC and KeySpan-Port Jeffers Energy Center LLC each have 25 year power purchase agreemer LIPA expiring in 2027 (the "2002 LIPA PPAs"). Under the terms (2002 LIPA PPAs, these subsidiaries sell capacity, energy conversi and ancillary services to LIPA. Each plant is designed to produc Pursuant to the 2002 LIPA PPAs, LIPA pays a monthly capacity guarantees full recovery of each plant's construction costs, as appropriate rate of return on investment.

Ravenswood Generating Station
We currently sell capacity, energy and ancillary services associated with the Ravenswood Generating Station through a bidding process into the NYISO energy and capacity markets. Energy is sold on both a day-ahead and a real-time basis. We also have the ability to enter into bilateral transactions to sell all or a portion of the energy produced by the Ravenswood Generating Station to load serving entities, i.e. entities that sell to end-users or to brokers and marketers.

Other Contingencies
LIPA completed its strategic review initiative that it had undertaken in connection with among other reasons, its option under the GPRA. As part of its review, LIPA engaged a team of advisors and consultants, held public hearings and explored its strategic options, including continuing its existing operations, municipalizing, privatizing, selling some, but not all of its assets, becoming a regulator of rates and services, or merging with one or more utilities. Upon completion of its strategic review, LIPA determined that it would continue its existing operations, as part of its settlement with KeySpan and the negotiation of the 2006 LIPA Agreements. As previously noted, the 2006 LIPA Agreements are subject to governmental approvals, and if such governmental approvals are not received and the 2006 LIPA Agreements do not become effective, then LIPA may revisit its strategic review alternatives.

Environmental Matters
KeySpan is subject to various federal, state and local laws and regulatory programs related to the environment. Through various rate orders issued by the NYPSC, MADTE and NHPUC, costs related to MGP environmental cleanup activities are recovered in rates charged to gas distribution customers and, as a result, adjustments to these reserve balances do not impact earnings. However, environmental cleanup activities related to the three non-utility sites are not subject to rate recovery.

During 2005, KeySpan undertook an extensive review of all its current and former properties that are or may be subject to environmental cleanup activities. As a result of this study, we adjusted reserve balances for estimated manufactured gas plant ("MGP") related environmental cleanup activities. As noted above, through various rate orders issued by the NYPSC, MADTE and NHPUC, costs related to MGP environmental cleanup activities are recovered in rates charged to gas distribution customers and, as a result, these adjustments to these reserve balances did not impact earnings.

We estimate that the remaining cost of our MGP related environmental cleanup activities, including costs associated with the Ravenswood Generating Station, will be approximately $404.0 million and we have recorded a related liability for such amount. We have also recorded an additional $19.7 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of December 31, 2005, we have expended a total of $174.0 million on environmental investigation and remediation activities. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Guarantees and Contingencies" for a further explanation of these matters.)

Market and Credit Risk Management Activities

Market Risk
KeySpan is exposed to market risk arising from potential changes in one or more market variables, such as energy commodity prices, interest rates, volumetric risk due to weather or other variables. Such risk includes any or all changes in value whether caused by commodity positions, asset ownership, business or contractual obligations, debt covenants, exposure concentration, currency, weather, and other factors regardless of accounting method. We manage our exposure to changes in market prices using various risk management techniques for non-trading purposes, including hedging through the use of derivative instruments, both exchange-traded and over-the-counter contracts, purchase of insurance and execution of other contractual arrangements.

KeySpan is exposed to price risk due to investments in equity and debt securities held to fund benefit payments for various employee pension and other postretirement benefit plans. To the extent that the value of investments held change, or long-term interest rates change, the effect will be reflected in KeySpan's recognition of periodic cost of such employee benefit plans and the determination of contributions to the employee benefit plans.

Credit Risk
KeySpan is exposed to credit risk arising from the potential that our counterparties fail to perform on their contractual obligations. Our credit exposures are created primarily through the sale of gas and transportation services to residential, commercial, electric generation, and industrial customers and the provision of retail access services to gas marketers, by our regulated gas businesses; the sale of commodities and services to LIPA and the NYISO; the sale of power and services to our retail customers by our unregulated energy service businesses; entering into financial and energy derivative contracts with energy marketing companies and financial institutions; and the sale of gas, oil and processing services to energy marketing and oil and gas production companies.

We have regional concentration of credit risk due to receivables from residential, commercial and industrial customers in New York, New Hampshire and Massachusetts, although this credit risk is spread over a diversified base of residential, commercial and industrial customers. Customers' payment records are monitored and action is taken, when appropriate and in accordance with various regulatory requirements.

We also have credit risk from LIPA, our largest customer, and from other energy and financial services companies. Counterparty credit risk may impact overall exposure to credit risk in that our counterparties may be similarly impacted by changes in economic, regulatory or other considerations. We actively monitor the credit profile of our wholesale counterparties in derivative and other contractual arrangements, and manage our

level of exposure accordingly. In instances where counterparties' credit quality has declined, or credit exposure exceeds certain levels, we may limit our credit exposure by restricting new transactions with the counterparty, requiring additional collateral or credit support and negotiating the early termination of certain agreements.

Regulatory Issues and Competitive Environment

We are subject to various other risk exposures and uncertainties associated with our gas and electric operations. Set forth below is a description of these exposures.

The Gas Industry

New York and Long Island

For the last several years, the NYPSC has been monitoring the progress of competition in the energy market. Based upon its findings of the current market and its continued desire to move toward fully competitive markets, the NYPSC, in August 2004, issued companion policy statements regarding its vision for the future of competitive markets and guidelines for separately stating the cost of competitive services currently performed by New York utilities. The NYPSC's vision for the future of competitive markets, as stated in the first policy statement, remains unchanged. Items of importance include:

- Elimination of a timeframe for the exit of utilities from the merchant function. Experience, time and maturation of each market/customer class will dictate the exit of utilities.
- Acknowledgement that competitive commodity markets for the largest customers has occurred. However, workable competition for the mass markets (i.e. residential and small commercial customers) is taking longer and needs to be nurtured.
- Future rate filings must include a plan for facilitating customer migration to competitive markets and a fully embedded cost of service study that develops unbundled rates for the utility's delivery service and all potentially competitive services.
- Utilities should avoid entering into long term capacity arrangements unless it is necessary for reliability and safety purposes.
- Where markets are not workably competitive, the NYPSC must ensure that rates continue to be just and reasonable, and protect customers from price volatility.

The NYPSC's second policy statement of August 2004 addresses the means by which New York utilities should state separately, or "unbundle," the costs of competitive and potentially competitive services currently performed by utilities from the cost of providing local distribution service. The objective of unbundling is to facilitate competition by providing customers with information as to savings available from purchasing competitive services from third-party providers, and to credit the customer's utility bill for the cost of unbundled services when they migrate to competitive suppliers. In its unbundling policy statement, the NYPSC directed utilities to file with their next base rate proceedings updated cost studies for unbundled competitive services that, once approved by the NYPSC, would replace existing backout credits for these services established in prior utility proceedings. The NYPSC also asked utilities to file with the unbundled cost studies a lost revenue recovery mechanism that would permit the utility to recover revenue associated with the difference between the cost the utility is able to avoid when a customer migrates to a competitive service provider and the unbundled rate for that service credited to the customer's bill.

KEDNY's and KEDLI's current backout credits for the billing function are both $.78 per account per month, and were established in May 2001 by the NYPSC's Order Establishing Retail Access Billing and Payment Processing Practices. Pursuant to that Order, customers that purchase commodity service from third-party providers and receive a consolidated bill from the utility receive a $.78 billing credit on their utility bills. KEDNY/KEDLI then invoices the third-party commodity provider for the billing service at the same $.78 per account per month that is credited to the customer's utility bill. As for the commodity merchant function, KEDNY's and KEDLI's existing backout credits are $.21/Dth and $.19/Dth, respectively, as established in May 2002 by the NYPSC's Order Adopting Terms of Gas Restructuring Joint Proposal Petition of KeySpan Energy Delivery New York and KeySpan Energy Delivery Long Island for a Multi-Year Restructuring Agreement ("Joint Proposal"). The Joint Proposal also established Transition Balancing Accounts ("TBA") for KEDNY and KEDLI that are funded by property tax refunds and other sums due to firm gas sales customers. The TBAs are currently the mechanisms for KEDNY and KEDLI to recover revenue lost to the merchant function backout credit. While the Joint Proposal expired in November 2003, the KEDNY and KEDLI tariffs provide that the merchant function backout credits and the TBAs will remain in effect until November 2006. As part of a retail choice program, KEDNY and KEDLI will propose a program to facilitate competition in their service territories, cost-based unbundled rates for competitive services, and a lost revenue recovery mechanism that prevents them from being harmed by the migration of customers to competitive services.

On December 5, 2005, a petition was filed with the NYPSC requesting authority to defer costs associated with high gas prices that are not reflected in existing gas sales rates, including commodity-related uncollectible expense, gas working capital and gas in storage. The NYPSC commenced the required 45-day notice of this petition in the New York State Register on January 25, 2006.

New England

In July 1997, the MADTE directed Massachusetts gas distribution companies to undertake a collaborative process with other stakeholders to develop common principles under which comprehensive gas service unbundling might proceed. A settlement agreement by the local distribution companies ("LDCs") and the marketer group regarding model terms and conditions for unbundled transportation service was approved by the

MADTE in November 1998. In February 1999, the MADTE issued its order on how unbundling of natural gas service will proceed. For a five year transition period, the MADTE determined that LDC contractual commitments to upstream capacity will be assigned on a mandatory, pro-rata basis to marketers selling gas supply to the LDCs' customers. The approved mandatory assignment method eliminates the possibility that the costs of upstream capacity purchased by the LDCs to serve firm customers will be absorbed by the LDC or other customers through the transition period. The MADTE also found that, through the transition period, LDCs will retain primary responsibility for upstream capacity planning and procurement to assure that adequate capacity is available to support customer requirements and growth. The MADTE approved the LDCs' Terms and Conditions of Distribution Service that conform to the settled upon model terms and conditions. Since November 1, 2000, all Massachusetts gas customers have the option to purchase their gas supplies from third party sources other than the LDCs.

In January 2004, the MADTE began a proceeding to re-examine whether the upstream capacity market has been sufficiently competitive to allow voluntary capacity assignment. KeySpan submitted comments maintaining its position that the upstream capacity market is not at this time sufficiently competitive to remove or modify the MADTE's mandatory capacity assignment requirement. On June 6, 2005, the MADTE issued an order in its continuing investigation into gas unbundling and found that mandatory capacity assignment should be continued, including continuation of slice of system versus path method of assignment, essentially maintaining the status-quo.

Beginning on November 1, 2001, the NHPUC began requiring gas utilities to offer transportation services to all commercial and residential customers. Since such time EnergyNorth has provided such transportation in accordance with the NHPUC order.

Electric Industry

10-Minute Spinning and Non-Spinning Reserves

Due to the volatility in the market clearing price of 10-minute spinning and non-spinning reserves during the first quarter of 2000, the NYISO requested that FERC approve a bid cap on such reserves, as well as requiring a refunding of so called alleged "excess payments" received by sellers, including the Ravenswood Facility. On May 31, 2000, FERC issued an order that granted approval of a $2.52 per MWh bid cap for 10-minute non-spinning reserves, plus payments for the opportunity cost of not making energy sales. The NYISO's other requests, such as a bid cap for spinning reserves, retroactive refunds, recalculation of reserve prices, etc., were rejected.

The NYISO, The Consolidated Edison Company of New York ("Con Edison"), Niagara Mohawk Power Corporation and Rochester Gas and Electric each individually appealed FERC's order in federal court. The appeals were consolidated into one case and on November 7, 2003, the United States Court of Appeals for the District of Columbia (the "Court") issued its decision in the case of Consolidated Edison Company of New York, Inc., v. Federal Energy Regulatory Commission (the "Decision"). Essentially, the Court found errors in FERC's order and remanded some issues back to FERC for further explanation and action.

On June 25, 2004, the NYISO submitted a motion to FERC seeking refunds as a result of the Decision. KeySpan and others submitted statements of opposition opposing the refunds. On March 4, 2005, FERC issued an order upholding its original decision not to order refunds. FERC also provided the further explanation requested by the Court as to why refunds were not being ordered. The NYISO and other market participants requested rehearing of FERC's latest order and on November 17, 2005, FERC denied those requests. The NYISO and various New York Transmission Owners appealed FERC's November 17, 2005 order to the United States Court of Appeals for the District of Columbia.

May 2000 Energy Market Clearing Prices

Due to unseasonably warm weather and scheduled maintenance outages in May 2000, energy prices spiked, and the NYISO revised prices downward after it determined a market design flaw existed which caused prices to be higher than what would occur in a competitive market. FERC originally agreed with the NYISO, but reversed its original decision on remand from the Court of Appeals. On March 4, 2005, FERC issued an order requiring the NYISO to reinstate the original prices for May 8 and 9, 2000 and to pay suppliers, including the Ravenswood Facility, accordingly. In 2005, the Ravenswood Generating Station received a $9.2 million increase in its payments for its May 2000 energy sales. The NYISO and other market participants requested rehearing of this March 4, 2005 order, and on November 22, 2005, FERC denied those requests. The NYISO and various New York Transmission Owners appealed FERC's November 22, 2005 order to the United States Court of Appeals for the District of Columbia.

NYISO Demand Curve Capacity Market Implementation

On March 21, 2003 the NYISO made a filing at FERC seeking approval of a Demand Curve to be used in place of its current deficiency auction for capacity procurement. On May 20, 2003, FERC approved, with some modifications, the Demand Curve to become effective May 21, 2003. On October 23, 2003, FERC denied various requests for rehearing of its order approving the Demand Curve and approved the NYISO's compliance filing. On December 9, 2003, the NYISO filed its first status report with FERC with respect to how the Demand Curve was working. The NYISO report found that there was no evidence of inappropriate withholding of capacity resources and that the Demand Curve was working as intended. On December 22, 2003, the Electric Consumers Resource Council filed an appeal with the DC Circuit Court of Appeals of FERC's May 20, 2003 order approving the Demand Curve and its October 23, 2003 order denying rehearing. On May 13, 2005, this appeal was denied.

NYISO Standard Market Design 2.0 ("SMD2")

The NYISO's revised market design and software SMD2, was implemented on February 1, 2005. It replaced the NYISO's current two step real-time market system, which consists of the Balancing Market Evaluation and Security Constrained Dispatch applications, with a more integrated Real Time Scheduling system ("RTS"). RTS uses a common computing plat-

form, algorithms, and network models for both the real-time commitment and real-time dispatch functions. This synergy between commitment and dispatch functions is expected to result in improved consistency between advisory and real-time price schedules, as well as more efficient use of control area resources. SMD2 will more closely align the NYISO markets with the FERC Standard Market Design Notice of Proposed Rule Making, issued on July 31, 2002. The NYISO reported that SMD2 is performing as expected, and they continue to monitor the market improvements.

The Ravenswood Generating Station and our New York City Operations

Currently, the NYISO's New York City local reliability rules require that 80% of the electric capacity needs of New York City be provided by "in-City" generators. On February 6, 2006, the NYISO Board increased the "in-City" generator requirement to 83% beginning in May 2006 through the period ending on April 2007, based in part on the statewide reserve margin of 118% set by the New York State Reliability Council. Our Ravenswood Generating Station is an "in-City" generator. As the electric infrastructure in New York City and the surrounding areas continues to change and evolve and the demand for electric power increases, the "in-City" generator requirement could be further modified. Construction of new transmission and generation facilities may cause significant changes to the market for sales of capacity, energy and ancillary services from our Ravenswood Generating Station. Recently 500 MW of capacity came on line and it is anticipated that another 500MW of new capacity may be available during 2006 as a result of the completion of an in-City generation project currently under construction. We can not, however, be certain as to when the new power plant will be in operation or the nature of future New York City energy, capacity or ancillary services market requirements or design.

Quantitative and Qualitative Disclosures About Market Risk

Financially-Settled Commodity Derivative Instruments – Hedging Activities

From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas distribution operations, gas exploration and production activities and its electric generating facilities. Seneca-Upshur utilizes over-the-counter ("OTC") natural gas swaps to hedge cash flow variability associated with forecasted sales of natural gas. The Ravenswood Generating Station uses derivative financial instruments to hedge the cash flow variability associated with the purchase of a portion of natural gas or fuel oil that will be consumed during the generation of electricity. The Ravenswood Generating Station also hedges the cash flow variability associated with a portion of electric energy sales. During 2005, our gas distribution operations utilized OTC natural gas and fuel oil swaps to hedge the cash-flow variability of specified portions of gas purchases and sales associated with certain large-volume customers. These derivative positions have all settled as of December 31, 2005.

KeySpan uses standard NYMEX futures prices to value gas futures and market quoted forward prices to value OTC swap contracts.

The following tables set forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2005.

TYPE OF CONTRACT GAS	YEAR OF MATURITY	VOLUMES (MMCF)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($ MILLIONS)
OTC Swaps – Short Natural Gas	2006	2,035	6.17 – 6.29	10.67 –12.04	(8.6)
	2007	1,691	5.86 – 5.97	9.81 – 12.49	(8.1)
	2008	1,549	6.77 – 6.85	8.91 – 11.52	(4.5)
		5,275			(21.2)

TYPE OF CONTRACT OIL	YEAR OF MATURITY	VOLUMES (BARRELS)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($ MILLIONS)
Swaps – Long Heating Oil	2006	2,056,794	39.65 – 67.75	56.00 – 57.80	(6.3)

TYPE OF CONTRACT ELECTRICITY	YEAR OF MATURITY	VOLUMES (MMCF)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($ MILLIONS)
Swaps – Energy	2006	1,648,000	76.00 – 208.00	107.61 – 153.25	9.4

The following tables detail the changes in and sources of fair value for the above derivatives:

CHANGE IN FAIR VALUE OF DERIVATIVE HEDGING INSTRUMENTS	(In Millions of Dollars) 2005
Fair value of contracts at January 1,	$ (1.4)
Net losses on contracts realized	36.6
Decrease in fair value of all open contracts	(53.3)
Fair value of contracts outstanding at December 31,	$ (18.1)

(In Millions of Dollars)

	FAIR VALUE OF CONTRACTS		
SOURCES OF FAIR VALUE	MATURITY IN 12 MONTHS	MATURITY 2006 AND 2007	TOTAL FAIR VALUE
Prices actively quoted	$ (9.2)	$ (12.6)	$ (21.8)
Local published indicies	3.7	—	3.7
	$ (5.5)	$ (12.6)	$ (18.1)

We measure the commodity risk of our derivative hedging instruments (indicated in the above table) using a sensitivity analysis. Based on a sensitivity analysis as of December 31, 2005, a 10% increase/decrease in heating oil and natural gas prices would decrease/increase the value of derivative instruments maturing in one year by $2.2 million. Further, a 10% increase/decrease in electricity and fuel prices would decrease/increase the value of derivative instruments maturing in one year by $9.7 million.

Firm Gas Sales Derivative Instruments – Regulated Utilities

We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. The accounting for these derivative instruments is subject to SFAS 71 "Accounting for the Effects of Certain Types of Regulation." Therefore, changes in the fair value of these derivatives are recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements.

The following table sets forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2005.

TYPE OF CONTRACT	YEAR OF MATURITY	VOLUMES (MMCF)	FLOOR ($)	CEILING ($)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($ IN MILLIONS)
Options	2006	7,200	5.50 –12.00	5.50 – 13.55	—	8.75 – 13.06	15.6
Swaps	2006	52,030	—	—	5.34 – 14.16	10.29 – 11.36	115.9
	2007	20,480	—	—	6.81 – 11.99	9.44 – 11.88	26.1
		79,710					157.6

See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" for a further description of all our derivative instruments.

Cautionary Statement Regarding Forward-Looking Statements

Certain statements contained herein are forward-looking statements, which reflect numerous assumptions and estimates and involve a number of risks and uncertainties. For these statements, we claim the protection of the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995.

There are possible developments that could cause our actual results to differ materially from those forecast or implied in the forward-looking statements. You are cautioned not to place undue reliance on these forward-looking statements, which are current only as of the date of this filing. We disclaim any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Among the factors that could cause actual results to differ materially are: volatility of energy prices of fuel used to generate electricity; fluctuations in weather and in gas and electric prices; general economic conditions, especially in the Northeast United States; our ability to successfully reduce our cost structure and operate efficiently; our ability to successfully contract for natural gas supplies required to meet the needs of our firm customers; implementation of new accounting standards; inflationary trends and interest rates; available sources and cost of fuel; creditworthiness of counter-parties to derivative instruments and commodity contracts; retention of key personnel; federal and state regulatory initiatives that increase competition, threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses; the impact of federal and state utility regulatory policies and orders on our regulated and unregulated businesses; potential write-down of our investment in natural gas properties when natural gas prices are depressed or if we have significant downward revisions in our estimated proved gas reserves; and other risks detailed from time to time in other reports and other documents filed by KeySpan with the Securities and Exchange Commission.

Controls and Procedures

We maintain disclosure controls and procedures (as defined under Exchange Act Rule 13a-15(e)) that are designed to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to KeySpan's management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. Any control system, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. Our management, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of December 31, 2005. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures provided reasonable assurance that the disclosure controls and procedures are effective to accomplish their objectives.

Furthermore, there has been no change in KeySpan's internal control over financial reporting identified in connection with the evaluation of such control that occurred during KeySpan's last fiscal quarter, which has materially affected, or is reasonably likely to materially affect, KeySpan's internal control over financial reporting.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined under Exchange Act Rule 13a-15(f)). KeySpan's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements, errors or fraud. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of or compliance with the policies or procedures may deteriorate.

Under the supervision and with participation of KeySpan's Chief Executive Officer and Chief Financial Officer, our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2005. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in a report entitled Internal Control-Integrated Framework. Our management concluded, as of December 31, 2005, that KeySpan's internal control over financial reporting is effective based on the COSO criteria.

Our independent registered public accounting firm, Deloitte & Touche LLP, has issued their report on management's assessment of KeySpan's internal control over financial reporting as of December 31, 2005, which is included herein.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of KeySpan Corporation:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that KeySpan Corporation and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2005 of the Company and our report dated February 28, 2006 expressed an unqualified opinion on those financial statements and included an explanatory paragraph regarding the adoption of Financial Accounting Standards Board Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143", referred to in Notes 1(O), 1 (P) and 7.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
New York, New York
February 28, 2006

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of KeySpan Corporation:

We have audited the accompanying Consolidated Balance Sheets and the Consolidated Statement of Capitalization of KeySpan Corporation and subsidiaries (the "Company") as of December 31, 2005 and 2004, and the related Consolidated Statements of Income, Retained Earnings, Comprehensive Income and Cash Flows for each of the three years in the period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of KeySpan Corporation and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1(P) to the consolidated financial statements, on December 31, 2003, the Company adopted Financial Accounting Standards Board Interpretation No. ("FIN") 46 "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51". As discussed in Notes 1(O), 1(P) and 7, on December 31, 2005, the Company adopted FIN 47, "Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143."

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 28, 2006 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
New York, New York
February 28, 2006

CONSOLIDATED BALANCE SHEET

DECEMBER 31,	2005	2004
		(In Millions of Dollars)
ASSETS		
Current Assets		
Cash and temporary cash investments	**$ 124.5**	$ 922.0
Restricted cash	**13.2**	—
Accounts receivable	**1,035.6**	788.5
Unbilled revenue	**685.6**	590.8
Allowance for uncollectible accounts	**(62.8)**	(67.8)
Gas in storage, at average cost	**766.9**	515.5
Material and supplies, at average cost	**140.5**	123.4
Derivative contracts	**142.8**	0.6
Other	**173.8**	162.7
Assets of discontinued operations	—	42.9
	3,020.1	3,078.6
Investments and Other	**242.4**	272.9
Property		
Gas	**7,275.9**	6,871.2
Electric	**2,492.3**	2,402.1
Other	**416.3**	398.6
Accumulated depreciation	**(2,922.6)**	(2,702.3)
Gas exploration and production, at cost	**184.2**	187.1
Accumulated depletion	**(109.2)**	(97.5)
Property of discontinued operations	—	8.7
	7,336.9	7,067.9
Deferred Charges		
Regulatory assets:		
Miscellaneous assets	**688.3**	535.3
Derivative contracts	**30.9**	20.1
Goodwill and other intangible assets, net of amortization	**1,666.3**	1,677.6
Derivative contracts	**75.2**	29.2
Other	**752.5**	682.5
	3,213.2	2,944.7
Total Assets	**$ 13,812.6**	$ 13,364.1

See accompanying Notes to the Consolidated Financial Statements.

CONSOLIDATED BALANCE SHEET

DECEMBER 31,	2005	2004
		(In Millions of Dollars)
LIABILITIES AND CAPITALIZATION		
Current Liabilities		
Accounts payable and other liabilities	**$ 1,087.0**	$ 906.7
Commercial paper	**657.6**	912.2
Current maturities of long-term debt and capital leases	**13.0**	16.1
Current redemption requirement of preferred stock	**—**	55.3
Taxes accrued	**176.3**	161.6
Dividends payable	**81.1**	74.1
Customer deposits	**39.1**	43.3
Interest accrued	**53.8**	48.8
Other current liability, derivative contracts	**47.3**	—
Liabilities of discontinued operations	**—**	64.2
	2,155.2	2,282.3
Deferred Credits and Other Liabilities		
Regulatory liabilities:		
Miscellaneous liabilities	**69.9**	66.5
Removal costs recovered	**516.4**	496.5
Derivative accounts	**175.4**	7.4
Asset retirement obligations	**47.4**	1.9
Deferred income tax	**1,157.9**	1,124.1
Postretirement benefits and other reserves	**1,118.4**	900.4
Derivative contracts	**44.3**	43.9
Other	**127.5**	94.3
	3,257.2	2,735.0
Commitments and Contingencies (See Note 7)	**—**	—
Capitalization		
Common stock	**3,975.9**	3,502.0
Retained earnings	**866.9**	792.2
Accumulated other comprehensive income	**(74.8)**	(54.3)
Treasury stock	**(303.9)**	(345.1)
Total common shareholders' equity	**4,464.1**	3,894.8
Preferred stock	**—**	19.7
Long-term debt and capital leases	**3,920.8**	4,418.7
Total Capitalization	**8,384.9**	8,333.2
Minority Interest in Consolidated Companies	**15.3**	13.6
Total Liabilities and Capitalization	**$ 13,812.6**	$ 13,364.1

See accompanying Notes to the Consolidated Financial Statements.

	(In Millions of Dollars, Except Per Share Amounts)		
YEAR ENDED DECEMBER 31,	2005	2004	2003
Revenues			
Gas Distribution	**$5,390.1**	$4,407.3	$4,161.3
Electric Services	**2,042.7**	1,738.7	1,606.0
Energy Services	**191.2**	182.4	158.9
Houston Exploration	—	268.1	495.3
Energy Investments	**38.0**	54.0	114.0
Total Revenues	**7,662.0**	6,650.5	6,535.5
Operating Expenses			
Purchased gas for resale	**3,597.3**	2,664.5	2,495.1
Fuel and purchased power	**752.1**	540.3	414.6
Operations and maintenance	**1,617.9**	1,567.0	1,622.6
Depreciation, depletion and amortization	**396.5**	551.8	571.7
Operating taxes	**407.1**	404.2	418.2
Impairment charges	—	41.0	—
Total Operating Expenses	**6,770.9**	5,768.8	5,522.2
Gain on sale of property	**1.6**	7.0	15.1
Income from equity investments	**15.1**	46.5	19.2
Operating Income	**907.8**	935.3	1,047.6
Other Income and (Deductions)			
Interest charges	**(269.3)**	(331.3)	(307.7)
Sale of subsidiary stock	**4.1**	388.3	13.3
Cost of debt redemption	**(20.9)**	(45.9)	(24.1)
Minority interest	**(0.4)**	(36.8)	(63.9)
Other	**16.6**	30.6	42.1
Total Other Income and (Deductions)	**(269.9)**	4.9	(340.3)
Income Taxes			
Current	**206.6**	201.9	(99.8)
Deferred	**32.7**	123.6	381.1
Total Income Taxes	**239.3**	325.5	281.3
Earnings from Continuing Operations	**398.6**	614.7	426.0
Discontinued Operations			
Income (loss) from operations, net of tax	**(4.1)**	(79.0)	(1.9)
Gain (Loss) on disposal, net of tax	**2.3**	(72.0)	—
Loss from Discontinued Operations	**(1.8)**	(151.0)	(1.9)
Cumulative Change in Accounting Principles, net of tax	**(6.6)**	—	(37.4)
Net Income	**390.2**	463.7	386.7
Preferred stock dividend requirements	**2.2**	5.6	5.8
Earnings for Common Stock	**$ 388.0**	$ 458.1	$ 380.9
Basic Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 2.33**	$ 3.80	$ 2.65
Discontinued Operations	**(0.01)**	(0.94)	(0.01)
Cumulative Change in Accounting Principles	**(0.04)**	—	(0.23)
Basic Earnings Per Share	**$ 2.28**	$ 2.86	$ 2.41
Diluted Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 2.32**	$ 3.78	$ 2.63
Discontinued Operations	**(0.01)**	(0.94)	(0.01)
Cumulative Change in Accounting Principles	**(0.04)**	—	(0.23)
Diluted Earnings Per Share	**$ 2.27**	$ 2.84	$ 2.39
Average Common Shares Outstanding (000)	**169,940**	160,294	158,256
Average Common Shares Outstanding – Diluted (000)	**170,801**	161,277	159,232

See accompanying Notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENT OF CASH FLOWS

YEAR ENDED DECEMBER 31,	2005	2004	2003
			(In Millions of Dollars)
Operating Activities			
Net income	**$ 390.2**	$ 463.7	$ 386.7
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation, depletion and amortization	**396.5**	551.8	571.7
Deferred income tax	**32.7**	123.6	188.7
Income from equity investments	**(15.1)**	(46.5)	(18.0)
Dividends from equity investments	**9.3**	14.2	2.8
Amortization of financing fees / interest rate swaps	**(1.4)**	(14.9)	(9.9)
Gain on sale of investments and property	**(5.6)**	(395.3)	(28.5)
Hedging (gain)/losses	**(3.2)**	2.5	(1.0)
Amortization of property taxes	**126.2**	101.9	87.5
Impairment charges	**—**	41.0	—
Loss from discontinued operations	**1.8**	151.0	1.9
Cumulative change in accounting principle	**6.6**	—	37.4
Environmental reserve adjustment	**—**	—	(10.5)
Minority interest	**0.4**	36.8	63.9
Changes in assets and liabilities			
Accounts receivable	**(305.7)**	(234.2)	60.4
Materials and supplies, fuel oil and gas in storage	**(268.4)**	(39.0)	(199.0)
Accounts payable and accrued expenses	**196.3**	159.5	225.8
Prepaid property taxes	**(136.2)**	(112.1)	(133.9)
Reserve payments	**(35.7)**	(37.3)	(36.5)
Insurance settlements	**21.1**	—	—
Other	**(6.5)**	(16.6)	33.9
Net Cash Provided by Continuing Operating Activities	**403.3**	750.1	1,223.4
Investing Activities			
Construction expenditures	**(539.5)**	(750.3)	(1,009.4)
Cost of removal	**(27.8)**	(36.3)	(31.1)
Net proceeds from sale of property and investments	**47.0**	1,021.3	309.7
Derivative margin call	**(8.9)**	—	—
Other investments	**—**	—	(211.3)
Issuance of long-term note	**—**	—	(55.0)
Net Cash (Used in) Provided by Continuing Investing Activities	**(529.2)**	234.7	(997.1)
Financing Activities			
Treasury stock issued	**41.2**	33.4	96.7
Common stock issuance	**460.0**	—	473.6
Issuance of long-term debt	**—**	49.3	1,024.5
Payment of long-term debt	**(515.0)**	(920.1)	(614.3)
Issuance / (payment) of commercial paper	**(254.6)**	430.4	(433.8)
Redemption of preferred stock	**(75.0)**	(8.5)	(14.3)
Net proceeds from sale/leaseback transaction	**—**	382.0	—
Redemption of promissory notes	**—**	—	(447.0)
Common and preferred stock dividends paid	**(308.4)**	(291.1)	(280.6)
Gain on interest rate swap	**—**	12.7	—
Other	**(5.4)**	36.1	15.0
Net Cash (Used in) Continuing Financing Activities	**(657.2)**	(275.8)	(180.2)
Net (Decrease) Increase in Cash and Cash Equivalents	**$ (783.1)**	$ 709.0	$ 46.1
Cash Flow from Discontinued Operations – Operating Activities*	**(3.8)**	8.1	(16.5)
Cash Flow from Discontinued Operations – Investing Activities*	**(10.6)**	1.3	2.3
Cash Flow from Discontinued Operations – Financing Activities*	**—**	0.2	0.9
Cash and Cash Equivalents at Beginning of Period	**922.0**	203.4	170.6
Cash and Cash Equivalents at End of Period	**$ 124.5**	$ 922.0	$ 203.4
Interest Paid	**$ 262.7**	$ 336.5	$ 355.1
Income Tax Paid	**$ 181.5**	$ 122.0	$ 65.5

** Revised See Note 1*

See accompanying Notes to the Consolidated Financial Statements.

ONSOLIDATED STATEMENT OF RETAINED EARNINGS

			(In Millions of Dollars)
EAR ENDED DECEMBER 31,	2005	2004	2003
alance at Beginning of Period	**$ 792.2**	$ 621.4	$ 522.8
let Income for Period	**390.2**	463.7	386.7
	1,182.4	1,085.1	909.5
eductions:			
ash dividends declared on common stock	**313.3**	287.3	282.3
ash dividends declared on preferred stock	**2.2**	5.6	5.8
alance at End of Period	**$ 866.9**	$ 792.2	$ 621.4

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	2005	2004	2003
Net Income	**$ 390.2**	$ 463.7	$ 386.7
Other comprehensive income, net of tax			
Net losses (gains) on derivative instruments	**23.8**	(0.3)	23.0
Unrealized (losses) gains on derivative financial instruments	**(35.1)**	15.4	(25.4)
Deconsolidation of certain subsidiaries	—	9.3	—
Foreign currency translation adjustments	**(5.0)**	(21.5)	28.7
Unrealized gains (losses) on marketable securities	**(0.5)**	7.1	8.5
Premium on derivative instrument	—	3.4	(3.4)
Accrued unfunded pension obligation	**(3.7)**	(7.8)	8.4
Other comprehensive income (loss), net of tax	**(20.5)**	5.6	39.8
Comprehensive Income	**$ 369.7**	$ 469.3	$ 426.5
Related tax (benefit) expense			
Net losses (gains) on derivative instruments	**12.8**	(0.2)	12.4
Unrealized (losses) gains on derivative financial instruments	**(20.7)**	8.2	(13.6)
Deconsolidation of certain subsidiaries	—	5.0	—
Foreign currency translation adjustments	**(2.7)**	(11.6)	15.4
Unrealized gains (losses) on marketable securities	**(0.2)**	3.8	4.6
Accrued unfunded pension obligation	**(2.1)**	(4.2)	4.5
Premium on derivative instrument	—	1.9	(1.9)
Total Tax (Benefit) Expense	**$ (12.9)**	$ 2.9	$ 21.4

See accompanying Notes to the Consolidated Financial Statements.

(In Millions of Dollars)

	DECEMBER 31, 2005	DECEMBER 31, 2004	DECEMBER 31, 2005	DECEMBER 31, 2004
	SHARES ISSUED			
Common Shareholders' Equity				
Common stock, $0.01 par value	**184,864,124**	172,737,654	**$ 1.7**	$ 1.7
Premium on capital stock			**3,974.2**	3,500.3
Retained earnings			**866.9**	792.2
Other comprehensive income			**(74.8)**	(54.3)
Treasury stock	**(10,495,743)**	(11,919,343)	**(303.9)**	(345.1)
Total Common Shareholders' Equity	**174,368,381**	160,818,311	**4,464.1**	3,894.8
Preferred Stock – Redemption Required				
Par Value $100 per share				
7.07% Series B – private placement	—	553,000	—	55.3
7.17% Series C – private placement	—	197,000	—	19.7
Less: current redemption requirements	—	(553,000)	—	(55.3)
Total Preferred Stock – Redemption Required	—	197,000	—	19.7
Long-Term Debt	INTEREST RATE	MATURITY		
Medium and Long Term Notes	4.65% – 9.75%	2006 – 2035	**2,437.2**	2,485.0
Gas Facilities Revenue Bonds	Variable	2020 – 2026	**230.0**	125.0
	4.70% – 6.95%	2020 – 2026	**410.5**	515.5
Total Gas Facilities Revenue Bonds			**640.5**	640.5
Promissory Notes to LIPA				
Pollution Control Revenue Bonds	5.15%	2016 – 2028	**108.0**	108.0
Electric Facilities Revenue Bonds	5.30%	2023 – 2027	**47.4**	47.4
Total Promissory Notes to LIPA			**155.4**	155.4
MEDS Equity Units	8.75%	2005	—	460.0
Industrial Development Bonds	5.25%	2027	**128.3**	128.3
First Mortgage Bonds	6.08% – 8.80%	2008 – 2028	**95.0**	95.0
Authority Financing Notes	Variable	2027 – 2028	**66.0**	66.0
Ravenswood Master Lease & Capital Leases		2006 – 2022	**423.0**	424.1
Subtotal			**3,945.4**	4,454.3
Unamortized interest rate hedge and debt discount			**(30.4)**	(55.2)
Derivative impact on debt			**18.8**	35.7
Less: current maturities			**13.0**	16.1
Total Long-Term Debt			**3,920.8**	4,418.7
Total Capitalization			**$ 8,384.9**	$ 8,333.2

See accompanying Notes to the Consolidated Financial Statements.

Note 1. Summary of Significant Accounting Policies

A. Organization of the Company

KeySpan Corporation, a New York corporation, was formed in May 1998, as a result of the business combination of KeySpan Energy Corporation, the parent of The Brooklyn Union Gas Company, and certain businesses of the Long Island Lighting Company ("LILCO"). On November 8, 2000, KeySpan acquired Eastern Enterprises ("Eastern"), a Massachusetts business trust, and the parent of several gas utilities operating in Massachusetts. Also on November 8, 2000, Eastern acquired EnergyNorth, Inc. ("ENI"), the parent of a gas utility operating in central New Hampshire. KeySpan Corporation will be referred to in these notes to the Consolidated Financial Statements as "KeySpan," "we," "us" and "our."

On February 25, 2006, KeySpan entered into an Agreement and Plan of Merger (the "Merger Agreement"), with National Grid PLC, a public limited company incorporated under the laws of England and Wales ("Parent") and National Grid USA, Inc., a New York Corporation ("Merger Sub"), pursuant to which Merger Sub will merge with and into KeySpan (the "Merger"), with KeySpan continuing as the surviving company. Pursuant to the Merger Agreement, at the effective time of the Merger, each outstanding share of common stock, par value $0.01 per share of KeySpan (the "Shares"), other than shares owned by KeySpan, shall be canceled and shall be converted into the right to receive $42.00 in cash, without interest.

Consummation of the Merger is subject to various closing conditions, including but not limited to the satisfaction or waiver of conditions regarding the receipt of requisite regulatory approvals and the adoption of the Merger Agreement by the stockholders of KeySpan and the Parent. Assuming receipt or waiver of the foregoing, it is currently anticipated that the Merger will be consummated in early 2007. However, no assurance can be given that the Merger will occur, or, the timing of its completion.

KeySpan's core businesses are engaged in gas distribution, electric services and generation and other energy related activities. KeySpan's gas distribution operations are conducted by our six regulated gas utility subsidiaries: The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York ("KEDNY") and KeySpan Gas East Corporation d/b/a KeySpan Energy Delivery Long Island ("KEDLI") distribute gas to customers in the Boroughs of Brooklyn, Staten Island, a portion of the Borough of Queens in New York City, and the counties of Nassau and Suffolk on Long Island and the Rockaway Peninsula in Queens, respectively; Boston Gas Company, Colonial Gas Company and Essex Gas Company, each doing business as KeySpan Energy Delivery New England ("KEDNE"), distribute gas to customers in southern, eastern and central Massachusetts; and EnergyNorth Natural Gas, Inc., d/b/a KeySpan Energy Delivery New England distributes gas to customers in central New Hampshire. Together, these companies distribute gas to approximately 2.6 million customers throughout the Northeast.

We own, lease and operate electric generating plants on Long Island and in New York City. Under contractual arrangements, we provide electric power, electric transmission and distribution services, billing and other customer services for approximately 1.1 million electric customers of the Long Island Power Authority ("LIPA"). On February 1, 2006, KeySpan and LIPA entered into agreements to extend, amend and restate these contractual arrangements. See Note 11 "2006 LIPA Settlement" for a discussion of the settlement.

Our other subsidiaries are involved in gas production; gas storage; liquefied natural gas storage; retail electric marketing; appliance service; fiber optic services; and engineering and consulting services. We also invest in, and participate in the development of natural gas pipelines; electric generation, and other energy-related projects. (See Note 2, "Business Segments" for additional information on each operating segment.)

At December 31, 2005, KeySpan was a holding company under the Public Utility Holding Company Act of 1935, as amended ("PUCHA 1935"). In August 2005, the Energy Policy Act of 2005 (the "Energy Act") was enacted. The Energy Act is a broad energy bill that places an increased emphasis on the production of energy and promotes the development of new technologies and alternative energy sources and provides tax credits to companies that produce natural gas, oil, coal, electricity and renewable energy. For KeySpan, one of the more significant provisions of the Energy Act is the repeal of PUHCA 1935, which became effective on February 8, 2006, and the transfer of certain holding company oversight from the Securities and Exchange Commission ("SEC") to the Federal Energy Regulatory Commission ("FERC") pursuant to the Public Utility Holding Company Act of 2005 ("PUHCA 2005").

Pursuant to PUHCA 2005, the SEC no longer has jurisdiction over our holding company activities, other than those associated with the registration and issuance of our securities under the federal securities laws. FERC now has jurisdiction over certain of our holding company activities, including (i) regulating certain transactions among our affiliates within our holding company system; (ii) governing the issuance, acquisition and disposition of securities and assets by certain of our public utility subsidiaries; and (iii) approving certain utility mergers and acquisitions.

Moreover, our affiliate transactions also remain subject to certain regulations of the Public Service Commission of the State of New York ("NYPSC"), the Massachusetts Department of Telecommunications and Energy ("MADTE") and the New Hampshire Public Utility Commission ("NHPUC") in addition to FERC.

Under our holding company structure, we have no independent operations or source of income of our own and conduct all of our operations through our subsidiaries and, as a result, we depend on the earnings and cash flow of, and dividends or distributions from, our subsidiaries to provide the funds necessary to meet our debt and contractual obligations. Furthermore, a substantial portion of our consolidated assets, earnings and cash flow is derived from the operations of our regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation by state regulatory authorities.

Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to KeySpan is conditioned upon maintenance of a utility capital structure with debt not exceeding 55% and 58%, respectively, of total utility capitalization. In addition, the level of dividends paid by both utilities may not be increased from current levels if a 40 basis point penalty is incurred under the customer service performance program.

B. Basis of Presentation

The Consolidated Financial Statements presented herein reflect the accounts of KeySpan and its subsidiaries. Most of our subsidiaries are fully consolidated in the financial information presented, except for certain subsidiary investments in the Energy Investments segment which are accounted for on the equity method as we do not have a controlling voting interest or otherwise have control over the management of such companies. All intercompany transactions have been eliminated. Certain reclassifications were made to conform prior period financial statements to current period financial statement presentation. For all periods presented, KeySpan revised and has separately disclosed the operating, investing and financing portions of the cash flows attributable to its discontinued operations, which in prior periods were reported on a combined basis as a single amount.

The preparation of financial statements in conformity with generally accepted accounting principles ("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.

C. Accounting for the Effects of Rate Regulation

The accounting records for our six regulated gas utilities are maintained in accordance with the Uniform System of Accounts prescribed by the NYPSC, the NHPUC, and the MADTE. Our electric generation subsidiaries are not subject to state rate regulation, but they are subject to FERC regulation. Our financial statements reflect the ratemaking policies and actions of these regulators in conformity with GAAP for rate-regulated enterprises.

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas Company and EnergyNorth Natural Gas, Inc.) and our Long Island based electric generation subsidiaries are subject to the provisions of Statement of Financial Accounting Standards ("SFAS") 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the ability of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies. Accordingly, we record these future economic benefits and obligations as regulatory assets and regulatory liabilities on the Consolidated Balance Sheet, respectively.

In separate merger related orders issued by the MADTE, the base rates charged by Colonial Gas Company and Essex Gas Company have been frozen at their current levels for ten-year periods ending 2009 and 2008, respectively. Due to the length of these base rate freezes, the Colonial and Essex Gas companies had previously discontinued the application of SFAS 71.

The following table presents our net regulatory assets at December 31, 2005 and December 31, 2004.

	(In Millions of Dollars)	
DECEMBER 31,	**2005**	**2004**
Regulatory Assets		
Regulatory tax asset	$ 33.4	$ 39.5
Property and other taxes	53.8	58.8
Environmental costs	454.7	272.6
Postretirement benefits	109.3	110.6
Costs associated with the KeySpan/LILCO transaction	27.3	39.1
Derivative financial instruments	30.9	20.1
Other	9.8	14.7
Total Regulatory Assets	$719.2	$555.4
Regulatory Liabilities	(245.3)	(73.9)
Net Regulatory Assets	473.9	481.5
Removal Costs Recovered	(516.4)	(496.5)
	$ (42.5)	$ (15.0)

The regulatory assets above are not included in utility rate base. However, we record carrying charges on the property tax and costs associated with the KeySpan/LILCO transaction cost deferrals. We also record carrying charges on our regulatory liabilities except for the current market value of our derivative financial instruments. The remaining regulatory assets represent, primarily, costs for which expenditures have not yet been made, and therefore, carrying charges are not recorded. We anticipate recovering these costs in our gas rates concurrently with future cash expenditures. If recovery is not concurrent with the cash expenditures, we will record the appropriate level of carrying charges. Deferred gas costs of $11.3 million and $37.7 million at December 31, 2005 and December 31, 2004, respectively are reflected in accounts receivable on the Consolidated Balance Sheet. Deferred gas costs are subject to current recovery from customers. We estimate that full recovery of our regulatory assets will not exceed 9 years.

Rate regulation is undergoing significant change as regulators and customers seek lower prices for utility service and greater competition among energy service providers. In the event that regulation significantly changes the opportunity to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of all or a portion of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101, "Regulated Enterprises – Accounting for the Discontinuation of Application of FASB Statement 71." We estimate that the write-off of all net regulatory assets at December 31, 2005, before consideration of removal costs recovered, could result in a charge to net income of $308.0 million after-tax or $1.81 per share, which would be classified as an extraordinary item. In management's opinion, the regulated subsidiaries that are currently subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

D. Revenues

Gas Distribution: Utility gas customers are billed monthly or bi-monthly on a cycle basis. Revenues include unbilled amounts related to the estimated gas usage that occurred from the most recent meter reading to the end of each month.

The cost of gas used is recovered when billed to firm customers through the operation of gas adjustment clauses ("GAC") included in utility tariffs. The GAC provision requires periodic reconciliation of recoverable gas costs and GAC revenues. Any difference is deferred pending recovery from or refund to firm customers. Further, net revenues from tariff gas balancing services, off-system sales and certain on-system interruptible sales are refunded, for the most part, to firm customers subject to certain sharing provisions.

The New York and Long Island gas utility tariffs contain weather normalization adjustments that largely offset shortfalls or excesses of firm net revenues (revenues less gas costs and revenue taxes) during a heating season due to variations from normal weather. Revenues are adjusted each month the clause is in effect and are generally included in rates in the following month. The New England gas utility rate structures contain no weather normalization feature, therefore their net revenues are subject to weather related demand fluctuations. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate the effect of fluctuations from normal weather on our financial position and cash flows, we may enter into weather related derivative instruments from time to time. (See Note 8 "Hedging, Derivative Financial Instruments and Fair Values" for additional information on these derivatives.)

In December 2005, Boston Gas received a MADTE order permitting regulatory recovery of the 2004 gas cost component of bad debt write-offs. This was approved for full recovery as an exogenous cost effective November 1, 2005. In addition, effective January 1, 2006 Boston Gas is permitted to fully recover the gas cost component of bad debt write-offs through its cost-of-gas adjustment clause rather than filing for recovery as an exogenous cost. We have reflected both of these favorable recovery mechanisms in our December 31, 2005 Allowance for Doubtful Accounts reserve requirement and related expense. Boston Gas also plans to request full recovery, as an exogenous cost, of the 2005 gas cost component of bad debt write-offs beginning November 1, 2006.

Electric Services: Electric revenues are primarily derived from: (i) billings to LIPA for management of LIPA's transmission and distribution ("T&D") system, electric generation, and procurement of fuel, and (ii): subsidiaries that own, lease and operate the 2,200 megawatt ("MW") Ravenswood electric generation facility ("Ravenswood Facility") and the 250 MW combined cycle generating facility located at the Ravenswood facility site ("Ravenswood Expansion").

LIPA Agreements:

In 1998, KeySpan and LIPA entered into three major long-term service agreements that (i) provide to LIPA all operation, maintenance and construction services and significant administrative services relating to the Long Island T&D system pursuant to the Management Services Agreement (the "1998 MSA"); (ii) supply LIPA with electric generating capacity, energy conversion and ancillary services from our Long Island generating units pursuant to the Power Supply Agreement (the "1998 PSA"); and (iii) manage all aspects of the fuel supply for our Long Island generating facilities, as well as all aspects of the capacity and energy owned by or under contract to LIPA pursuant to the Energy Management Agreement (the "1998 EMA"). The 1998 MSA, 1998 PSA and 1998 EMA all are collectively referred to as the 1998 LIPA Agreements and are discussed in greater detail below.

KeySpan manages the day-to-day operations, maintenance and capital improvements of the T&D system under the 1998 MSA. KeySpan's billings to LIPA are based on certain agreed upon terms. In addition, KeySpan earns a $10 million annual management fee. Annual service incentives or penalties exist under the 1998 MSA if certain targets are achieved or not achieved. In addition, we can earn certain incentives for budget underruns associated with the day-to-day operations, maintenance and capital improvements of LIPA's T&D system. These incentives provide for KeySpan to (i) retain 100% on the first $5 million in annual budget underruns, and (ii) retain 50% of additional annual underruns up to 15% of the total cost budget, thereafter all savings accrue to LIPA. With respect to cost overruns, KeySpan will absorb the first $15 million of overruns, with a sharing of overruns above $15 million. There are certain limitations on the amount of cost sharing of overruns.

In addition, KeySpan sells to LIPA under the 1998 PSA all of the capacity and, to the extent requested, energy conversion services from its existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC. Rates charged to LIPA include a fixed and variable component. The variable component is billed to LIPA on a monthly per megawatt hour basis and is dependent on the number of megawatt hours dispatched. The 1998 PSA provides incentives and penalties that can total $4 million annually for the maintenance of the output capability and the efficiency of the generating facilities.

KeySpan also procures and manages fuel supplies on behalf of LIPA, under the 1998 EMA, to fuel the generating facilities under contract to it and perform off-system capacity and energy purchases on a least-cost basis to meet LIPA's needs. In exchange for these services KeySpan earns an annual fee of $1.5 million. In addition, we arrange for off-system sales on behalf of LIPA of excess output from the generating facilities and other power supplies either owned or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales. In addition, the 1998 EMA provides incentives and penalties that can total $5 million annually for performance related to fuel purchases and off-system power purchases. The 1998 EMA is expected to be in effect through 2013 for the procurement of fuel supplies and through 2006 for off-system arrangement services.

On February 1, 2006, KeySpan and LIPA entered into (i) an amended and restated Management Services Agreement (the "2006 MSA"), pursuant to which KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island; (ii) 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; and (iii) a Settlement Agreement (the "2006 Settlement Agreement") resolving outstanding issues between the parties regarding the 1998 LIPA Agreements. The 2006 MSA, the 2006 Option Agreement and the 2006 Settlement Agreement are collectively referred to herein as the "2006 LIPA Agreements". Each of the 2006 LIPA Agreements will become effective as of January 1, 2006 upon all of the 2006 LIPA Agreements receiving the required governmental approvals; otherwise none of the 2006 LIPA Agreements will become effective. See Note 11, "2006 LIPA Settlement" for additional details on these agreements.

KeySpan Glenwood Energy Center LLC and KeySpan Port Jefferson Energy Center LLC have entered into 25 year Power Purchase Agreements with LIPA (the "PPAs"). Under the terms of the PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Each plant is designed to produce 79.9 MW each. Under the PPAs, LIPA pays a monthly capacity fee, which guarantees full 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.

The Electric Services segment also conducts retail marketing of electricity to commercial customers. Energy sales made by our electric marketing subsidiary are recorded upon delivery of the related commodity.

Ravenswood Facilities:

In addition, electric revenues are derived from our investment in the 2,200 MW Ravenswood electric generation facility ("Ravenswood Facility"), (which KeySpan acquired in June 1999). KeySpan has an arrangement with a variable interest entity through which we lease a portion of the Ravenswood Facility. Further, in May 2004 KeySpan completed construction of a 250 MW combined cycle generating facility located at the Ravenswood facility site ("Ravenswood Expansion"). To finance the Ravenswood Expansion, KeySpan entered into a leveraged lease financing arrangement. Collectively the Ravenswood Facility and Ravenswood Expansion will be referred to as the Ravenswood Generating Station. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for a description of the financing arrangements associated with the Ravenswood Generating Station.) We realize revenues from our investment in the Ravenswood Generating Station through the sale, at wholesale, of energy, capacity, and ancillary services to the New York Independent System Operator ("NYISO"). Energy and ancillary services are sold through a bidding process into the NYISO energy markets on a day ahead or real time basis.

Energy Services: Revenues earned by our Energy Services segment for service and maintenance contracts associated with small commercial and residential appliances are recognized as earned or over the life of the service contract, as appropriate. Revenues earned for engineering services are derived from services rendered under fixed price and cost-plus contracts and generally are recognized on the percentage-of-completion method. Fiber optic service revenue is recognized upon delivery of service access. We have unearned revenue recorded in deferred credits and other liabilities – other on the Consolidated Balance Sheet totaling $29.3 million and $28.5 million as of December 31, 2005, and December 31, 2004, respectively. These balances represent primarily unearned revenues for service contracts and are generally amortized to income over a one year period.

KeySpan completed its sale of its mechanical contracting companies in the first quarter of 2005, and therefore, no longer has revenues form mechanical contracting operations. (See Note 10 "Energy Services – Discontinued Operations" for additional details on the mechanical contracting companies.)

Gas Exploration and Production: Natural gas and oil revenues earned by our gas exploration and production activities are recognized using the entitlements method of accounting. Under this method of accounting, income is recorded based on the net revenue interest in production or nominated deliveries. Production gas volume imbalances are incurred in the ordinary course of business. Net deliveries in excess of entitled amounts are recorded as liabilities, while net under deliveries are recorded as assets. Imbalances are reduced either by subsequent recoupment of over and under deliveries or by cash settlement, as required by applicable contracts. Production imbalances are marked-to-market at the end of each month using the market price at the end of each period. During 2004 KeySpan disposed of its interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company. KeySpan continues to maintain, on a significantly smaller scale, gas exploration and production activities. (See Note 2 "Business Segments" for a discussion on the disposition of Houston Exploration and KeySpan's remaining gas exploration activities.)

E. Utility and Other Property – Depreciation and Maintenance

Property, principally utility gas property is stated at original cost of construction, which includes allocations of overheads, including taxes, and an allowance for funds used during construction. The rates at which KeySpan subsidiaries capitalized interest for the year ended December 31, 2005 ranged from 1.80% to 7.02%. Capitalized interest for 2005, 2004 and 2003 was $1.4 million, $7.4 million and $13.5 million, respectively.

Depreciation is provided on a straight-line basis in amounts equivalent to composite rates on average depreciable property. The cost of property retired is charged to accumulated depreciation.

KeySpan recovers cost of removal through rates charged to customers as a portion of depreciation expense. At December 31, 2005 and 2004, KeySpan had costs recovered in excess of costs incurred totaling $516.4 million and $496.5 million, respectively. These amounts are reflected as a regulatory liability.

The cost of repair and minor replacement and renewal of property is charged to maintenance expense. The composite rates on average depreciable property were as follows:

YEAR ENDED DECEMBER 31,	2005	2004	2003
Electric	3.75%	3.87%	3.81%
Gas	3.72%	3.55%	3.37%

We also had $416.3 million of other property at December 31, 2005, consisting of assets held primarily by our corporate service subsidiary of $290.0 million and $96.0 million in Energy Services assets. The corporate service assets consist largely of land, buildings, office equipment and furniture, vehicles, computer and telecommunications equipment and systems. These assets have depreciable lives ranging from three to 40 years. We allocate the carrying cost of these assets to our operating subsidiaries through our filed allocation methodology. Energy Services assets consist largely of computer equipment and fiber optic cable and related electronics and have service lives ranging from seven to 40 years.

KeySpan's repair and maintenance costs, including planned major maintenance in the Electric Services segment for turbine and generator overhauls, are expensed as incurred unless they represent replacement of property to be capitalized. Planned major maintenance cycles primarily range from seven to eight years. Smaller periodic overhauls are performed approximately every 18 months.

KeySpan capitalizes costs incurred in connection with its projects to develop and build energy facilities after a project has been determined to be probable of completion.

F. Gas Exploration and Production Property – Depletion

KeySpan maintains gas exploration and production activities through its two wholly-owned subsidiaries – KeySpan Exploration and Production, LLC ("KeySpan Exploration") and Seneca-Upshur Petroleum, Inc. ("Seneca-Upshur"). At December 31, 2005, these subsidiaries had net exploration and production property in the amount of $75.0 million. These assets are accounted for under the full cost method of accounting. Under the full cost method, costs of acquisition, exploration and development of natural gas and oil reserves plus asset retirement obligations are capitalized into a "full cost pool" as incurred. Unproved properties and related costs are excluded from the depletion and amortization base until a determination is made as to the existence of proved reserves. Properties are depleted and charged to operations using the unit of production method using proved reserve quantities.

To the extent that such capitalized costs (net of accumulated depletion) less deferred taxes exceed the present value (using a 10% discount rate) of estimated future net cash flows from proved natural gas and oil reserves and the lower of cost or fair value of unproved properties, less deferred taxes, such excess costs are charged to operations, but would not have an impact on cash flows. Once incurred, such impairment of gas properties is not reversible at a later date even if gas prices increase.

The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, held flat over the life of the reserves. We use derivative financial instruments that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," to hedge the volatility of natural gas prices. In accordance with current SEC guidelines, we have included estimated future cash flows from our hedging program in ceiling test calculations.

As of December 31, 2005, we estimated that our capitalized costs did not exceed the ceiling test limitation. We used an average wellhead price of $10.43 per MCF, adjusted for derivative instruments.

As a result of the disposition of Houston Exploration in 2004, during 2004 KeySpan calculated the ceiling test on KeySpan Exploration and Production's and Seneca-Upshur's assets independently of Houston Exploration's assets. Based on a report furnished by an independent reservoir engineer during the second quarter of 2004, it was determined that the remaining proved undeveloped oil reserves held in the joint venture required a substantial investment in order to develop.

Therefore, KeySpan and Houston Exploration elected not to develop these oil reserves. As a result, in the second quarter of 2004, we recorded a $48.2 million non-cash impairment charge to write down our wholly-owned gas exploration and production subsidiaries' assets. This charge was recorded in depreciation, depletion and amortization on the Consolidated Statement of Income.

Natural gas prices continue to be volatile and the risk that a write down to the full cost pool increases when, among other things, natural gas prices are low, there are significant downward revisions in our estimated proved reserves or we have unsuccessful drilling results.

Houston Exploration, for 2004 and 2003, capitalized interest related to their unevaluated natural gas and oil properties, as well as some properties under development which were not being amortized. For years ended December 31, 2004 and 2003, capitalized interest was $3.4 million and $7.3 million, respectively.

G. Goodwill and Other Intangible Assets

The balance of goodwill and other intangible assets was $1.7 billion at December 31, 2005 and December 31, 2004, representing primarily the excess of acquisition cost over the fair value of net assets acquired. Goodwill and other intangible assets reflect the Eastern and EnergyNorth acquisitions, the KeySpan/LILCO transaction, as well as acquisitions of non-utility energy-related service companies and also relates to certain ownership interests of 50% or less in energy-related investments, which are accounted for under the equity method.

The table below summarizes the goodwill and other intangible assets balance for each segment at December 31, 2005 and 2004:

	(In Millions of Dollars)	
AT DECEMBER 31,	2005	2004
Operating Segment		
Gas Distribution	$1,436.9	$1,436.9
Energy Services	65.2	65.8
Energy Investments and other	164.2	174.9
	$1,666.3	$1,677.6

As prescribed in SFAS 142 "Goodwill and Other Intangible Assets," KeySpan is required to compare the fair value of a reporting unit to its carrying amount, including goodwill. This evaluation is required to be performed at least annually, unless facts and circumstances indicated that the evaluation should be performed at an interim period during the year. At December 31, 2005, KeySpan had $1.7 billion of recorded goodwill and has concluded that the fair value of the business units that have recorded goodwill exceed their carrying value.

During 2004, KeySpan conducted an evaluation of the carrying value of goodwill recorded in its Energy Services segment. As a result of this evaluation, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on Energy Services segment's continuing operations; and (ii) $93.9 million as discontinued operations reflecting the impairment on the mechanical contracting companies. (See Note 10 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for further details.)

At the end of 2004, KeySpan entered into an agreement to sell its then 50% interest in Premier Transmission Limited ("Premier"). This investment was accounted for under the equity method of accounting in the Energy Investments segment. In the fourth quarter of 2004 KeySpan recorded a partial pre-tax non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share. The impairment charge reflected the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value at that time and was recorded as a reduction to goodwill.

H. Hedging and Derivative Financial Instruments

From time to time, we employ derivative instruments to hedge a portion of our exposure to commodity price risk and interest rate risk, as well as to hedge cash flow variability associated with a portion of our peak electric energy sales. Whenever hedge positions are in effect, we are exposed to credit risk in the event of nonperformance by counter-parties to derivative contracts, as well as nonperformance by the counter-parties of the transactions against which they are hedged. We believe that the credit risk related to the futures, options and swap instruments is no greater than that associated with the primary commodity contracts which they hedge. Our currently outstanding derivative instruments do not qualify as energy trading contracts as defined by current accounting literature.

Financially-Settled Commodity Derivative Instruments: We employ derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with forecasted purchases and sales of various energy-related commodities. All such derivative instruments are accounted for pursuant to the requirements of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS 149, "Amendment of Statement 133 Derivative Instruments and Hedging Activities" (collectively, "SFAS 133"). With respect to those commodity derivative instruments that are designated and accounted for as cash flow hedges, the effective portion of periodic changes in the fair market value of cash flow hedges is recorded as other comprehensive income on the Consolidated Balance Sheet, while the ineffective portion of such changes in fair value is recognized in earnings. Unrealized gains and losses (on such cash flow hedges) that are recorded as other comprehensive income are subsequently reclassified into earnings concurrent when hedged transactions impact earnings. With respect to those commodity derivative instruments that are not designated as hedging instruments, such derivatives are accounted for on the Consolidated Balance Sheet at fair value, with all changes in fair value reported in earnings.

Firm Gas Sales Derivatives Instruments – Regulated Utilities: We utilize derivative financial instruments to reduce cash flow variability associated with the purchase price for a portion of our future natural gas purchases. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. Since these derivative instruments are being employed to support our gas sales prices to regulated firm gas sales customers, the accounting for these derivative instruments is subject to SFAS 71. Therefore, changes in the market value of these derivatives are recorded as regulatory assets or regulatory liabilities on our Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers during the appropriate winter heating season consistent with regulatory requirements.

Physically-Settled Commodity Derivative Instruments: Certain of our contracts for the physical purchase of natural gas were assessed as no longer being exempt from the requirements of SFAS 133 as normal purchases. As such, these contracts are recorded on the Consolidated Balance Sheet at fair market value. However, since such contracts were executed for the purchases of natural gas that is sold to regulated firm gas sales customers, and pursuant to the requirements of SFAS 71, changes in the fair market value of these contracts are recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet.

Weather Derivatives: The utility tariffs associated with our New England gas distribution operations do not contain a weather normalization adjustment. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate the effect of fluctuations from normal weather on our financial position and cash flows, we may enter into derivative instruments from time to time. Based on the terms of the contracts, we account for these instruments pursuant to the requirements of Emerging Issues Task Force ("EITF") 99-2 "Accounting for Weather Derivatives." In this regard, we account for weather derivatives using the "intrinsic value method" as set forth in such guidance.

Interest Rate Derivative Instruments: We continually assess the cost relationship between fixed and variable rate debt. Consistent with our objective to minimize our cost of capital, we periodically enter into hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable or variable to fixed. Payments made or received on these derivative contracts are recognized as an adjustment to interest expense as incurred. Hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable are designated and accounted for as fair-value hedges pursuant to the requirements of SFAS 133. Hedging transactions that effectively convert the terms of underlying debt obligations from variable to fixed are considered cash flow hedges.

I. Equity Investments

Certain subsidiaries own as their principal assets, investments (including goodwill), representing ownership interests of 50% or less in energy-related businesses that are accounted for under the equity method. None of these current investments are publicly traded.

J. Income and Excise Tax

Upon implementation of SFAS 109, "Accounting for Income Taxes", certain of our regulated subsidiaries recorded a regulatory asset and a net deferred tax liability for the cumulative effect of providing deferred income taxes on certain differences between the financial statement carrying amounts of assets and liabilities, and their respective tax bases. This regulatory asset continues to be amortized over the lives of the individual assets and liabilities to which it relates. Additionally, investment tax credits which were available prior to the Tax Reform Act of 1986, were deferred and generally amortized as a reduction of income tax over the estimated lives of the related property.

We report our collections and payments of excise taxes on a gross basis. Gas distribution revenues include the collection of excise taxes, while operating taxes include the related expense. For the years ended December 31, 2005, 2004 and 2003, excise taxes collected and paid were $65.8 million, $73.3 million, $90.5 million, respectively.

K. Subsidiary Common Stock Issuances to Third Parties

We follow an accounting policy of income statement recognition for parent company gains or losses from issuances of common stock by subsidiaries to unaffiliated third parties.

L. Foreign Currency Translation

We followed the principles of SFAS 52, "Foreign Currency Translation," for recording our investments in foreign affiliates. Under this statement, all elements of the financial statements are translated by using a current exchange rate. Translation adjustments result from changes in exchange rates from one reporting period to another. At December 31, 2004, the foreign currency translation adjustment was included on the Consolidated Balance Sheet. The functional currency for our foreign affiliates was their local currency. At December 31, 2005, SFAS 52 was not applicable to KeySpan since we completed the sale of our remaining foreign investment in the first quarter of 2005.

M. Earnings Per Share

Basic earnings per share ("EPS") is calculated by dividing earnings for common stock by the weighted average number of shares of common stock outstanding during the period. No dilution for any potentially anti-dilutive securities is included. Diluted EPS assumes the conversion of all potentially dilutive securities and is calculated by dividing earnings for common stock, as adjusted, by the sum of the weighted average number of shares of common stock outstanding plus all potentially dilutive securities.

At December 31, 2005, we had approximately 4.6 million options outstanding to purchase KeySpan common stock that were not used in the calculation of diluted EPS since the exercise price associated with these options were greater than the average per share market price of Keyspan's common stock. In addition, there were approximately 384,000 performance shares not used in the calculation of diluted EPS since these shares would not have been issued if December 31, 2005 were the end of the performance period. In 2003, we had 85,676 shares of convertible preferred stock outstanding that could have been converted into 221,153 shares of common stock. These shares were redeemed in 2004.

Under the requirements of SFAS 128, "Earnings Per Share" our basic and diluted EPS are as follows:

	(In Millions of Dollars, Except Per Share Amounts)		
YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Earnings for common stock	$388.0	$458.1	$380.9
Houston Exploration dilution	—	—	(0.3)
Preferred stock dividend	—	—	0.5
Earnings for common stock – adjusted	$388.0	$458.1	$381.1
Weighted average shares outstanding (000)	169,940	160,294	158,256
Add dilutive securities:			
Options	861	983	755
Convertible preferred stock	—	—	221
Total weighted average shares outstanding – assuming dilution	170,801	161,277	159,232
Basic earnings per share	$ 2.28	$ 2.86	$ 2.41
Diluted earnings per share	$ 2.27	$ 2.84	$ 2.39

N. Stock Options and Other Stock Based Compensation

Stock options are issued to all KeySpan officers and certain other management employees as approved by the Board of Directors. These options generally vest over a three-to-five year period and have exercise periods between five to ten years. Up to approximately 21 million shares have been authorized for the issuance of options and approximately 3.7 million of these shares were available for issuance at December 31, 2005. Under a separate plan, Houston Exploration had issued stock options to its key employees. KeySpan and Houston Exploration adopted the prospective method of transition in accordance with SFAS 148 "Accounting for Stock-Based Compensation – Transition and Disclosure." Accordingly, compensation expense has been recognized by employing the fair value recognition provisions of SFAS 123 "Accounting for Stock-Based Compensation" for grants awarded after January 1, 2003.

KeySpan continues to apply APB Opinion 25, "Accounting for Stock Issued to Employees," and related Interpretations in accounting for grants awarded prior to January 1, 2003. Prior to the disposition of Houston Exploration, Houston Exploration also applied APB Opinion 25, and related Interpretations in accounting for grants awarded prior to January 1, 2003. Accordingly, no compensation cost has been recognized for these fixed stock option plans in the Consolidated Financial Statements since the exercise prices and market values were equal on the grant dates. Had compensation cost for these plans been determined based on the fair value at the grant dates for awards under the plans consistent with SFAS 123, our net income and earnings per share would have decreased to the pro-forma amounts indicated below:

(In Millions of Dollars, Except Per Share Amounts)

YEAR ENDED DECEMBER 31,	2005	2004	2003
Earnings available for common stock:			
As reported	$388.0	$458.1	$380.9
Add: recorded stock-based			
compensation expense, net of tax	7.0	9.1	3.7
Deduct: total stock-based			
compensation expense, net of tax	(8.9)	(12.4)	(9.4)
Pro-forma earnings	$386.1	$454.8	$375.2
Earnings per share:			
Basic – as reported	$ 2.28	$ 2.86	$ 2.41
Basic – pro-forma	$ 2.27	$ 2.84	$ 2.37
Diluted – as reported	$ 2.27	$ 2.84	$ 2.39
Diluted – pro-forma	$ 2.26	$ 2.82	$ 2.36

All grants are estimated on the date of the grant using the Black-Scholes option-pricing model. The following table presents the weighted average fair value, exercise price and assumptions used for the periods indicated:

YEAR ENDED DECEMBER 31,	2005	2004	2003
Fair value of grants issued	$ 6.15	$ 5.47	$ 4.26
Dividend yield	4.64%	4.74%	5.49%
Expected volatility	22.63%	23.48%	24.26%
Risk free rate	4.10%	3.22%	3.16%
Expected lives	6.4 years	6.5 years	6 years
Exercise price	$39.25	$37.54	$32.40

A summary of the status of our fixed stock option plans and changes is presented below for the periods indicated:

YEAR ENDED DECEMBER 31,	2005		2004		2003	
FIXED OPTIONS	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	SHARES	WEIGHTED AVERAGE EXERCISE PRICE
Outstanding at beginning of period	10,540,946	$32.61	10,320,743	$31.39	9,524,900	$30.74
Granted during the year	1,451,650	$39.25	1,602,850	$37.54	1,650,450	$32.40
Exercised	(1,400,190)	$30.65	(1,150,464)	$28.05	(664,902)	$23.64
Forfeited	(149,351)	$36.32	(232,183)	$35.18	(189,705)	$34.63
Outstanding at end of period	10,443,055	$33.74	10,540,946	$32.61	10,320,743	$31.39
Exercisable at end of period	5,673,084	$31.55	5,523,259	$30.39	5,365,545	$28.76

REMAINING CONTRACTUAL LIFE	OPTIONS OUTSTANDING AT DECEMBER 31, 2005	WEIGHTED AVERAGE EXERCISE PRICE	RANGE OF EXERCISE PRICE	OPTIONS EXERCISABLE AT DECEMBER 31, 2005	WEIGHTED AVERAGE EXERCISE PRICE	RANGE OF EXERCISE PRICE
1 years	148,000	$30.50	30.50	148,000	$30.50	30.50
2 years	230,410	$32.54	$ 19.15 – 32.63	230,410	$32.54	$19.15 – 32.63
3 years	844,625	$27.96	$ 24.73 – 29.38	844,625	$27.96	$24.73 – 29.38
4 years	392,848	$26.97	$ 21.99 – 27.06	392,847	$26.97	$21.99 – 27.06
5 years	998,887	$22.68	$ 22.50 – 32.76	998,887	$22.68	$22.50 – 32.76
6 years	1,657,075	$39.50	$39.50	1,313,025	$39.50	$39.50
7 years	1,944,811	$32.66	$32.66	1,054,195	$32.66	$32.66
8 years	1,286,493	$32.40	$32.40	415,856	$32.40	$32.40
9 years	1,502,756	$37.54	$37.54	275,239	$37.54	$37.54
10 years	1,437,150	$39.25	$39.25	—	$ 39.25	$39.25
	10,443,055			5,673,084		

Since 2003, KeySpan provides long-term incentive compensation for officers consisting of 50% stock options and 50% performance shares. Performance shares are awarded based upon the attainment of overall corporate performance goals and better aligns incentive compensation with overall corporate performance. These performance shares are measured over a three year period by comparing KeySpan's cumulative total shareholder return to the S&P Utilities Group. The award "cliff" vests after each 3 year period.

During 2005, it became apparent to management that the 2003 performance share award would not be achieved and the 2004 performance share award would not be achieved at the level of expense being recorded. Since these awards meet the definition of a performance condition not achieved under SFAS 123, KeySpan reversed the previously recognized expense for the 2003 award and one half of previously recognized expense for the 2004 award amounting to $3.8 million ($2.5 million after tax). For the 2005 award, it is too early to predict whether the performance condition will be achieved and therefore none of the expense recorded to date for the 2005 performance share award has been reversed.

In December 2004, the FASB issued SFAS 123R "Share-Based Payment" which superseded SFAS 123. The effective date of SFAS 123R is the first quarter of 2006. Under this standard, we will be prohibited from reversing any previously recorded expense for the portion of the 2004 and 2005 performance share awards currently deemed attainable. This is due to the fact that the condition of our current performance share awards will be viewed as market conditions under SFAS 123R.

O. Recent Accounting Pronouncements

On July 14, 2005, the Financial Accounting Standards Board ("FASB") issued an Exposure Draft "Accounting for Uncertain Tax Positions," that would interpret SFAS 109, "Accounting for Income Taxes." This proposal seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement requirements related to accounting for income taxes. Specifically, the proposal would require that a tax position meet a "probable recognition threshold" for the benefit of an uncertain tax position to be recognized in the financial statements. The proposal would require recognition in the financial statements of the best estimate of the effect of a tax position only if that position is probable of being sustained on audit by the appropriate taxing authorities, based solely on the technical merits of the position.

The proposed effective date has been delayed until the first fiscal year ending after January 1, 2007. KeySpan is currently evaluating this Exposure Draft, and at this time cannot determine the impact, if any, that the potential requirements of this Exposure Draft may have on its results of operations, financial position or cash flows.

In March 2005, the FASB issued FASB Interpretation No. 47 ("FIN 47") "Accounting for Conditional Asset Retirement Obligations – an interpretation of FASB Statement No. 143." FIN 47 clarifies that the term conditional asset retirement obligation as used in SFAS No. 143 "Accounting for Asset Retirement Obligations", refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. Accordingly, an entity is required to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Uncertainty about the timing and/or method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. An entity shall recognize the cumulative effect of initially applying FIN 47 as a change in accounting principle. KeySpan implemented FIN 47 in December 2005. See Note 1 Item P below and Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for further information on FIN 47.

In 2004, the FASB issued FASB Staff Position ("FSP") 106-2 "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." This guidance clarified the accounting and disclosure requirements for employers with postretirement benefit plans that have been affected by the passage of the Medicare Prescription Drug Improvement and Modernization Act of 2003 (the "Medicare Act"). The Act introduced two new features to Medicare that an employer needs to consider in measuring its obligation and net periodic postretirement benefit costs.

KeySpan's retiree health benefit plan currently includes a prescription drug benefit that is provided to retired employees. KeySpan implemented the requirements of FSP 106-2 in 2004 and determined that the savings associated with the Medicare.Act reduced KeySpan's retiree health care costs by approximately $10 million in 2004. However, KEDLI and Boston Gas Company are subject to certain deferral accounting requirements mandated by the NYPSC and MADTE, respectively for pension costs and other postretirement benefit costs. Further, in accordance with our service agreements with LIPA, variations between pension costs and other postretirement benefit costs incurred by KeySpan compared to those costs recovered through rates charged to LIPA are deferred subject to recovery from or refund to LIPA. As a result of these various requirements, approximately $7 million of savings attributable to the implementation of FSP 106-2 and the Medicare Act was deferred and used to offset increases in overall pension and postretirement benefit costs, with the remaining approximately $3 million recorded as a reduction to 2004 postretirement expense. The implementation of FSP 106-2 and the Medicare Act had no immediate impact on KeySpan's cash flow.

In January 2005, the Department of Health and Human Services/Centers for Medicare and Medicaid Services ("CMS") released final regulations with regard to the implementation of the major provisions of the Medicare Act. KeySpan reviewed the new provisions and believes that the new guidance will not have a material impact on its results of operations, financial position or cash flows.

In December 2004 the FASB issued SFAS 123 (revised 2004) "Share-Based Payment." This Statement focuses primarily on accounting for transactions in which an entity obtains employee services in share-based

payment transactions. This Statement revises certain provisions of SFAS 123 "Accounting for Stock-Based Compensation" and supersedes APB Opinion 25 "Accounting for Stock Issued to Employees." The fair-value-based method in this Statement is similar to the fair-value-based method in SFAS 123 in most respects. However, the following are key differences between the two: entities are required to measure liabilities incurred to employees in share-based payment transactions at fair value as compared to using the intrinsic method allowed under SFAS 123; entities are required to estimate the number of instruments for which the requisite service is expected to be rendered, as compared to accounting for forfeitures as they occur under SFAS 123; and incremental compensation cost for a modification of the terms or conditions of an award are also measured differently under this Statement compared to Statement 123. This Statement also clarifies and expands SFAS 123's guidance in several areas. The effective date of this Statement is the beginning of the first fiscal year beginning after June 15, 2005. KeySpan adopted the prospective method of transition for stock options in accordance with SFAS 148 "Accounting for Stock-Based Compensation – Transition and Disclosure." Accordingly, compensation expense has been recognized by employing the fair value recognition provisions of SFAS 123 for grants awarded after January 1, 2003. KeySpan believes that implementation of this Statement will not have a material impact on its results of operations or financial position and no impact on its cash flows.

P. Impact of Cumulative Effect of Change in Accounting Principles

As previously discussed, KeySpan implemented FIN 47, effective December 31, 2005. FIN 47 required KeySpan to record a liability and corresponding asset representing the present value of conditional asset retirement obligations associated with the retirement of tangible, long-lived assets on the date the obligations were incurred. At year-end, we recorded a $45.6 million liability and corresponding asset representing the present value of conditional asset retirement obligations associated with the retirement of tangible, long-lived assets on the date the obligations were incurred. For the $45.6 million initial asset recorded, approximately $4.3 million represents asset retirement costs that have been deferred on the Consolidated Balance Sheet and will be depreciated over the remaining life of the underlying associated assets lives.

The remaining $41.3 million represented cumulative accretion and depreciation expense associated with the liability and asset from the dates the various obligations would have been recorded had this Interpretation been in effect at the time the obligations were incurred.

Of the $41.3 million recorded, $11.3 million ($6.6 million, after-tax, was recorded as a cumulative change in accounting principle on the Consolidated Statement of Income. The remaining $30.0 million was attributable to the Gas Distribution segment and was recorded as a reduction to the removal cost recovered. For asset retirement costs incurred in the Gas Distribution segment, KeySpan is recovering these costs from utility customers and has been expensing a like amount through its depreciation expense. A portion of this depreciation expense represents removal costs not yet incurred. The $30 million recorded to the removal cost recovered is for purposes of reclassifying a portion of this reserve to the asset retirement obligation. (See Note 7, "Contractual Obligations, Financial Guarantees and Contingencies – Asset Retirement Obligations" for further details.)

KeySpan has an arrangement with a variable interest entity through which it leases a portion of the 2,200-megawatt Ravenswood electric generation facility. On December 31, 2003, KeySpan adopted FASB Interpretation No. 46 ("FIN 46"). This pronouncement required KeySpan to consolidate its variable interest entity, which had a fair market value of $425 million at the inception of the lease, June 1999. As a result, in 2003 KeySpan recorded a $37.6 million after-tax charge, or $0.23 per share, cumulative change in accounting principle on the Consolidated Statement of Income, representing approximately four and a half years of depreciation. (See Note 7, "Contractual Obligations, Financial Guarantees and Contingencies – Variable Interest Entity" for a detailed description of the impact of the adoption of this standard.)

Under Accounting Principle Board Opinion No. 20 ("APB 20"), the pro-forma impact of the retroactive application resulting from the adoption of a change in accounting principle is to be disclosed as follows:

	(In Millions of Dollars, Except Per Share Amounts)		
YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Earnings for common stock	$388.0	$458.1	$380.9
Add back: Cumulative effect of a change in accounting principle	6.6	—	37.4
Earnings for common stock before cumulative effect of a change in accounting principle	394.6	458.1	418.3
Less: FIN 47 Accretion expense, net of taxes	(0.5)	(0.4)	(0.4)
Add: FIN 47 Depreciation expense, net of taxes	(0.2)	(0.2)	(0.1)
Less: FIN 46 Depreciation expense, net of taxes	—	—	(9.5)
Pro-forma earnings	$393.9	$457.5	$408.3
Earnings per share before cumulative change in accounting principle:			
Basic – as reported	$ 2.32	$ 2.86	$ 2.64
Basic – pro-forma	$ 2.32	$ 2.85	$ 2.58
Diluted – as reported	$ 2.31	$ 2.84	$ 2.62
Diluted – pro-forma	$ 2.31	$ 2.84	$ 2.56
Earnings per share for common stock:			
Basic – as reported	$ 2.28	$ 2.86	$ 2.41
Basic – pro-forma	$ 2.32	$ 2.85	$ 2.58
Diluted – as reported	$ 2.27	$ 2.84	$ 2.39
Diluted – pro-forma	$ 2.31	$ 2.84	$ 2.56

In addition to the above disclosure, FIN 47 requires disclosure of the pro-forma impact of the liability for the asset retirement obligation for the beginning of the earliest year presented and at the end of all years presented as if this Interpretation had been applied during all periods effected. The disclosure is as follows:

	(In Millions of Dollars)	
DECEMBER 31,	**2005**	**2004**
Asset retirement obligation – January 1	$44.9	$42.5
Accretion	2.5	2.4
Asset retirement obligation – December 31	$47.4	44.9

Q. Accumulated Other Comprehensive Income

As required by SFAS 130, "Reporting Comprehensive Income," the components of accumulated other comprehensive income are as follows:

	(In Millions of Dollars)	
DECEMBER 31,	**2005**	**2004**
Foreign currency translation adjustments	$ —	$ 5.0
Unrealized (losses) on marketable securities	(0.9)	(0.4)
Accrued unfunded pension obligation	(63.5)	(59.8)
Unrealized (losses) gain on derivative financial instruments	(10.4)	0.9
Accumulated other comprehensive income	$(74.8)	$(54.3)

Note 2. Business Segments

We have four reportable segments: Gas Distribution, Electric Services, Energy Services and Energy Investments.

The Gas Distribution segment consists of our six gas distribution subsidiaries. KEDNY provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Staten Island and a portion of the Borough of Queens. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. The remaining gas distribution subsidiaries, collectively doing business as KEDNE, provide gas distribution service to customers in Massachusetts and New Hampshire.

The Electric Services segment consists of subsidiaries that: operate the electric transmission and distribution system owned by LIPA; own and provide capacity to and produce energy for LIPA from our generating facilities located on Long Island; and manage fuel supplies for LIPA to fuel our Long Island generating facilities. These services are provided in accordance with long-term service contracts having remaining terms that range from one to seven years and power purchase agreements having remaining terms that range from seven to 21 years. On February 1, 2006, KeySpan and LIPA agreed to extend, amend and restate these contractual arrangements. (See Note 11, "2006 LIPA Settlement" for a further discussion of these agreements.) The Electric Services segment also includes subsidiaries that own or lease and operate the 2,200 MW Ravenswood Facility located in Queens, New York, and the 250 MW combined-cycle Ravenswood Expansion. Collectively the Ravenswood Facility and Ravenswood Expansion are referred to as the "Ravenswood Generating Station". All of the energy, capacity and ancillary services related to the Ravenswood Generating Station are sold to the NYISO energy markets. To finance the purchase and/or construction of the Ravenswood Generating Station, KeySpan entered into leasing arrangement for each facility. The Electric Services segment also conducts retail marketing of electricity to commercial customers. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for further details on the leasing arrangements.)

The Energy Services segment includes companies that provide energy-related services to customers located primarily within the Northeastern United States. Subsidiaries in this segment provide residential and small commercial customers with service and maintenance of energy systems and appliances, as well as operation and maintenance, design, engineering, consulting and fiber optic services to commercial, institutional and industrial customers.

In January and February of 2005, KeySpan sold its mechanical contracting subsidiaries. The operating results and financial position of these companies, which were previously consolidated within the Energy Services segment, have been reflected as discontinued operations on the Consolidated Statement of Income, Consolidated Balance Sheet and Consolidated Statement of Cash Flows.

In regard to the January 2005 transactions, KeySpan received proceeds of approximately $16 million, including approximately $5 million to be paid within a three year period. In addition, KeySpan retained a portion of its previously incurred surety indemnity support obligations related to certain performance and payment bonds issued for the benefit of KeySpan's former subsidiaries prior to closing. In June 2005, the balance to be paid over a three year period was fully collected on a present value basis and a significant portion of the performance bonds were replaced without any remaining indemnification obligation on the part of KeySpan. The current estimated cost to complete projects supported by the remaining indemnity obligations associated with the January 2005 transactions is approximately $0.2 million. The buyers have agreed to complete the projects for which such indemnity obligations were incurred and to indemnify and hold KeySpan harmless with respect to its liabilities in connection with such bonds.

In connection with the February 2005 transaction, KeySpan paid or contributed approximately $26 million to a former subsidiary prior to closing the sale transaction in exchange for, among other things, the disposition of outstanding shares in the former subsidiary and the settlement of intercompany advances and replacement of a performance and payment bond issued for the benefit of its former subsidiary with respect to a pending project, which bond had been supported by a $150 million indemnity obligation of KeySpan. In addition, KeySpan received from its former subsidiary an indemnity bond issued by a third party surety company, the purpose of which is to reimburse KeySpan in an amount up to $80 million in the event it is required to perform under all other indemnity obligations previously incurred by KeySpan to support the remaining

bonded projects of its former subsidiary as of the closing. As of December 31, 2005, the total cost to complete such remaining bonded projects is estimated to be approximately $40 million. The aforementioned guarantees are reflected in Note 7 "Contractual Obligations, Financial Guarantees and Contingencies." KeySpan's former subsidiary has also agreed to complete the projects for which such indemnity obligations were incurred and indemnify and hold KeySpan harmless with respect to any liabilities in connection with such bonds.

In the fourth quarter of 2004, KeySpan's investment in its mechanical contracting subsidiaries was written-down to an estimated fair value. During 2004, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) associated with its mechanical contracting operations and certain remaining operations. In addition, an impairment charge of $100.3 million ($72.1 million after-tax or $0.45 per share) was also recorded to reduce the carrying value of the remaining assets of the mechanical contracting companies. (See Note 10 "Energy Services – Discontinued Operations" for additional details regarding these charges.) During the first six months of 2005, operating losses were incurred through the dates of sale of these companies of $4.1 million after-tax, including but not limited to costs incurred for employee related benefits. Partially offsetting these losses was a gain of $2.3 million associated with the related divestitures, reflecting the difference between the fair value estimates and the financial impact of the actual sale transactions. The net income impact of the operating losses and the disposal gain was a loss of $1.8 million, or $0.01 per share for the twelve months ended December 31, 2005.

The Energy Investments segment consists of our gas exploration and production investments, as well as certain other domestic energy-related investments. KeySpan's gas exploration and production activities include our wholly-owned subsidiaries Seneca-Upshur Petroleum, Inc. ("Seneca-Upshur") and KeySpan Exploration and Production, LLC ("KeySpan Exploration"). Seneca-Upshur is engaged in gas exploration and production activities primarily in West Virginia. KeySpan Exploration is engaged in a joint venture with The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company located in Houston, Texas.

During the first five months of 2004, our gas exploration and production investments also included a 55% equity interest in Houston Exploration, the operations of which were fully consolidated in KeySpan's Consolidated Financial Statements. On June 2, 2004, KeySpan exchanged 10.8 million shares of common stock of Houston Exploration for 100% of the stock of Seneca-Upshur, previously a wholly owned subsidiary of Houston Exploration. This transaction reduced our interest in Houston Exploration from 55% to the then current level of 23.5%. Effective June 1, 2004, Houston Exploration's earnings and our ownership interest in Houston Exploration were accounted for on the equity method of accounting. This transaction resulted in a gain to KeySpan of $150.1 million. The deconsolidation of Houston Exploration required the recognition of certain deferred taxes on our remaining investment resulting in a net deferred tax expense of $44.1 million. Therefore, the net gain on the share exchange less the deferred tax provision was $106 million, or $0.66 per share.

In November 2004, KeySpan sold its remaining 23.5% interest in Houston Exploration (6.6 million shares) and received cash proceeds of approximately $369 million. KeySpan recorded a pre-tax gain of $179.6 million which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was $116.8 million or $0.73 per share.

Houston Exploration's revenues, which are reflected in KeySpan's Consolidated Statement of Income in fiscal years 2004 and 2003, were $268.1 million, and $495.3 million, respectively. Houston Exploration's operating income, including KeySpan's share of equity earnings, was $138.5 million and $196.3 million in fiscal years 2004 and 2003, respectively.

Asset transactions regarding our investment in Houston Exploration were also recorded in 2003. In February 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. We realized net proceeds of $79 million in connection with this repurchase. KeySpan realized a gain of $19 million on this transaction, which is reflected in other income and (deductions) on the Consolidated Statement of Income. Income taxes were not provided, since this transaction was structured as a return of capital. The per share gain on this transaction was $0.12.

The Energy Investments segment is also engaged in pipeline development activities. KeySpan and Duke Energy Corporation each own a 50% interest in the Islander East Pipeline Company, LLC ("Islander East"). Islander East was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Shoreham, Long Island. Once in service, the pipeline is expected to transport up to 260,000 DTH daily to the Long Island and New York City energy markets. Further, KeySpan has a 21% interest in the Millennium Pipeline project which is expected to transport up to 525,000 DTH of natural gas a day from Corning to Ramapo, New York, where it will connect to an existing pipeline. Additionally, subsidiaries in this segment hold a 20% equity interest in the Iroquois Gas Transmission System LP, a pipeline that transports Canadian gas supply to markets in the Northeastern United States. These subsidiaries are accounted for under the equity method. Accordingly, equity income from these investments is reflected as a component of operating income in the Consolidated Statement of Income.

Changes in Standardized Measure of Discounted Future Net Cash Flows from Proved Reserve Quantities

	(In Millions of Dollars)
AT DECEMBER 31,	2003
Standardized measure – beginning of year	$1,103.9
Sales and transfers, net of production costs	(492.3)
Net change in sales and transfer prices, net of production costs	384.3
Extensions and discoveries and improved recovery, net of related costs	434.3
Changes in estimated future development costs	(9.4)
Development costs incurred during the period that reduced future development costs	81.0
Revisions of quantity estimates	(123.9)
Accretion of discount	142.3
Net change in income taxes	(236.5)
Net purchases of reserves in place	254.0
Changes in production rates (timing) and other	(17.2)
Standardized measure – end of year	$1,520.5

Average Sales Prices and Production Costs Per Unit

AT DECEMBER 31,	2003
Average Sales Price*	
Natural gas ($/Mcf)	5.23
Oil, condensate and natural gas liquid ($/Bbl)	28.26
Production cost per equivalent Mcf ($)	0.58

**Represents the cash price received which excludes the effect of any hedging transactions.*

Note 15. Summary of Quarterly Information (Unaudited)

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2005.

				(In Millions of Dollars, Except Per Share Amounts)	
QUARTER ENDED	3/31/2005	6/30/2005	9/30/2005	12/31/2005	
Operating Revenue	2,480.5	1,342.5	1,303.1	2,535.9	
Operating Income	438.7	103.2	102.8	263.1	
Earnings (loss) from continuing operations, less preferred stock dividends	234.4	18.0	22.6	121.4	
Cumulative change in accounting principles, net of tax	—	—	—	(6.6)	(a)
Earnings (loss) from discontinued operations	—	(1.8)	—	—	
Earnings (loss) for common stock	234.4	16.2	22.6	114.8	
Basic earnings per common share from continuing operations less preferred stock dividends	1.45	0.11	0.13	0.70	
Basic earnings per common share from discontinued operations	—	(0.01)	—	—	
Basic earnings per common share from cumulative change in accounting principles	—	—	—	(0.04)	(a)
Basic earnings per common share	1.45	0.10	0.13	0.66	
Diluted earnings per common share	1.44	0.09	0.13	0.65	
Dividends declared	0.455	0.455	0.455	0.455	

(a) Cumulative change in accounting principles for implementation of FASB Interpretation No. 47 ("FIN 47") "Accounting for Conditional Asset Retirement Obligations."

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2004.

				(In Millions of Dollars, Except Per Share Amounts)			
QUARTER ENDED	**3/31/2004**	**6/30/2004**		**9/30/2004**		**12/31/2004**	
Operating Revenue	2,510.6	1,277.8		975.6		1,886.5	
Operating Income	487.6	122.2	(a)	87.6	(c)	237.9	(e)
Earnings (loss) from continuing operations, less preferred stock dividends	246.6	128.5	(a) (b)	(30.1)	(c) (d)	264.1	(e) (f)
Earnings (loss) from discontinued operations (g)	(0.4)	0.8		(87.0)		(64.4)	
Earnings (loss) for common stock	246.2	129.3		(117.1)		199.7	
Basic earnings per common share from continuing operations less preferred stock dividends	1.54	0.81		(0.19)		1.64	
Basic earnings per common share from discontinued operations	—	—		(0.54)		(0.40)	
Basic earnings per common share	1.54	0.81		(0.73)		1.24	
Diluted earnings per common share	1.53	0.80		(0.73)		1.23	
Dividends declared	0.445	0.445		0.445		0.445	

(a) KeySpan's wholly owned gas exploration and production subsidiaries recorded a non-cash impairment charge of $48.2 million ($31.1 million after-tax) or $0.19 per share to recognize the reduced valuation of proved reserves.

(b) In June 2004, KeySpan exchanged 10.8 million shares of common stock of Houston Exploration for 100% of the stock of Seneca-Upshur Petroleum, Inc. We recorded a gain of $150.1 million and were required to record deferred tax expense of $44.1 million. The net gain on the share exchange less the deferred tax provision was $106 million or $0.66 per share. In April 2004, KeySpan recorded a gain of $22.8 million ($10.1 million after-tax) or $0.06 per share, resulting from the sale of 35.9% of our ownership interest in KeySpan Canada.

(c) KeySpan recorded a $14.4 million ($12.6 million after-tax) or $0.08 per share non-cash goodwill impairment charge associated with our continuing investments in the Energy Services segment.

(d) In August 2004, we redeemed approximately $758 million of outstanding debt and recorded a charge of $45.9 million ($29.3 million after-tax) or $0.18 per share representing call premiums incurred on this redemption.

(e) In December 2004, we recorded a $26.5 million ($18.8 million after-tax) or $0.12 per share non-cash impairment charge related to our 50% ownership interest in Premier Transmission Pipeline.

(f) In November 2004, KeySpan decided to sell its remaining 6.6 million shares in Houston Exploration and recorded a gain of $179.6 million ($116.8 million after-tax) or $0.73 per share. 'n December 2004, KeySpan sold its remaining interest in KeySpan Canada and recorded a gain of $35.8 million ($24.7 million after tax) or $0.15 per share.

g) At December 31, 2004, KeySpan intended to sell a significant portion of its ownership interest in certain companies within the Energy Services segment, specifically those companies ngaged in mechanical contracting activities. As a result, KeySpan recorded a loss in discontinued operations of $151.0 million, or $0.94 per share. This loss reflects $139.9 million after-tax npairment charges, which were recorded in the third and fourth quarters, and operating losses at $11.1 million.

(In Millions of Dollars, Except Per Share Amounts)

YEAR ENDED DECEMBER 31,	2005	2004	2003	2002	2001
Income Summary					
Revenues					
Gas Distribution	$5,390.1	$4,407.3	$4,161.3	$3,163.8	$3,613.6
Electric Services	2,042.8	1,738.7	1,606.0	1,645.7	1,850.4
Energy Services	191.2	182.4	158.9	208.6	243.5
Energy Investments	37.9	322.1	609.3	447.1	498.3
Total revenues	7,662.0	6,650.5	6,535.5	5,465.2	6,205.8
Operating expenses					
Purchased gas for resale	3,597.3	2,664.5	2,495.1	1,653.3	2,171.1
Fuel and purchased power	752.1	540.3	414.6	395.9	538.5
Operations and maintenance	1,617.9	1,567.0	1,622.6	1,631.3	1,704.4
Depreciation, depletion and amortization	396.5	551.8	571.7	513.7	564.0
Operating taxes	407.1	404.2	418.2	380.5	448.9
Impairment Charges	—	41.0	—	—	—
Total operating expenses	6,770.9	5,768.8	5,522.2	4,574.7	5,426.9
Gain on sale of property	1.6	7.0	15.1	4.7	—
Income from equity investments	15.1	46.5	19.2	14.1	13.1
Operating income	907.8	935.3	1,047.6	909.3	792.0
Other income and (deductions)	(269.9)	4.9	(340.3)	(301.4)	(359.5)
Income taxes	239.3	325.5	281.3	229.6	200.5
Earnings from continuing operations	398.6	614.7	426.0	378.3	232.0
Discontinued Operations					
Income (loss) from operations, net of tax	(4.1)	(79.0)	(1.9)	15.7	22.6
Loss on disposal, net of tax	2.3	(72.0)	—	(16.3)	(30.3)
Loss from discontinued operations	(1.8)	(151.0)	(1.9)	(0.6)	(7.7)
Cumulative change in accounting principles	(6.6)	—	(37.4)	—	—
Net income	390.2	463.7	386.7	377.7	224.3
Preferred stock dividend requirements	2.2	5.6	5.8	5.8	5.9
Earnings for common stock	$ 388.0	$ 458.1	$ 380.9	$ 371.9	$ 218.4
Financial Summary					
Earnings per share ($)	2.28	2.86	2.41	2.63	1.58
Cash dividends declared per share ($)	1.82	1.78	1.78	1.78	1.78
Book value per share, year-end ($)	25.60	24.22	22.99	20.67	20.73
Market value per share, year-end ($)	35.69	39.45	36.80	35.24	34.65
Shareholders, year-end	68,421	72,549	75,067	78,281	82,300
Capital expenditures ($)	539.5	750.3	1,009.4	1,057.5	1,059.8
Total assets ($)	13,812.6	13,364.1	14,640.2	12,980.1	11,789.6
Common shareholders' equity ($)	4,464.1	3,894.7	3,670.7	2,944.6	2,890.6
Preferred stock redemption required ($)	—	75.0	75.0	75.0	75.0
Preferred stock no redemption required ($)	—	—	8.6	8.8	9.1
Long-term debt ($)	3,920.8	4,418.7	5,610.9	5,224.1	4,697.6
Total capitalization ($)	8,384.9	8,333.2	9,365.2	8,252.5	7,672.3

Through its wholly owned subsidiary, KeySpan LNG, LP, KeySpan owns a liquefied natural gas storage and receiving facility in Providence, Rhode Island, the operations of which are fully consolidated.

During the first quarter of 2004, we also had an approximate 61% investment in certain midstream natural gas assets in Western Canada through KeySpan Energy Canada Partnership ("KeySpan Canada"). These assets included 14 processing plants and associated gathering systems that produced approximately 1.5 BCFe of natural gas daily and provided associated natural gas liquids fractionation.These operations were fully consolidated in KeySpan's Consolidated Financial Statements. On April 1, 2004, KeySpan and KeySpan Facilities Income Fund (the "Fund"), which previously owned a 39.09% interest in KeySpan Canada, consummated a transaction whereby the Fund sold 15.617 million units of the Fund and acquired an additional 35.91% interest in KeySpan Canada from KeySpan. As a result of this transaction, KeySpan's ownership of KeySpan Canada decreased to 25%. KeySpan recorded a gain of $22.8 million ($10.1 million after-tax, or $0.06 per share) at the time of this transaction. Effective April 1, 2004 KeySpan Canada's earnings and our ownership interest in KeySpan Canada were accounted for on the equity method of accounting.

In July 2004, the Fund issued an additional 10.7 million units, the proceeds of which were used to fund the acquisition of the midstream assets of Chevron Canada Midstream Inc. This transaction had the effect of further diluting KeySpan's ownership of KeySpan Canada to 17.4%. KeySpan continued to account for its investment in KeySpan Canada on the equity basis of accounting since it still exercised significant influence over this entity.

In December 2004, KeySpan sold its remaining 17.4% interest in KeySpan Canada to the Fund and received net proceeds of approximately $119 million and recorded a pre-tax gain of approximately $35.8 million, which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was approximately $24.7 million, or $0.15 per share.

KeySpan Canada's revenues, which are reflected in KeySpan's Consolidated Statement of Income in fiscal years 2004 and 2003, were $25.2 million and $90.3 million, respectively. KeySpan Canada's operating income, including KeySpan's share of equity earnings, was $16.5 million and $29.7 million, respectively.

Asset transactions regarding our investment in KeySpan Canada were also recorded in 2003. In 2003, we sold a portion of our interest in KeySpan Canada through the Fund. The Fund acquired a 39.1% ownership interest in KeySpan Canada through an indirect subsidiary, and then issued 17 million trust units to the public through an initial public offering. Additionally, we sold our 20% interest in Taylor NGL LP that owns and operates two extraction plants in Canada to AltaGas Services, Inc. Net proceeds of $119.4 million from the two sales, plus proceeds of $45.7 million drawn under a credit facility made available to KeySpan Canada, were used to pay down existing KeySpan Canada credit facilities of $160.4 million. A pre-tax loss of $30.3 million was recognized on the transactions and is included in other income and (deductions) on the Consolidated Statement of Income. These transactions produced a tax expense of $3.8 million as a result of certain United States partnership tax rules and resulted in an after-tax loss of $34.1 million, or $0.22 per share.

In the first quarter of 2005, KeySpan sold its 50% interest in Premier Transmission Limited ("Premier"), a gas pipeline from southwest Scotland to Northern Ireland. On February 25, 2005, KeySpan entered into a Share Sale and Purchase Agreement with BG Energy Holdings Limited and Premier Transmission Financing Public Limited Company ("PTFPL"), pursuant to which all of the outstanding shares of Premier were to be purchased by PTFPL. On March 18, 2005, the sale was completed and generated cash proceeds of approximately $48.1 million. In the fourth quarter of 2004, KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value. The final sale of Premier resulted in a pre-tax gain of $4.1 million reflecting the difference from earlier estimates; this gain was recorded in the first quarter of 2005.

In the fourth quarter of 2003, we completed the sale of our 24.5% interest in Phoenix Natural Gas Limited for $96 million and recorded a pre-tax gain of $24.7 million in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was $16.0 million, or $0.10 per share.

The accounting policies of the segments are the same as those used for the preparation of the Consolidated Financial Statements. Our segments are strategic business units that are managed separately because of their different operating and regulatory environments. Operating results of our segments are evaluated by management on an operating income basis. For fiscal years 2004 and 2003, the operating data of Houston Exploration has been separately displayed. The reportable segment information is as follows:

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2005	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	OTHER INVESTMENTS	ELIMINATIONS	CONSOLIDATED
Unaffiliated revenue	5,390.1	2,042.7	191.2	38.0	—	7,662.0
Intersegment revenue	—	4.6	10.8	5.0	(20.4)	—
Depreciation, depletion and amortization	277.0	91.7	7.6	6.8	13.4	396.5
Gain on sales of property	0.1	1.2	—	0.1	0.2	1.6
Income from equity investments	—	—	—	15.1	—	15.1
Operating income	565.7	342.3	(2.7)	20.6	(18.1)	907.8
Interest income	0.9	0.8	0.2	2.8	7.6	12.3
Interest charges	178.2	71.7	18.4	1.8	(0.8)	269.3
Total assets	10,052.5	2,348.0	199.0	341.9	871.2	13,812.6
Equity method investments	—	—	—	106.7	—	106.7
Construction expenditures	410.3	88.8	7.4	23.6	9.4	539.5

Eliminating items include intercompany interest income and expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $2.0 billion for the year ended December 31, 2005 represents approximately 26% of our consolidated revenues during that period.

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2004	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	HOUSTON EXPLORATION	OTHER INVESTMENTS	ELIMINATIONS	CONSOLIDATED
Unaffiliated revenue	4,407.3	1,738.7	182.4	268.1	54.0	—	6,650.5
Intersegment revenue	—		11.5		4.9	(16.4)	—
Depreciation, depletion and amortization	276.5	88.2	7.5	104.6	59.7	15.3	551.8
Gain on sales of property	—	2.0		—	5.0		7.0
Income from equity investments	—			20.7	25.8		46.5
Operating income	579.6	289.8	(48.3)	138.5	(33.8)	9.5	935.3
Interest income	2.2	9.9		3.5	3.0	(9.2)	9.4
Interest charges	176.8	72.9	19.4	3.5	3.9	54.8	331.3
Total assets	8,908.8	2,144.3	246.6	—	701.3	1,363.1	13,364.1
Equity method investments	—				107.1		107.1
Construction expenditures	414.5	150.3	13.7	146.5	13.7	11.6	750.3

Eliminating items include intercompany interest income and expense, the elimination of certain intercompany accounts, as well as activities of our corporate and administrative subsidiaries

Electric Services revenues from LIPA and the NYISO of $1.7 billion for the year ended December 31, 2004 represents approximately 25% of our consolidated revenues during that period.

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2003	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	HOUSTON EXPLORATION	OTHER INVESTMENTS	ELIMINATIONS	CONSOLIDATED
Unaffiliated revenue	4,161.3	1,606.0	158.9	495.3	114.0	—	6,535.5
Intersegment revenue	—	0.1	7.5	—	5.0	(12.6)	—
Depreciation, depletion and amortization	259.9	67.2	7.1	204.1	19.1	14.3	571.7
Gain on sales of property	15.1	—	—	—	—	—	15.1
Income from equity investments	—	—	—	—	19.1	0.1	19.2
Operating income	574.3	269.9	(33.0)	196.3	42.2	(2.1)	1,047.6
Interest income	1.2	4.6	1.1	—	1.0	(2.2)	5.7
Interest charges	203.7	44.2	15.8	8.5	7.5	28.0	307.7
Total assets	8,457.5	2,511.1	407.5	1,530.9	915.4	817.8	14,640.2
Equity method investments	—	—	—	—	97.0	—	97.0
Construction expenditures	419.6	256.5	7.0	295.9	18.1	12.3	1,009.4

Eliminating items include intercompany interest income and expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.

Electric Services revenues from LIPA and the NYISO of $1.5 billion for the year ended December 31, 2003 represents approximately 22% of our consolidated revenues during that period.

Note 3. Income Tax

KeySpan files a consolidated federal income tax return. A tax sharing agreement between the holding company and its subsidiaries provides for the allocation of a realized tax liability or asset based upon separate return contributions of each subsidiary to the consolidated taxable income or loss in the consolidated income tax return. The subsidiaries record income tax payable or receivable from KeySpan resulting from the inclusion of their taxable income or loss in the consolidated return

Income tax expense is reflected as follows in the Consolidated Statement of Income:

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Current income tax	$206.6	$201.9	$ (99.8)
Deferred income tax	32.7	123.6	381.1
Total income tax	$239.3	$325.5	$281.3

At December 31, the significant components of KeySpan's deferred tax assets and liabilities calculated under the provisions of SFAS No.109 "Accounting for Income Taxes" were as follows:

		(In Millions of Dollars)
DECEMBER 31,	**2005**	**2004**
Reserves not currently deductible	$ 28.4	$ 23.9
State income tax	(20.6)	(19.0)
Property related differences	(1,080.8)	(1,080.0)
Regulatory tax asset	(24.5)	(21.4)
Employee benefits and compensation	(64.4)	(16.6)
Property taxes	(84.1)	(99.1)
Other items – net	88.1	88.1
Net deferred tax liability	$(1,157.9)	$(1,124.1)

KeySpan is currently in discussions with the Internal Revenue Service ("IRS") at the Appeals level with regard to LILCO's tax returns for the tax years ending December 31, 1996 through March 31, 1999 and KeySpan's and the Brooklyn Union Gas Company's tax returns for the years ending September 30, 1997 through December 31, 1998. The primary issue relates to the valuation of the transferred assets in the KeySpan/LILCO combination. Additionally, the IRS has recently commenced the examination of KeySpan's tax returns for the year ended 2002 and 2003. At this time, we cannot predict the result of these audits. However, KeySpan has evaluated the potential outcomes based on the issues raised and progress of the discussions to date. KeySpan believes that it has adequately provided for the additional tax, if any, which may result.

The federal income tax amounts included in the Consolidated Statement of Income differ from the amounts which result from applying the statutory federal income tax rate to income before income tax.

The table below sets forth the reasons for such differences:

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Computed at the statutory rate	$ 223.3	$ 329.1	$ 247.6
Adjustments related to:			
Tax credits	(1.4)	(2.2)	—
Removal costs	(2.9)	(0.6)	(6.6)
Accrual to return adjustments	6.7	(10.7)	0.5
Sale of subsidiary stock	—	(22.5)	—
Minority interest in Houston Exploration	—	12.9	20.0
State income tax, net of federal benefit	29.0	24.8	28.5
Contribution of land	(3.8)	—	—
Dividends paid to employee benefit plan	(3.9)	(3.6)	—
Other items – net	(7.7)	(1.7)	(8.7)
Total income tax	$ 239.3	$ 325.5	$ 281.3
Effective income tax rate (1)	38%	35%	40%

(1) Reflects both federal as well as state income taxes.

The American Jobs Creation Act of 2004, signed into law on October 22, 2004 provides for a special one-time tax deduction, or dividend received deduction ("DRD") of 85% of qualifying foreign earnings that are repatriated in 2004 or 2005. We currently estimate that KeySpan has repatriated dividends of approximately $9.5 million of earnings under this provision and received, as a result, a tax benefit of $2.8 million.

As of December 31, 2005 KeySpan had $285 million of state tax net operating loss carryforwards which, if fully utilized at current rates, will yield tax credits of approximately $25 million. These credits will expire between 2011 and 2022.

Note 4. Postretirement Benefits

Pension Plans: The following information represents the consolidated results for our noncontributory defined benefit pension plans which cover substantially all employees. Benefits are typically based on age, years of service and compensation. Funding for pensions is in accordance with requirements of federal law and regulations. KEDLI and Boston Gas Company are subject to certain deferral accounting requirements mandated by the NYPSC and MADTE, respectively for pension costs and other postretirement benefit costs.

The calculation of net periodic pension cost is as follows:

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Service cost, benefits earned during the period	$ 56.5	$ 52.9	$ 47.5
Interest cost on projected benefit obligation	148.5	144.2	138.3
Expected return on plan assets	(173.1)	(158.2)	(130.6)
Net amortization and deferral	74.1	63.3	67.0
Special termination benefits	2.2	—	—
Total pension cost	$108.2	$102.2	$122.2

The following table sets forth the pension plans' funded status at December 31, 2005 and December 31, 2004.

	(In Millions of Dollars)	
YEAR ENDED DECEMBER 31,	**2005**	**2004**
Change in benefit obligation:		
Benefit obligation at beginning of period	$(2,520.1)	$(2,343.2)
Service cost	(56.6)	(52.9)
Interest cost	(148.5)	(144.2)
Amendments	(0.1)	(2.3)
Actuarial loss	(117.9)	(114.6)
Benefits paid	130.4	137.1
Special termination benefits	(2.2)	—
Benefit obligation at end of period	$(2,715.0)	$(2,520.1)
Change in plan assets:		
Fair value of plan assets at beginning of period	2,028.9	1,855.2
Actual return on plan assets	166.7	164.2
Employer contribution	148.3	146.6
Benefits paid	(130.4)	(137.1)
Fair value of plan assets at end of period	2,213.5	2,028.9
Funded status	(501.5)	(491.2)
Unrecognized net loss from past experience different from that assumed and from changes in assumptions	672.1	612.1
Unrecognized prior service cost	48.2	57.7
Net prepaid pension cost reflected on consolidated balance sheet	$ 218.8	$ 178.6

YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Assumptions:			
Obligation discount	5.75%	6.00%	6.25%
Asset return	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	4.00%

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years indicated:

	(In Millions of Dollars)
	PENSION BENEFITS
2006	$132.2
2007	$134.1
2008	$137.7
2009	$141.4
2010	$146.0
Years 2011- 2015	$839.3

Unfunded Pension Obligation: At December 31, 2005 the accumulated benefit obligation was in excess of pension assets. As prescribed by SFAS 87 "Employers' Accounting for Pensions," KeySpan had a $257.3 million minimum liability at December 31, 2005, for this unfunded pension obligation. As permitted under current accounting guidelines, these accruals can be offset by a corresponding debit to a long-term asset up to the amount of accumulated unrecognized prior service costs. Any remaining amount is to be recorded in accumulated other comprehensive income on the Consolidated Balance Sheet.

Therefore, at year-end, we had a long-term asset in deferred charges other of $41.2 million, representing the amount of unrecognized prior service cost and a debit to accumulated other comprehensive income of $97.8 million, or $63.6 million after-tax. The remaining amount of $118.3 million was recorded as a contractual receivable from LIPA of $103.8 million and a regulatory asset of $14.5 million, representing the amounts that could be recovered from LIPA and the Boston Gas ratepayer in accordance with our service and rate agreements if the underlying assumptions giving rise to this minimum liability were realized and recorded as pension expense. Boston Gas has received approval from the MADTE to defer as a regulatory asset the amount of its current and future minimum pension liability to reflect its ability to recover in rates its actual pension liability.

At December 31, 2005 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in excess of plan assets were $1.4 billion, $1.3 billion and $997 million, respectively.

At December 31, 2004, the accumulated benefit obligation was also in excess of pension assets. As a result, we had a minimum liability of $255.9 million, a long-term asset in deferred charges other of $49.7 million, and a debit to other comprehensive income of $91.9 million, or $59.8 million after-tax. The remaining amount of $114.3 million was recorded as a contractual receivable from LIPA of $100.1 million and a regulatory asset of $14.2 million.

At December 31, 2004 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in plan assets were $1.3 billion, $1.2 billion and $881 million, respectively.

At the end of each year, we will re-measure the accumulated benefit obligation and pension assets, and adjust the accrual and deferrals as appropriate.

Other Postretirement Benefits: The following information represents the consolidated results for our contributory medical and prescription drug programs and non-contributory life insurance programs for retired employees. We have 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.

Net periodic other postretirement benefit cost included the following components:

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	2005	2004	2003
Service cost, benefits earned during the period	$ 24.4	$19.7	$18.8
Interest cost on accumulated postretirement benefit obligation	75.7	70.2	69.8
Expected return on plan assets	(36.1)	(33.9)	(27.5)
Net amortization and deferral	59.9	41.0	35.8
Special termination benefit	1.7	—	—
Other postretirement cost	$125.6	$97.0	$96.9

The following table sets forth the plans' funded status at December 31, 2005 and December 31, 2004.

		(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	2005	2004
Change in benefit obligation:		
Benefit obligation at beginning of period	$ (1,336.7)	$ (1,267.6)
Impact due to Medicare subsidy	—	60.6
Service cost	(24.4)	(19.7)
Interest cost	(75.7)	(70.2)
Plan participants' contributions	(3.4)	(1.9)
Amendments	3.2	27.4
Actuarial (loss)	(38.3)	(119.9)
Benefits paid	62.7	54.6
Special termination benefit	(1.7)	—
Benefit obligation at end of period	(1,414.3)	(1,336.7)
Change in plan assets:		
Fair value of plan assets at beginning of period	464.0	438.4
Actual return on plan assets	29.1	38.8
Employer contribution	35.8	39.5
Plan participants' contributions	3.4	1.9
Benefits paid	(62.7)	(54.6)
Fair value of plan assets at end of period	469.6	464.0
Funded status	(944.7)	(872.7)
Unrecognized net loss from past experience different from that assumed and from changes in assumptions	557.5	576.8
Unrecognized prior service cost	(97.5)	(106.5)
Accrued postretirement cost reflected on consolidated balance sheet	$ (484.7)	$ (402.4)

YEAR ENDED DECEMBER 31,	2005	2004	2003
Assumptions:			
Obligation discount	5.75%	6.00%	6.25%
Asset return	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	4.00%

The measurement of plan liabilities also assumes a health care cost trend rate of 9.5% grading down to 4.75% over six years, and 4.75% thereafter. A 1% increase in the health care cost trend rate would have the effect of increasing the accumulated postretirement benefit obligation as of December 31, 2005 by $173.1 million and the net periodic health care expense by $14.9 million. A 1% decrease in the health care cost trend rate would have the effect of decreasing the accumulated postretirement benefit obligation as of December 31, 2005 by $151.1 million and the net periodic health care expense by $12.6 million.

At December 31, 2005, KeySpan had a contractual receivable from LIPA of $297.4 million representing the pension and other postretirement benefits associated with the electric business unit employees recorded in deferred charges other on the Consolidated Balance Sheet. LIPA has been reimbursing us for costs related to the postretirement benefits of the electric business unit employees in accordance with the LIPA Agreements.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years indicated:

		(In Millions of Dollars)
	GROSS BENEFIT PAYMENTS	SUBSIDIARY RECEIPTS EXPECTED**
2006	$ 65.9	$ 3.5
2007	$ 70.6	$ 3.9
2008	$ 74.9	$ 4.3
2009	$ 79.6	$ 4.7
2010	$ 83.9	$ 5.0
Years 2011- 2015	$469.3	$28.1

*** Rebates are based on calendar year in which prescription drug costs are incurred. Actual receipt of rebates may occur in the following year.*

Pension/Other Post Retirement Benefit Plan Assets: KeySpan's weighted average asset allocations at December 31, 2005 and 2004, by asset category, for both the pension and other postretirement benefit plans are as follows:

	PENSION		OPEB	
ASSET CATEGORY	2005	2004	2005	2004
Equity securities	65%	64%	70%	72%
Debt securities	27%	28%	23%	23%
Cash and equivalents	3%	3%	2%	—
Venture capital	5%	5%	5%	5%
Total	100%	100%	100%	100%

The long-term rate of return on assets (pre-tax) is assumed to be 8.5% which management believes is an appropriate long-term expected rate of return on assets based on our investment strategy, asset allocation mix and the historical performance of equity and fixed income investments over long periods of time. The actual ten-year compound rate of return for our Plans is greater than 8.5%.

Our master trust investment allocation policy target for the assets of the pension and other postretirement benefit plans is 70% equity and 30% fixed income.

During 2003, KeySpan conducted an asset and liability study projecting asset returns and expected benefit payments over a ten-year period. Based on the results of the study, KeySpan developed a multi-year funding strategy for its plans. We believe that it is reasonable to assume assets can achieve or outperform the assumed long-term rate of return with the target allocation as a result of historical performance of equity investments over long-term periods.

Cash Contributions: In 2006, KeySpan is expected to contribute approximately $90 million to its pension plans and approximately $30 million to its other postretirement benefit plans.

Defined Contribution Plan: KeySpan also offers both its union and management employees a defined contribution plan. Both the KeySpan Energy 401(k) Plan for Management Employees and the KeySpan Energy 401(k) Plan for Union Employees are available to all eligible employees. These Plans are defined contribution plans subject to Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"). Eligible employees contributing to the Plan may receive certain employer contributions including matching contributions and a 10% discount on the purchase of KeySpan Common Stock in the Plan. The matching contributions were in KeySpan's common stock until January 2006. The matching contributions are now determined at the election of KeySpan employees. For the years ended December 31, 2005, 2004 and 2003, we recorded an expense of $15.2 million, $14.7 million, and $11.2 million, respectively.

Note 5. Capital Stock

Common Stock: Currently we have 450,000,000 shares of authorized common stock. At December 31, 2005, we had 10.5 million shares, or $303.9 million of treasury stock outstanding. During 2005, we issued 1.4 million shares out of treasury for the dividend reinvestment feature of our Investor Program, the Employee Discount Stock Purchase Plan, the 401(k) Plan and the Long-Term Incentive Compensation Plan.

On May 16, 2005, KeySpan issued 12.1 million shares of common stock, in association with the MEDS Equity Units conversion, at an issuance price of $37.93 per share pursuant to the terms of the forward purchase contract. KeySpan received proceeds of approximately $460 million from the equity conversion. The number of shares issued was dependent on the average closing price of our common stock over the 20 day trading period ending on the third trading day prior to May 16, 2005. (See Note 6 "Long-Term Debt and Commercial Paper" for further details on the MEDS Equity Units.)

Preferred Stock: We have the authority to issue 100,000,000 shares of preferred stock with the following classifications: 16,000,000 shares of preferred stock, par value $25 per share; 1,000,000 shares of preferred stock, par value $100 per share; and 83,000,000 shares of preferred stock, par value $.01 per share.

At December 31, 2004 we had 553,000 shares outstanding of 7.07% Mandatory Redeemable Preferred Stock Series B par value $100 redeemable in 2005; and 197,000 shares outstanding of 7.17% Mandatory Redeemable Preferred Stock Series C par value $100 redeemable in 2008.

In May 2005, $55.3 million of 7.07% Series B preferred stock was redeemed on its scheduled redemption date. Additionally, also in May 2005, KeySpan called for the optional redemption of $19.7 million of 7.17% Series C of Preferred Stock due 2008. KeySpan no longer has preferred stock outstanding.

Note 6. Long-Term Debt And Commercial Paper

Notes Payable: KEDLI had $125 million of medium-term notes at 6.90% due January 15, 2008, and $400 million of 7.875% Medium-Term Notes due February 1, 2010, outstanding at December 31, 2005 and 2004, each of which is guaranteed by KeySpan.

KeySpan also had $1.96 billion of medium and long term notes outstanding at December 31, 2004 of which $950 million of these notes were associated with the acquisition of Eastern and ENI. These notes were issued in two series as follows: $700 million of 7.625% Notes due 2010 and $250 million of 8.00% Notes due 2030. The remaining debt of approximately $1 billion had interest rates ranging from 4.65% to 9.75%.

During 2005, KeySpan redeemed $500 million 6.15% Notes due 2006. We applied the provisions of SFAS 145 "Rescission of FASB Statement No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections" and recorded an expense of $20.9 million associated with call premiums and wrote-off $1.3 million of previously deferred financing costs. Further, KeySpan accelerated the amortization of approximately $11.2 million of previously unamortized benefits associated with an interest rate swap on these bonds. The accelerated amortization was recorded as a reduction to interest expense on the Consolidated Statement of Income. In addition, during the first quarter of 2005, $15 million of 8.87% notes of a KeySpan subsidiary were redeemed at maturity.

Further, in association with the MEDS Equity Units conversion, KeySpan converted $460 million of MEDS Equity Units into $467.2 million of medium and long term bonds. (For further details on the MEDS Equity Units see "MEDS Equity Units" below.) As a result of the aforementioned transactions, at December 31, 2005 KeySpan had $2.4 billion of notes outstanding with interest rates ranging from 4.65% to 9.75% that mature in 2006-2035.

Gas Facilities Revenue Bonds: KEDNY can issue tax-exempt bonds through the New York State Energy Research and Development Authority ("NYSERDA"). Whenever bonds are issued for new gas facilities projects, proceeds are deposited in trust and subsequently withdrawn to finance qualified expenditures. There are no sinking fund requirements on any of our Gas Facilities Revenue Bonds ("GFRBs"). At December 31, 2005,

$640.5 million of GFRBs were outstanding. The interest rate on the variable rate series due through December 1, 2026 is reset weekly and ranged from 1.40% to 2.95% during the year ended December 31, 2005, at which time the rate was 2.85%.

In November 2005, KEDNY, issued $137 million of tax-exempt GFRBs through the NYSERDA in the following series: (i) $82 million of 4.70% GFRB, 2005 Series A (the "Series A Bonds"); and (ii) $55 million GFRB, 2005 Series B (the "Series B Bonds"). The interest rate on the Series B bonds is reset every seven days through an auction process and at December 31, 2005 the interest rate on these bonds was 3.15%. KEDNY used the proceeds from this issuance to redeem the following three series: (i) $41 million Adjustable Rate GFRB Series 1989 A due February 2024; (ii) $41 million Adjustable Rate GFRB Series 1989 B due February 2024; and (iii) $55 million 5.60% GFRB Series 1993 C due June 2025. KEDNY incurred $3.7 million in call premiums and financing fees, all of which have been deferred for future rate recovery.

In December 2005, KEDNY converted $50 million of fixed rate GFRB's (5.64% GFRB Series D1 and D2 due 2026) into variable rate debt. The interest rate on these bonds is reset, through an auction process, every seven days. At December 31, 2005 the interest rate was 3.00%.

Promissory Notes to LIPA: In connection with the KeySpan/LILCO transaction, KeySpan and certain of its subsidiaries issued promissory notes to LIPA to support certain debt obligations assumed by LIPA. At December 31, 2005, $155.4 million of these promissory notes remained outstanding. Under these promissory notes, KeySpan is required to obtain letters of credit to secure its payment obligations if its long-term debt is not rated at least in the "A" range by at least two nationally recognized statistical rating agencies. At December 31, 2005, KeySpan was in compliance with this requirement.

MEDS Equity Units: At December 31, 2004, KeySpan had $460 million of MEDS Equity Units outstanding at 8.75% consisting of a three-year forward purchase contract for our common stock and a six-year note. The purchase contract required us, three years from the date of issuance of the MEDS Equity Units, May 16, 2005, to issue and the investors to purchase, a number of shares of our common stock based on a formula tied to the market price of our common stock at that time. The 8.75% coupon was composed of interest payments on the six-year note of 4.9% and premium payments on the three-year equity forward contract of 3.85%.

In 2005, KeySpan was required to remarket the note component of the Equity Units between February 2005 and May 2005 and reset the interest rate to the then current market rate of interest; however, the reset interest rate could not be set below 4.9%. In March 2005, KeySpan remarketed the note component of $394.9 million of the Equity Units at the reset interest rate of 4.9% through their maturity date of May 2008. The balance of the notes ($65.1 million) were held by the original MEDS equity holders in accordance with their terms and not remarketed. KeySpan then exchanged $300 million of the remarketed notes for $307.2 million of new 30 year notes bearing an interest rate of 5.8%. Therefore, KeySpan now has $160 million of 4.9% notes outstanding with a maturity date of May 2008 and $307.2 million of 5.8% notes outstanding with a maturity date of April 2035 that are classified as medium and long term notes.

On May 16, 2005 KeySpan issued 12.1 million shares of common stock, at an issuance price of $37.93 per share, pursuant to the terms of the financial purchase contract described above. KeySpan received proceeds of approximately $460 million from the equity conversion. The number of shares issued was dependent on the average closing price of our common stock over the 20 day trading period ending on the third trading day prior to May 16, 2005.

Industrial Development Revenue Bonds: At December 31, 2005 KeySpan had outstanding $128.3 million of tax-exempt bonds with a 5.25% coupon maturing in June 2027. Fifty-three million dollars of these Industrial Development Revenue Bonds were issued in its behalf 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 in its behalf by the Suffolk County Industrial Development Authority for the Port Jefferson Energy Center an electric-generation peaking plant. KeySpan has guaranteed all payment obligations of these subsidiaries with regard to these bonds.

First Mortgage Bonds: Colonial Gas Company had outstanding $95.0 million of first mortgage bonds at December 31, 2005. These bonds are secured by gas utility property. The first mortgage bond indentures include, among other provisions, limitations on: (i) the issuance of long-term debt; (ii) engaging in additional lease obligations; and (iii) the payment of dividends from retained earnings. At December 31, 2005, these bonds remain outstanding and have interest rates ranging from 6.08% to 8.80% and maturities that range from 2008-2028.

Authority Financing Notes: Certain of our electric generation subsidiaries can issue tax-exempt bonds through the NYSERDA. At December 31, 2005, $41.1 million of Authority Financing Notes 1999 Series A Pollution Control Revenue Bonds due October 1, 2028 were outstanding. The interest rate on these notes is reset based on an auction procedure. The interest rate during 2005 ranged from 1.40% to 2.85%, through December 31, 2005, at which time the rate was 3.00%.

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 ranged from 1.47% to 3.42% for the year ended December 31, 2005, at which time the rate was 3.42%.

Ravenswood Master Lease: We have an arrangement with an unaffiliated variable interest financing entity through which we lease a portion of the Ravenswood Facility. We acquired the Ravenswood Facility, in part, through the variable interest entity, from the Consolidated Edison Company of New York ("Consolidated Edison") on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into a lease agreement (the "Master Lease") with the variable interest entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to a KeySpan subsidiary. The variable interest financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity. KeySpan has guaranteed all payment and performance obligations of our subsidiary under the Master Lease. Monthly lease payments are substantially equal to the monthly interest expense on the debt securities.

We have classified the Master Lease as $412.3 million of long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary as defined in Financial Accounting Standards Board Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." Further, we have an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date, or approximately $322.8 million. Under the terms of our credit facilities, the Master Lease is considered debt in the ratio of debt-to-total capitalization. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding the leasing arrangement associated with the Master Lease Agreement.)

Commercial Paper and Revolving Credit Agreements: In June 2005, KeySpan closed on a $920 million revolving credit facility for five years due June 24, 2010, which was syndicated among fifteen banks, and an amended $580 million revolving credit facility due June 24, 2009. These facilities replaced an existing $660 million, 3-year facility due June 2006, and a 5-year $640 million facility due June 2009. The two credit facilities, which now total $1.5 billion – $920 million for five years through 2010, and $580 million for the amended facility through 2009, will continue to support KeySpan's commercial paper program for ongoing working capital needs.

The fees for the facilities are based on KeySpan's current credit ratings and are increased or decreased based on a downgrading or upgrading of our ratings. The current annual facility fee is 0.07% based on our credit rating of A3 by Moody's Investor Services and A by Standard & Poor's for each facility. Both credit facilities allow for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin that is tied to our applicable credit ratings. ABR loans are based on the higher of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders. We do not anticipate borrowing against these facilities; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The facilities contain certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its utility property to any lien, as well as certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 65% at the last day of any fiscal quarter. Violation of these covenants could result in the termination of the facilities and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements. At December 31, 2005, KeySpan's consolidated indebtedness was 50.7% of its consolidated capitalization and KeySpan was in compliance with all covenants.

Subject to certain conditions set forth in the credit facility, KeySpan has the right, at any time, to increase the commitments under the $920 million facility up to an additional $300 million. In addition, KeySpan has the right to request that the termination date be extended for an additional period of 365 days prior to each anniversary of the closing date. This extension option, however, requires the approval of lenders holding more than 50% of the total commitments to such extension request. Under the agreements, KeySpan has the ability to replace non-consenting lenders with other pre-approved banks or financial institutions.

At December 31, 2005, we had cash and temporary cash investments of $124.5 million. During 2005, we repaid $254.6 million of commercial paper and, at December 31, 2005, $657.6 million of commercial paper was outstanding at a weighted average annualized interest rate of 4.38%. At December 31, 2005, KeySpan had the ability to issue up to an additional $842 million, under its commercial paper program.

Capital Leases: Our subsidiaries lease certain facilities and equipment under long-term leases, which expire on various dates through 2014. The weighted average interest rate on these obligations was 6.0%.

Debt Maturity: The following table reflects the maturity schedule for our debt repayment requirements, including capitalized leases and related maturities, at December 31, 2005:

(In Millions of Dollars)

	LONG-TERM DEBT	CAPITAL LEASES	TOTAL
Repayments:			
2006	$ 12.0	$ 1.0	$ 13.0
2007	—	1.1	1.1
2008	305.0	1.1	306.1
2009	412.3	1.2	413.5
2010	1,110.0	1.3	1,111.3
Thereafter	2,095.4	5.1	2,100.5
	$3,934.7	$ 10.8	$3,945.5

Note 7. Contractual Obligations, Financial Guarantees and Contingencies

Lease Obligations: Lease costs included in operating expense were $76.5 million in 2005 including, the lease of KeySpan's Brooklyn headquarters of $14.1 million. Further, in March 2005, KeySpan renegotiated the lease of the Brooklyn headquarters. The original agreement was to expire in 2012. The current lease will expire in 2025. Yearly lease expense is approximately $11.7 million. In May 2004 KeySpan entered into a leveraged lease financing arrangement associated with the Ravenswood Expansion. The yearly operating lease expense is approximately $17 million per year. (See the caption below "Sale/Leaseback Transaction" for further details of this lease.) Lease costs also include leases for other buildings, office equipment, vehicles and power operated equipment. Lease costs for the year ended December 31, 2004 and 2003 were $67.7 million and $82.1 million, respectively. As previously mentioned, the Master Lease is consolidated and, as a result, lease payments are reflected as interest expense on the Consolidated Statement of Income. The future minimum cash lease payments under various leases, excluding the Master Lease, but including the Ravenswood Expansion lease, all of which are operating leases, are $100.6 million per year over the next five years and $652.4 million, in the aggregate, for all years thereafter. (See discussion below for further information regarding the Master Lease and the Ravenswood Expansion sale/leaseback transaction.)

Variable Interest Entity: As mentioned, KeySpan has an arrangement with an unaffiliated variable interest financing entity through which we lease a portion of the Ravenswood Facility. We acquired the Ravenswood Facility, a 2,200-megawatt electric generating facility located in Queens, New York, in part, through the variable interest entity from Consolidated Edison on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into the Master Lease with the variable interest entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to our subsidiary. The variable interest entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity. KeySpan has guaranteed all payment and performance obligations of our subsidiary under the Master Lease. Monthly lease payments substantially equal the monthly interest expense on such debt securities. Interest expense for the year ended December 31, 2005 was $29.7 million.

The term of the Master Lease extends through June 20, 2009. On all future semi-annual payment dates, we have the right to: (i) purchase the facility for the original acquisition cost of $425 million, plus the present value of the lease payments that would otherwise have been paid through June 2009; or (ii) terminate the Master Lease and dispose of the facility. In June 2009, when the Master Lease terminates, we may purchase the facility in an amount equal to the original acquisition cost, subject to adjustment, or surrender the facility to the lessor. If we elect not to purchase the property, the Ravenswood Facility will be sold by the lessor. We have guaranteed to the lessor 84% of the residual value of the original cost of the property.

We have classified the Master Lease as $412.3 million of long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary. Further, we have an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date, or approximately $322.8 million.

If our subsidiary that leases the Ravenswood Facility was not able to fulfill its payment obligations with respect to the Master Lease payments, then the maximum amount KeySpan would be exposed to under its current guarantees would be $425 million plus the present value of the remaining lease payments through June 20, 2009.

Sale/leaseback Transaction: KeySpan also has a leveraged lease financing arrangement associated with the Ravenswood Expansion. In May 2004, the unit was acquired by a lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to that subsidiary. All the obligations of KeySpan Ravenswood, LLC have been unconditionally guaranteed by KeySpan. This lease transaction generated cash proceeds of $385 million, before transaction costs, which approximated the fair market value of the facility, as determined by a third-party appraiser. This lease transaction qualifies as an operating lease under SFAS 98 "Accounting for Leases: Sale/Leaseback Transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; an Initial Direct Costs of Direct Financing Leases, an amendment of FASB Statements No.13, 66, 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11." The lease has an initial term of 36 years and the yearly operating lease expense is approximately $17 million per year. Lease payments will fluctuate from year to year, but are substantially paid over the first 16 years. The future minimum cash lease payments under this lease is approximately $152 million over the next five years and $417 million, in the aggregate, for all years thereafter. The sale/leaseback transaction resulted in a pre-tax gain of approximately $6 million which has been deferred and is being amortized over the life of the lease.

Asset Retirement Obligations: On December 31, 2005, KeySpan 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 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 December 31, the following asset retirement obligations are recorded on the Consolidated Balance Sheet at their estimated present values:

		(In Millions of Dollars)	
DECEMBER 31,		**2005**	**2004**
Asset Retirement Obligations			
Asbestos removal	(i)	$ 3.5	$ —
Tanks removal and cleaning	(ii)	6.9	—
Main – cutting, purging and capping	(iii)	30.6	—
Wells – plug and capping	(iv)	0.2	—
KeySpan LNG tank demolition	(v)	2.1	—
Waste water treatment pond removal	(vi)	1.4	—
Fiber network removal	(vii)	0.8	—
Exploration wells – plug and capping	(viii)	1.9	1.9
Total Asset Retirement Obligations		$ 47.4	$ 1.9

(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 has a legal obligation to remove asbestos upon either a major renovation or demolition.

(ii) KeySpan 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 has a legal requirement to cut (disconnect from the gas distribution system), purge (clean of natural gas and PCB contaminants) and cap gas mains within its gas distribution and transmission system when mains are retired in place. Gas mains are generally abandoned in place when retired, unless the main and other equipment needs to be removed due to sewer or water system rerouting or other roadblock work. When such main and equipment are removed certain PCB test procedures must be employed.

(iv) KeySpan owns approximately 52% of an underground gas storage facility in western New York State. The facility includes 39 gas injection and extraction wells. There is a regulatory obligation to close and seal the wells.

(v) KeySpan owns a 600,000 gallon barrel Liquefied Natural Gas ("LNG") tank and ancillary facilities located in Providence, RI under a 30 year contract with New England Gas Company. At the end of the contract, the contract can be; (i) Extended; or (ii) New England Gas Company can require KeySpan to dismantle and remove the LNG tank and ancillary facilities or; (iii) KeySpan can elect to dismantle and remove the LNG tank and ancillary facilities. Since we may or may not be required to dismantle and remove the LNG tank and ancillary facilities, the obligation to perform was discounted to a 50% probability as allowed under FIN 47.

(vi) KeySpan 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.

(vii) KeySpan Communications has portions of its fiber optic network (underground and above ground) that are required to be removed upon termination of various agreements.

(viii) KeySpan has a regulatory obligation to close and seal the wells primarily associated with its gas exploration and production activities.

Financial Guarantees: KeySpan has issued financial guarantees in the normal course of business, primarily on behalf of its subsidiaries, to various third party creditors. At December 31, 2005, the following amounts would have to be paid by KeySpan in the event of non-payment by the primary obligor at the time payment is due:

		(In Millions of Dollars)	
		AMOUNT OF EXPOSURE	**EXPIRATION DATES**
Guarantees for Subsidiaries			
Medium-Term Notes – KEDLI	(i)	$ 525.0	2008 – 2010
Industrial Development Revenue Bonds	(ii)	128.3	2027
Ravenswood – Master Lease	(iii)	425.0	2009
Ravenswood – Sale/leaseback	(iv)	403.5	2019
Surety Bonds	(v)	76.0	2005 – 2008
Commodity Guarantees and Other	(vi)	83.2	2005 – 2009
Letters of Credit	(vii)	73.0	2006 – 2010
		$1,714.0	

The following is a description of KeySpan's outstanding subsidiary guarantees:

(i) KeySpan has fully and unconditionally guaranteed $525 million to holders of Medium-Term Notes issued by KEDLI. These notes are due to be repaid on January 15, 2008 and February 1, 2010. KEDLI is required to comply with certain financial covenants under the debt agreements. The face values of these notes are included in long-term debt on the Consolidated Balance Sheet.

(ii) KeySpan has fully and unconditionally guaranteed the payment obligations of its subsidiaries with regard to $128 million of Industrial Development Revenue Bonds issued through the Nassau County and Suffolk County Industrial Development Authorities for the construction of two electric-generation peaking plants on Long Island. The face values of these notes are included in long-term debt on the Consolidated Balance Sheet.

(iii) KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, the lessee under the Master Lease. The term extends through June 20, 2009. The Master Lease is classified as $412.3 million long-term debt on the Consolidated Balance Sheet.

(iv) KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, the lessee under the sale/leaseback transaction associated with the 250 MW Ravenswood Expansion, including future decommissioning costs. The initial term of the lease is for 36 years. As noted previously, this lease qualifies as an operating lease and is not reflected on the Consolidated Balance Sheet.

(v) KeySpan has agreed to indemnify the issuers of various surety and performance bonds associated with certain construction projects being performed by certain current or former subsidiaries. In the event that the subsidiaries fail to perform their obligations under contracts, the injured party may demand that the surety make payments or provide services under the bond. KeySpan would then be obligated to reimburse the surety for any expenses or cash outlays it incurs. Although KeySpan is not guaranteeing any new bonds for any of the former subsidiaries, KeySpan's indemnity obligation supports the contractual obligation of these former subsidiaries. KeySpan has also received from a former subsidiary an indemnity bond issued by a third party insurance company, the purpose of which is to reimburse KeySpan in an amount up to $80 million in the event it is required to perform under all other indemnity obligations previously incurred by KeySpan to support such company's bonded projects existing prior to divestiture. At December 31, 2005, the total cost to complete such remaining bonded projects is estimated to be approximately $40.2 million.

(vi) KeySpan has guaranteed commodity-related payments for subsidiaries within the Energy Services segment, as well as for KeySpan Ravenswood, LLC. These guarantees are provided to third parties to facilitate physical and financial transactions involved in the purchase of natural gas, oil and other petroleum products for electric production and marketing activities. The guarantees cover actual purchases by these subsidiaries that are still outstanding as of December 31, 2005.

(vii) KeySpan has arranged for stand-by letters of credit to be issued to third parties that have extended credit to certain subsidiaries. Certain vendors require us to post letters of credit to guarantee subsidiary performance under our contracts and to ensure payment to our subsidiary subcontractors and vendors under those contracts. Certain of our vendors also require letters of credit to ensure reimbursement for amounts they are disbursing on behalf of our subsidiaries, such as to beneficiaries under our self-funded insurance programs. Such letters of credit are generally issued by a bank or similar financial institution. The letters of credit commit the issuer to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, KeySpan would be required to reimburse the issuer of the letter of credit.

To date, KeySpan has not had a claim made against it for any of the above guarantees and we have no reason to believe that our subsidiaries or former subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact any such defaults may have on our consolidated results of operations, financial condition or cash flows.

Fixed Charges Under Firm Contracts: Our utility subsidiaries and the Ravenswood Generating Station have entered into various contracts for gas delivery, storage and supply services. Certain of these contracts require payment of annual demand charges in the aggregate amount of approximately $492.7 million. We are liable for these payments regardless of the level of service we require from third parties. Such charges associated with gas distribution operations are currently recovered from utility customers through the gas adjustment clause.

Legal Matters

From time to time we are subject to various legal proceedings arising out of the ordinary course of our business. Except as described below, 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, financial condition or cash flows.

KeySpan and certain of its current and former officers and directors were named as defendants in a shareholder derivative action asserting claims on behalf of KeySpan based upon breach of fiduciary duty. The complaint, which was filed in the New York State Supreme Court for the County of Kings on February 9, 2005, also relates to the 2001 Roy Kay-related losses and alleges that KeySpan's directors and certain senior officers breached their fiduciary duties when they placed their own personal interests above the interests of KeySpan by using material non-public information (the fraud at Roy Kay) to sell securities at artificially inflated prices. On January 3, 2006, the parties entered into a settlement agreement to settle the action for a nominal sum of $250,000 for plaintiff's counsel fees and for KeySpan to implement certain corporate governance practices. The settlement agreement is subject to court approval, the timing of which cannot be predicted. While KeySpan denies any wrongdoing, we believe the settlement is in the best interest of KeySpan and its shareholders.

KeySpan subsidiaries, along with several other parties, have been named as defendants in numerous proceedings filed by plaintiffs claiming various degrees of injury from asbestos exposure at generating facilities formerly owned by LILCO and others. In connection with the May 1998 transaction with LIPA, costs incurred by KeySpan for liabilities for asbestos exposure arising from the activities of the generating facilities previously owned by LILCO are recoverable from LIPA through the PSA between LIPA and KeySpan.

KeySpan is unable to determine the outcome of the outstanding asbestos proceedings, but does not believe that such outcome, if adverse, will have a material effect on its financial condition, results of operation or cash flows. KeySpan believes that its cost recovery rights under the 1998 and 2006 PSA, its indemnification rights against third parties and its insurance coverage (above applicable deductible limits) cover its exposure for asbestos liabilities generally.

Other Contingencies: We derive a substantial portion of our revenues in our Electric Services segment from a series of agreements with LIPA pursuant to which we manage LIPA's transmission and distribution system and supply the majority of LIPA's customers' electricity needs. KeySpan and LIPA have entered into agreements to extend, amend, and restate these contractual arrangements. See Note 11 "2006 LIPA Settlement" for a further discussion these agreements.

LIPA completed its strategic review initiative that it had undertaken in connection with among other reasons, its option under the Generation Purchase Rights Agreement. As part of its review, LIPA engaged a team of advisors and consultants, held public hearings and explored its strategic options, including continuing its existing operations, municipalizing, privatizing, selling some, but not all of its assets, becoming a regulator of rates and services, or merging with one or more utilities. Upon completion of its strategic review, LIPA determined that it would continue its existing operations, as part of its settlement with KeySpan and the renegotiated 2006 LIPA Agreements noted above. The 2006 LIPA Agreements are subject to governmental approvals, and if such governmental approvals are not received then LIPA may revisit its strategic review alternatives.

Environmental Matters

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 Phase I, II and III NOx reduction requirements established under the Ozone Transport Commission memorandum of understanding and forthcoming requirements under the Clean Air Interstate Rule ("CAIR") designed to address both ozone and particulate matter. 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 the emission reductions required. KeySpan is developing its compliance strategy in response to the implementation of the CAIR rule, which is expected in 2009. Since detailed requirements under the CAIR rule have not yet been fully articulated, it is not possible to definitively estimate capital expenditures that may be required to meet these regulatory mandates. Although, it is anticipated that NOx control equipment may be required at one or more of the KeySpan's Long Island facilities at a cost between $25 to $35 million, such amounts are recoverable from LIPA pursuant to the 1998 PSA or if applicable, the 2006 PSA.

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 satisfy these evolving regulatory requirements. It is not possible at this time to predict the extent of such capital investments but these upgrades are expected to cost up to $60 million, however, such amounts are recoverable from LIPA pursuant to the 1998 PSA or if applicable, the 2006 PSA. The Ravenswood Generating Station may also require upgrades at a cost of up to $15 million. 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.

Land, Manufactured Gas Plants and Related Facilities

During 2005, KeySpan undertook an extensive review of all its current and former properties that are or may be subject to environmental cleanup activities. As a result of this study, we adjusted reserve balances for estimated manufactured gas plant ("MGP") related environmental cleanup activities. Through various rate orders issued by the NYPSC, MADTE and NHPUC, costs related to MGP environmental cleanup activities are recovered in rates charged to gas distribution customers and, as a result, adjustments to these reserve balances do not impact earnings.

New York Sites: Within the State of New York we have identified 43 historical MGP sites and related facilities, which were owned or operated by KeySpan subsidiaries or such companies' predecessors. These former sites, some of which are no longer owned by us, have been identified to the NYPSC and the DEC for inclusion on appropriate site inventories. Administrative Orders on Consent ("ACO") or Voluntary Cleanup Agreements ("VCA") have been executed with the DEC to address the investigation and remediation activities associated with certain sites and one waterway. In March 2005, KeySpan withdrew its previously filed applications under the DEC's Brownfield Cleanup Program ("BCP") because of the uncertainty associated with contribution suits which we may need to bring against other parties who impacted these sites for

nedial cost. As a result of the December 2004 Cooper
ıll Services, Inc. decision by the United States Supreme
merging case law in New York, KeySpan continues to
ɔ proceed with respect to participation in the BCP or alter-
ıediation programs.

identified 28 of these sites as being associated with the
ations of KEDNY. One site has been fully remediated.
ɜ issues described in the preceding paragraph, the remaining
oe investigated and, if necessary, remediated under the
ɔnditions of ACOs, VCAs or Brownfield Cleanup Agreements
penditures incurred to date by us with respect to KEDNY
d activities total $60.9 million.

maining 15 sites have been identified as being associated
storical operations of KEDLI. Expenditures incurred to date by
spect to KEDLI MGP-related activities total $51.8 million. One
een fully investigated and requires no further action. The
ȝ sites will be investigated and, if necessary, remediated under
itions of ACOs, VCAs or BCAs.

presently estimate the remaining cost of our KEDNY and KEDLI
ıated environmental remediation activities will be $355.3 million,
ımount has been accrued by us as a reasonable estimate of prob-
ıst for known sites, however remediation costs for each site may
terially higher than noted, depending upon changing technologies
gulatory standards, selected end use for each site, and actual envi-
ntal conditions encountered. Expenditures incurred to date by us
espect to these MGP-related activities total $112.7 million.

With respect to remediation costs, the KEDNY rate plan provides,
g other things, that if the total cost of investigation and remediation
from that which is specifically estimated for a site under investiga-
nd/or remediation, then KEDNY will retain or absorb up to 10% of
ariation. The KEDLI rate plan also provides for the recovery of inves-
on and remediation costs but with no consideration of the difference
een estimated and actual costs. At December 31, 2005, we have
ted a regulatory asset of $388.0 million for our KEDNY/KEDLI MGP
In October 2003, KEDNY and KEDLI filed a joint petition with the
C seeking rate treatment for additional environmental costs that
oe incurred in the future. That petition is still pending.

We are also responsible for environmental obligations associated
the Ravenswood Facility, purchased from Consolidated Edison in
, including remediation activities associated with its historical opera-
and those of the MGP facilities that formerly operated at the site.
re not responsible for liabilities arising from disposal of waste at off-
ocations prior to the acquisition closing and any monetary fines aris-
rom Consolidated Edison's pre-closing conduct. We presently esti-
the remaining environmental clean up activities for this site will be
million, which amount has been accrued by us. Expenditures
rred to date total $3.3 million.

New England Sites: Within the Commonwealth of Massachusetts and the State of New Hampshire, we are aware of 74 former MGP sites and related facilities within the existing or former service territories of KEDNE.

Boston Gas Company, Colonial Gas Company and Essex Gas Company may have or share responsibility under applicable environmental laws for the remediation of 64 of these sites. A subsidiary of National Grid USA ("National Grid"), formerly New England Electric System, has assumed responsibility for remediating 11 of these sites, subject to a limited contribution from Boston Gas Company, and has provided full indemnification to Boston Gas Company with respect to eight other sites. In addition, Boston Gas Company, Colonial Gas Company, and Essex Gas Company have assumed responsibility for remediating three sites each. At this time, it is uncertain as to whether Boston Gas Company, Colonial Gas Company or Essex Gas Company have or share responsibility for remediating any of the other sites. No notice of responsibility has been issued to us for any of these sites from any governmental environmental authority.

We presently estimate the remaining cost of these Massachusetts KEDNE MGP-related environmental cleanup activities will be $15.5 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites, however remediation costs for each site may be materially higher than noted, depending upon changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered. Expenditures incurred since November 8, 2000, the date KeySpan acquired Eastern Enterprises, with respect to these MGP-related activities total $27.9 million.

In 2004, Boston Gas Company reached settlements with certain insurance carriers for recovery of a portion of previously incurred environmental expenditures. Under a previously issued MADTE rate order, insurance and third-party recoveries, after deducting legal fees, are shared between Boston Gas and its firm gas customers. As a result of these settlements, in 2004 Boston Gas Company recorded a $5.0 million benefit to operations and maintenance expense.

We may have or share responsibility under applicable environmenta
laws for the remediation of 10 MGP sites and related facilities associate
with the historical operations of EnergyNorth. At four of these sites we
have entered into cost sharing agreements with other parties who shar
responsibility for remediation of these sites. EnergyNorth also has enter
into an agreement with the United States Environmental Protection Agency ("EPA") for the contamination from the Nashua site that was allegedly commingled with asbestos at the so-called Nashua River Asbestos Site, adjacent to the Nashua MGP site.

We presently estimate the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $31.5 million, which
amount has been accrued by us as a reasonable estimate of probab
cost for known sites, however remediation costs for each site may b
materially higher than noted, depending upon changing technologi
regulatory standards, selected end use for each site, and actual en
mental conditions encountered. Expenditures incurred since Nover
2000, with respect to these MGP-related activities total $17.0 mi

By rate orders, the MADTE and the NHPUC provide for the recovery of site investigation and remediation costs and, accordingly, at December 31, 2005, we have reflected a regulatory asset of $66.7 million for the KEDNE MGP sites. As previously mentioned, Colonial Gas Company and Essex Gas Company are not subject to the provisions of SFAS 71 and therefore have recorded no regulatory asset. However, rate orders currently in effect for these subsidiaries provide for the recovery of investigation and remediation costs.

KeySpan New England LLC Sites: We are aware of three non-utility sites associated with KeySpan New England, LLC, a successor company to Eastern Enterprises, for which we may have or share environmental remediation or ongoing maintenance responsibility. These three sites, located in Philadelphia, Pennsylvania, New Haven, Connecticut and Everett, Massachusetts, were associated with historical operations involving the production of coke and related industrial processes. Honeywell International, Inc. and Beazer East, Inc. (both former owners and/or operators of certain facilities at Everett ("the Everett Facility") together with KeySpan, entered into an ACO with the Massachusetts Department of Environmental Protection for the investigation and development of a remedial response plan for a portion of that site. KeySpan, Honeywell and Beazer East entered into a cost-sharing agreement under which each company agreed to pay one-third of the costs of compliance with the consent order, while preserving any claims against the other companies for, among other things, reallocation of proportionate liability. In 2002, Beazer East commenced an action in the U.S. District Court for the Southern District of New York, which sought a judicial determination on the allocation of liability for the Everett Facility. A confidential settlement agreement has been executed on favorable terms to KeySpan and the Beazer lawsuit has been discontinued.

In 2004, KeySpan reached a settlement with insurance carriers regarding cost recovery for expenses at one of the above noted sites and recorded an $11.6 million reduction to operating expenses. We presently estimate the remaining cost of our environmental cleanup activities for the three non-utility sites will be approximately $19.7 million, which amount has been accrued by us as a reasonable estimate of probable costs for known sites, however remediation costs for each site may be materially higher than noted, depending upon changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered. Expenditures incurred since November 8, 2000, with respect to these sites total $13.1 million.

We believe that in the aggregate, the accrued liability for these MGP sites and related facilities identified above are reasonable estimates of the probable cost for the investigation and remediation of these sites and facilities. As circumstances warrant, we periodically re-evaluate the accrued liabilities associated with MGP sites and related facilities. We may be required to investigate and, if necessary, remediate each site previously noted, or other currently unknown former sites and related facility sites, the cost of which is not presently determinable but may be material to our financial position, results of operations or cash flows.

Insurance Reimbursement of MGP Response Costs: We have instituted lawsuits in New York, Massachusetts and New Hampshire against numerous insurance carriers for reimbursement of costs incurred for the investigation and remediation of these MGP sites.

In January 1998 and July 2001, KEDLI and KEDNY, respectively, filed complaints for the recovery of its remediation costs in the New York State Supreme Court against the various insurance companies that issued general comprehensive liability policies to KEDLI and KEDNY. The outcome of these proceedings cannot yet be determined.

In March 1999, Boston Gas Company and a subsidiary of National Grid filed a complaint for the recovery of remediation costs in the Massachusetts Superior Court against various insurance companies that issued comprehensive general liability policies to National Grid and its predecessors with respect to, among other things, the 11 sites for which Boston Gas Company has agreed to make a limited contribution. And in October 2002, Boston Gas Company filed a complaint in the United States District Court – Massachusetts District against one of the insurance companies that issued comprehensive general liability policies to Boston Gas Company for its remaining sites. On November 14, 2005, the trial commenced on the declaratory judgment action of Boston Gas against Century Indemnity for insurance coverage for the costs incurred in the investigation and remediation at the former Boston Gas Everett MGP site and on December 6, 2005, the jury returned a verdict in favor of KeySpan. KeySpan anticipates that Century Indemnity will appeal this verdict. The outcome of these proceedings cannot yet be determined.

EnergyNorth has filed a number of lawsuits in both the New Hampshire Superior Court and the United States District Court for the District of New Hampshire for recovery of its remediation costs against the various insurance companies that issued comprehensive general liability and excess liability insurance policies to EnergyNorth and its predecessors. On October 5, 2004, EnergyNorth's case against the London Market Insurers for the costs incurred investigating and remediating the former MGP site in Laconia went to trial and on October 25, 2004, the jury returned a verdict in favor of EnergyNorth, finding that EnergyNorth was entitled to recover against London Market Insurers. The precise amount of the recovery will depend on the allocation calculations which the court has yet to apply to this case. We anticipate that London Market Insurers will appeal this verdict. On February 15, 2005, the trial of EnergyNorth's coverage action for the Dover MGP site began against the only remaining defendant, Century Indemnity (all other carriers settled prior to trial) and at the conclusion of the trial the federal judge directed a verdict in EnergyNorth's favor on all issues. Century filed an appeal with the First Circuit Court of Appeals and oral argument on Century's appeal was on January 13, 2006. A jury trial in the Nashua MGP action commenced against the London Market Insurers and Century Indemnity on November 1, 2005 and on November 14, 2005, the jury returned a verdict in favor of KeySpan finding that London and Century was obligated

to indemnify EnergyNorth for response costs incurred at the site. We anticipate that the carriers will appeal this verdict. The outcome of these proceedings cannot yet be determined.

In 1993 KeySpan New England LLC filed a declaratory judgment action against the Hanover and Travelers insurance companies in the Superior Court for Middlesex County for the Everett Facility ("the Eastern Action"). Eastern sought to have the court compel the Insurers to defend Eastern in connection with the Massachusetts DEP's Notice of Responsibility ("NOR"). In 2004, the Court granted KeySpan's unopposed motion for leave to file a Second Amended Complaint in the Eastern Action to seek a declaratory ruling that the insurers have a duty to indemnify KeySpan for the costs associated with the Everett NOR and certain other related private actions. The Second Amended Complaint also adds certain excess insurance carriers as defendants in the Eastern Action. The outcome of this proceeding cannot yet be determined.

Note 8. Hedging, Derivative Financial Instruments and Fair Values

Financially-Settled Commodity Derivative Instruments – Hedging Activities: From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas distribution operations, gas exploration and production activities and its electric generating facilities at the Ravenswood site.

Derivative financial instruments are employed by our gas distribution operations to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases for our regulated firm gas sales customers. The accounting for these derivative instruments is subject to SFAS 71. See the caption below "Firm Gas Sales Derivative Instruments – Regulated Utilities" for a further discussion of these derivatives. During 2005 our gas distribution operations employed certain derivative instruments associated with large-volume customers that were not subject to SFAS 71. Those derivative financial instruments settled by year-end.

Seneca-Upshur utilizes OTC natural gas swaps to hedge the cash flow variability associated with forecasted sales of a portion of its natural gas production. At December 31, 2005, Seneca-Upshur has hedge positions in place for approximately 85% of its estimated 2005 through 2008 gas production, net of gathering costs. We use market quoted forward prices to value these swap positions. The maximum length of time over which Seneca-Upshur has hedged such cash flow variability is through December 2008. The fair value of these derivative instruments at December 31, 2005 was a liability of $21.8 million. The estimated amount of losses associated with such derivative instruments that are reported in other comprehensive income and that are expected to be reclassified into earnings over the next twelve months is $9.2 million, or approximately $6.0 million after-tax. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial at December 31, 2005.

The Ravenswood Generating Station uses derivative financial instruments to hedge the cash flow variability associated with the purchase of natural gas or fuel oil that will be consumed during the generation of electricity. The Ravenswood Generating Station also hedges the cash flow variability associated with a portion of electric energy sales.

With respect to price exposure associated with fuel purchases for the Ravenswood Generating Station, KeySpan employed the use of financially-settled oil swap contracts to hedge the cash flow variability for a portion of forecasted purchases of fuel oil that was consumed by the Ravenswood Generating Station. We use market quoted forward prices to value oil swap contracts. The maximum length of time over which we have hedged cash flow variability associated with forecasted purchases of fuel oil is through June 2006. The fair value of these derivative instruments at December 31, 2005 was $0.3 million, which is reported in other comprehensive income and is expected to be reclassified into earnings within the next twelve months. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial at December 31, 2005.

We have also engaged in the use of cash-settled swap instruments to hedge the cash flow variability associated with a portion of forecasted electric energy sales from the Ravenswood Generating Station. Our hedging strategy is to hedge at least 50% of forecasted on-peak summer season electric energy sales and a portion of forecasted electric energy sales for the remainder of the year. The maximum length of time over which we have hedged cash flow variability is through August 2006. To accomplish our stated hedging strategy, KeySpan employs financially-settled electric-power swap contracts with offsetting financially-settled oil swap contracts and OTC natural gas swaps. We use market quoted forward prices to value the electric-power swap contracts. The fair value of these derivative instruments at December 31, 2005 was $9.5 million all of which is expected to be reclassified into earnings within the next twelve months. We use market quoted forward prices to value the oil swap contracts. The fair value of these derivative instruments at December 31, 2005 was a liability of $6.6 million all of which is expected to be reclassified into earnings within the next twelve months. We use market quoted forward prices to value the gas swap contracts. The fair value of these derivative instruments at December 31, 2005 was $0.5 million all of which is expected to be reclassified into earnings within the next twelve months. The after-tax benefit of these derivative instruments is anticipated to be $2.2 million. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial at December 31, 2005.

The above noted derivative financial instruments are cash flow hedges that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," collectively SFAS 133, and are not considered held for trading purposes as defined by current accounting literature. Accordingly, we carry the fair value of our derivative instruments on the Consolidated

Balance Sheet as either a current or deferred asset or liability, as appropriate, and defer the effective portion of unrealized gains or losses in accumulated other comprehensive income. Gains and losses are reclassified from accumulated other comprehensive income to the Consolidated Statement of Income in the period the hedged transaction affects earnings. Gains and losses are reflected as a component of either revenue or fuel and purchased power depending on the hedged transaction. Hedge ineffectiveness, which was negligible for the year ended December 31, 2005, results from changes during the period in the price differentials between the index price of the derivative contract and the price of the purchase or sale for the cash flow that is being hedged, and is recorded directly to earnings.

Firm Gas Sales Derivative Instruments – Regulated Utilities: We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. The accounting for these derivative instruments is subject to SFAS 71. Therefore, changes in the fair value of these derivatives have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements. At December 31, 2005, these derivatives had a fair value of $157.6 million and are reflected as a current asset of $131.6 million and a deferred asset of $26.0 million, with offsetting positions in regulatory liabilities and deferred credits of $146.5 million and $11.1 million, respectively on the Consolidated Balance Sheet.

Physically-Settled Commodity Derivative Instruments: SFAS 133 establishes criteria that must be satisfied in order for option contracts, forward contracts with optionality features, or contracts that combine a forward contract and a purchase option contract to be exempted as normal purchases and sales. Certain contracts for the physical purchase of natural gas associated with our regulated gas utilities are not exempt as normal purchases from the requirements of SFAS 133. Since these contracts are for the purchase of natural gas sold to regulated firm gas sales customers, the accounting for these contracts is subject to SFAS 71. Therefore, changes in the market value of these contracts have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. At December 31, 2005, these derivatives had a fair value of $18.4 million and are reflected as a deferred asset of $49.2 million and a regulatory asset of $30.9 million with offsetting positions in regulatory liabilities, current liabilities and deferred credits of $28.9 million, $30.6 million and $20.6 million, respectively on the Consolidated Balance Sheet.

The table below summarizes the fair value of the above outstanding derivative instruments at December 31, 2005 and December 31, 2004, and the related line item on the Consolidated Balance Sheet. Fair value is the amount at which derivative instruments could be exchanged in a current transaction between willing parties, other than in a forced liquidation sale.

	(In Millions of Dollars)	
DECEMBER 31,	**2005**	**2004**
Gas Contracts:		
Other current assets	$132.1	$ —
Other deferred charges	75.2	21.7
Regulatory asset	30.9	20.1
Other current liability	(39.8)	—
Other deferred liabilities	(44.3)	(43.9)
Regulatory liability	(175.4)	(7.4)
Oil Contracts:		
Other current assets	0.5	0.3
Other deferred charges	—	7.5
Other current liability	(6.8)	—
Electric Contracts:		
Other current assets	10.2	0.3
Other current liability	(0.7)	—
	$ (18.1)	$(1.4)

Financially-Settled Commodity Derivative Instruments that Do Not Qualify for Hedge Accounting: KeySpan subsidiaries also have employed a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133. During 2004, we purchased a series of call options on the spread between the price of heating oil and the price of natural gas to further complement our hedging strategy regarding sales to certain large-volume customers. As stated, these positions settled prior to year end. In addition, the Ravenswood Generating Station sold a three year option for 30-day peaking gas service. The 30-day peaking gas service is for the following three winter seasons: October 2004 – March 2005, October 2005 – March 2006 and October 2006 – March 2007. For each of these winter seasons, the counterparty can call on the Ravenswood Generating Station to supply no more than 30,000 Mdth of a gas a day for no more than 30 days. We recorded a $0.8 million gain in other income and deductions on the Consolidated Statement of Income to reflect the change in the market value associated with this derivative instrument for the twelve months ended December 31, 2005.

Interest Rate Derivative Instruments: In January 2005, KeySpan redeemed $500 million of outstanding debt – 6.15% Notes due 2006, and accelerated the amortization of approximately $11.2 million of previously unamortized benefits associated with an interest rate swap on these notes that was previously settled. The accelerated amortization was recorded as a reduction to interest expense. (See Note 6 "Long-term Debt and Commercial Paper" for additional details regarding the debt redemption.) There were no interest rate derivative instruments outstanding at December 31, 2005.

Weather Derivatives: The utility tariffs associated with KEDNE's operations do not contain weather normalization adjustments. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations.

In 2005, we entered into heating-degree day put options to mitigate the effect of fluctuations from normal weather on KEDNE's financial position and cash flows for the 2005/2006 winter heating season – November 2005 through March 2006. These put options will pay KeySpan up to $40,000 per heating degree day when the actual temperature is below 4,169 heating degree days, or approximately 5% warmer than normal, based on the most recent 20-year average for normal weather. The maximum amount KeySpan will receive on these purchased put options is $16 million. The net premium cost for these options is $1.2 million and will be amortized over the heating season. Since weather was near normal during the fourth quarter of 2005, there was no earnings impact associated with these derivative instruments other than the premium cost for purchasing the options. We account for these derivatives pursuant to the requirements of EITF 99-2, "Accounting for Weather Derivatives." In this regard, such instruments are accounted for using the "intrinsic value method" as set forth in such guidance.

In 2004, we entered into heating-degree day put options to mitigate the effect of fluctuations from normal weather on KEDNE's financial position and cash flows for the 2004/2005 winter heating season – November 2004 through March 2005. These put options would have paid KeySpan up to $40,000 per heating degree day when the actual temperature was below 4,130 heating degree days, or approximately 5% warmer than normal, based on the most recent 20-year average for normal weather. The maximum amount KeySpan would have received on these purchased put options was $16 million. The net premium cost for these options was $1.6 million and was amortized over the heating season. Since weather was colder than normal during the first quarter of 2005, there was no earnings impact associated with these derivative instruments other than the premium cost for purchasing the options.

Credit and Collateral: Derivative contracts are primarily used to manage exposure to market risk arising from changes in commodity prices and interest rates. In the event of non-performance by a counterparty to a derivative contract, the desired impact may not be achieved. The risk of counterparty non-performance is generally considered a credit risk and is actively managed by assessing each counterparty credit profile and negotiating appropriate levels of collateral and credit support. In instances where the counterparties' credit quality has declined, or credit exposure exceeds certain levels, we may limit our credit exposure by restricting new transactions with counterparties, requiring additional collateral or credit support and negotiating the early termination of certain agreements. At December 31, 2005, KeySpan has received $13.2 million from its counterparties as collateral associated with outstanding derivative contracts. This amount has been recorded as restricted cash, with an offsetting position in current liabilities on the Consolidated Balance Sheet. Further, KeySpan has paid $8.9 million in margin calls to its counterparties. This amount has been recorded as an accounts receivable on the December 31, 2005 Consolidated Balance Sheet.

We believe that our credit risk related to the above mentioned derivative financial instruments is no greater than the risk associated with the primary contracts which they hedge and that the elimination of a portion of the price risk reduces volatility in our reported results of operations, financial position and cash flows and lowers overall business risk.

Long-term Debt: The following tables depict the fair values and carrying values of KeySpan's long-term debt at December 31, 2005 and 2004.

Fair Values of Long-Term Debt

	(In Millions of Dollars)	
DECEMBER 31,	**2005**	**2004**
First Mortgage Bonds	$ 114.1	$ 115.8
Notes	2,692.1	2,571.8
Gas Facilities Revenue Bonds	651.3	666.9
Authority Financing Notes	66.0	66.0
Promissory Notes	156.6	159.8
MEDS Equity Units	—	480.0
Master Lease	430.5	460.9
Tax Exempt Bonds	130.8	135.0
	$4,241.4	$4,656.2

Carrying Values of Long-Term Debt

	(In Millions of Dollars)	
DECEMBER 31,	**2005**	**2004**
First Mortgage Bonds	$ 95.0	$ 95.0
Notes	2,437.2	2,485.0
Gas Facilities Revenue Bonds	640.5	640.5
Authority Financing Notes	66.0	66.0
Promissory Notes	155.4	155.4
MEDS Equity Units	—	460.0
Master Lease	412.3	412.3
Tax Exempt Bonds	128.3	128.3
	$3,934.7	$4,442.5

Our subsidiary debt was carried at an amount approximating fair value because interest rates are based on current market rates. All other financial instruments included in the Consolidated Balance Sheet such as cash, commercial paper, accounts receivable and accounts payable, are also stated at amounts that approximate fair value.

Note 9. Gas Exploration and Production Property – Depletion

As described in Note 2 "Business Segments," during much of 2004 KeySpan's investment in gas exploration and production activities consisted of its ownership interest in Houston Exploration, as well as KeySpan's wholly-owned subsidiary KeySpan Exploration and Production, which is still engaged in a joint drilling program with Houston Exploration. Further, KeySpan's investment in these activities also includes its wholly-owned subsidiary Seneca-Upshur. These assets are accounted for under the full cost method of accounting. Under the full cost method, costs of acquisition, exploration and development of natural gas and oil reserves plus asset retirement obligations are capitalized into a "full cost pool" as incurred. Unproved properties and related costs are excluded from the depletion and amortization base until a determination as to the existence of proved reserves. Properties are depleted and charged to operations using the unit of production method.

To the extent that such capitalized costs (net of accumulated depletion) less deferred taxes exceed the present value (using a 10% discount rate) of estimated future net cash flows from proved natural gas and oil reserves and the lower of cost or fair value of unproved properties, less deferred taxes, such excess costs are charged to operations, but would not have an impact on cash flows. Once incurred, such impairment of gas properties is not reversible at a later date even if prices increase. The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, adjusted for outstanding derivative instruments, held flat over the life of the reserves.

As a result of the June 2004 stock transaction discussed in Note 2 "Business Segments", KeySpan accounted for its investment in Houston Exploration on the equity method from June 2004 through November 19, 2004. Therefore, we were required to calculate a ceiling test on KeySpan Exploration and Production's and Seneca-Upshur's assets independently of Houston Exploration's assets in the second quarter of 2004. Based on a report furnished by an independent reservoir engineer at that time, it was determined that the remaining proved undeveloped oil reserves held in the joint venture required a substantial investment in order to develop. Therefore, KeySpan and Houston Exploration elected not to develop these oil reserves. As a result, in the second quarter of 2004, KeySpan recorded a $48.2 million non-cash impairment charge to write down its wholly-owned gas exploration and production subsidiaries' assets. This charge was recorded in depreciation, depletion and amortization on the Consolidated Statement of Income.

Note 10. Energy Services – Discontinued Operations

In 2004, the Energy Services segment experienced significantly lower operating profits and cash flows than originally projected. At a meeting held on November 2, 2004, KeySpan's Board of Directors authorized management to begin the process of disposing of a significant portion of its ownership interests in certain companies within the Energy Services segment – specifically those companies engaged in mechanical contracting activities. In January and February of 2005, KeySpan sold its mechanical contracting investments. The operating results and financial position of these companies, are reflected as discontinued operations on the Consolidated Statement of Income, Consolidated Balance Sheet and Consolidated Statement of Cash Flows.

In regard to the January 2005 transactions, KeySpan received proceeds of approximately $16 million, including approximately $5 million to be paid within a three year period. In addition, KeySpan retained its previously incurred indemnity support obligations related to certain surety, performance and payment bonds issued for the benefit of KeySpan's former subsidiaries prior to closing. In June 2005, the balance to be paid over the three year period was fully collected on a present value basis and a significant portion of the performance bonds were replaced without any remaining indemnification obligation on the part of KeySpan. The current estimated cost to complete projects supported by such indemnity obligations is approximately $0.2 million. The buyers have agreed to complete the projects for which such indemnity obligations were incurred and to indemnify and hold KeySpan harmless with respect to its liabilities in connection with such bonds.

In connection with the February 2005 transaction, KeySpan paid or contributed approximately $26 million to its former subsidiary prior to closing the sale transaction in exchange for, among other things, the disposition of outstanding shares in the former subsidiary and the settlement of intercompany advances and replacement of a performance and payment bond issued for the benefit of its former subsidiary with respect to a pending project, which bond had been supported by a $150 million indemnity obligation of KeySpan. In addition, KeySpan received from its former subsidiary an indemnity bond issued by a third party insurance company, the purpose of which is to reimburse KeySpan in an amount up to $80 million in the event it is required to perform under all other indemnity obligations previously incurred by KeySpan to support the remaining bonded projects of its former subsidiary as of the closing. As of December 31, 2005, the total cost to complete such remaining bonded projects is estimated to be approximately $40 million. The aforementioned guarantees are reflected in Note 7 "Contractual Obligations, Financial Guarantees and Contingencies". KeySpan's former subsidiary has also agreed to complete the projects for which such indemnity obligations were incurred and to indemnify and hold KeySpan harmless with respect to its liabilities in connection with such bonds.

In anticipation of these sales and in connection with the preparation of the third quarter and fourth quarter 2004 financial statements, KeySpan conducted an evaluation of the carrying value of these investments, including recorded goodwill. Further, we evaluated the carrying

value of goodwill for the entire Energy Services segment. As noted, KeySpan records goodwill on purchased transactions, representing the excess of acquisition cost over the fair value of net assets acquired.

As a result of these evaluations, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on Energy Services segment's continuing operations; and (ii) $93.9 million ($67.8 million after-tax) as discontinued operations reflecting the impairment on the mechanical contracting companies.

In addition, an impairment charge of $100.3 million ($72.1 million after-tax or $0.45 per share) was also recorded in 2004 to reduce the carrying value of the remaining assets of the mechanical contracting companies. This charge is reflected in discontinued operations on the Consolidated Statement of Income to reflect the estimated loss on disposal.

KeySpan employed a combination of two methodologies in determining the estimated fair value for its investment in the Energy Services segment, a market valuation approach and an income valuation approach. Under the market valuation approach, KeySpan utilized a range of near-term potential realizable values for the mechanical contracting businesses. Under the income valuation approach, the fair value was obtained by discounting the sum of (i) the expected future cash flows and (ii) the terminal value. KeySpan utilized certain significant assumptions in this valuation, specifically the weighted-average cost of capital, short and long-term growth rates and expected future cash flows. Approximately $65 million of goodwill remains in this segment.

The information below highlights the major classes of assets and liabilities of the discontinued mechanical contracting companies, as well as major income and expense captions.

	(In Millions of Dollars)
DECEMBER 31,	**2004**
Property	$ 8.7
Current assets	$42.9
Current liabilities	$64.2

			(In Millions of Dollars)
FOR THE YEAR ENDED DECEMBER 31,	**2005**	**2004**	**2003**
Revenues	$33.8	$ 338.7	$379.6
Less:			
Operating expenses	40.2	364.9	385.5
Goodwill impairment	—	108.3	—
	(6.4)	(134.5)	(5.9)
Income taxes (benefit)	(2.3)	(55.5)	(4.0)
Operating income (loss)	(4.1)	(79.0)	(1.9)
Gain (Loss) on disposal, net of tax	2.3	(72.0)	—
Net (Loss)	$ (1.8)	$(151.0)	$ (1.9)

Note 11. 2006 LIPA Settlement

LIPA is a corporate municipal instrumentality and a political subdivision of the State of New York. On May 28, 1998, certain of LILCO's business units were merged with KeySpan and LILCO's common stock and remaining assets were acquired by LIPA. At the time of this transaction, KeySpan and LIPA entered into three major long-term service agreements that (i) provide to LIPA all operation, maintenance and construction services and significant administrative services relating to the Long Island electric transmission and distribution ("T&D") system pursuant to a Management Services Agreement (the "1998 MSA"); (ii) supply LIPA with electric generating capacity, energy conversion and ancillary services from our Long Island generating units pursuant to a Power Supply Agreement (the "1998 PSA") and other long-term agreements through which we provide LIPA with approximately one half of its customers' energy needs; and (iii) manage all aspects of the fuel supply for our Long Island generating facilities, as well as all aspects of the capacity and energy owned by or under contract to LIPA pursuant to an Energy Management Agreement (the "1998 EMA"). We also purchase energy, capacity and ancillary services in the open market on LIPA's behalf under the 1998 EMA. The 1998 MSA, 1998 PSA and 1998 EMA all became effective on May 28, 1998 and are collectively referred to as the 1998 LIPA Agreements.

On February 1, 2006, KeySpan and LIPA entered into (i) an amended and restated Management Services Agreement (the "2006 MSA"), pursuant to which KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island; (ii) 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; and (iii) a Settlement Agreement (the "2006 Settlement Agreement") resolving outstanding issues between the parties regarding the 1998 LIPA Agreements. The 2006 MSA, the 2006 Option Agreement and the 2006 Settlement Agreement are collectively referred to herein as the "2006 LIPA Agreements". Each of the 2006 LIPA Agreements will become effective as of January 1, 2006 upon all of the 2006 LIPA Agreements receiving the required governmental approvals; otherwise none of the 2006 LIPA Agreements will become effective.

2006 Settlement Agreement

Pursuant to the terms of the 2006 Settlement Agreement, KeySpan and LIPA agreed to resolve issues that have existed between the parties relating to the various 1998 LIPA Agreements. In addition to the resolution of these matters, KeySpan's entitlement to utilize LILCO's available tax credits and other tax attributes will increase from approximately $50 million to approximately $200 million. These credits and attributes may be used to satisfy KeySpan's previously incurred indemnity obligation to LIPA for any federal income tax liability that may result from the settlement of a pending Internal revenue Service ("IRS") audit for LILCO's tax year ended March 31, 1999. In recognition of these items, as well as for the modification and extension of the 1998 MSA and the elimination of the GPRA,

upon effectiveness of the Settlement Agreement KeySpan will record a contractual asset in the amount of approximately $160 million, of which approximately $110 million will be attributed to the right to utilize such additional tax credits and attributes and approximately $50 million will be amortized over the eight year term of the 2006 MSA. In order to compensate LIPA for the foregoing, KeySpan will pay LIPA $69 million in cash and will settle certain accounts receivable in the amount of approximately $90 million due from LIPA.

Generation Purchase Rights Agreement and 2006 Option Agreement.

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 has the option during the period January 1, 2006 to December 31, 2006 to purchase only 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. The 2006 Option Agreement replaces the GPRA, the expiration of which has been stayed pending effectiveness of the 2006 LIPA Agreements. In the event such agreements do not become effective by reason of failure to secure the requisite governmental approvals, the GPRA will be reinstated for a period of 90 days. 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 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.

Management Services Agreements

In place of the previous compensation structure (whereby KeySpan was reimbursed for budgeted costs, and earned a management fee and certain performance and cost-based incentives), KeySpan's compensation for managing the T&D System under the 2006 MSA consists of two components: a minimum compensation component of $224 million per year and a variable component based on electric sales. The $224 million component will remain unchanged for three years and then increase annually by 1.7%, plus inflation. The variable component, which will comprise no more than 20% of KeySpan's compensation, is based on electric sales on Long Island exceeding a base amount of 16,558 gigawatt hours, increasing by 1.7% in each year. Above that level, KeySpan will receive approximately 1.34 cents per kilowatt hour for the first contract year, 1.29 cents per kilowatt hour in the second contract year (plus an annual inflation adjustment), 1.24 cents per kilowatt hour in the third contract year (plus an annual inflation adjustment), with the per kilowatt hour rate thereafter adjusted annually by inflation. Subject to certain limitations, KeySpan will be able to retain all operational efficiencies realized during the term of the 2006 MSA.

LIPA will continue to reimburse KeySpan for certain expenditures incurred in connection with the operation and maintenance of the T&D System, and other payments made on behalf of LIPA, including: real property and other T&D System taxes, return postage, capital construction expenditures and storm costs.

Note 12. Subsequent Events

On February 25, 2006, KeySpan entered into an Agreement and Plan of Merger (the "Merger Agreement"), with National Grid PLC, a public limited company incorporated under the laws of England and Wales ("Parent") and National Grid USA, Inc., a New York Corporation ("Merger Sub"), pursuant to which Merger Sub will merge with and into KeySpan (the "Merger"), with KeySpan continuing as the surviving company. Pursuant to the Merger Agreement, at the effective time of the Merger, each outstanding share of common stock, par value $0.01 per share of KeySpan (the "Shares"), other than shares owned by KeySpan, shall be canceled and shall be converted into the right to receive $42.00 in cash, without interest.

Consummation of the Merger is subject to various closing conditions, including but not limited to the satisfaction or waiver of conditions regarding the receipt of requisite regulatory approvals and the adoption of the Merger Agreement by the stockholders of KeySpan and the Parent. Assuming receipt or waiver of the foregoing, it is currently anticipated that the Merger will be consummated in early 2007. However, no assurance can be given that the Merger will occur, or, the timing of its completion.

Financial Swap Agreement for In-City Unforced Capacity

Currently, the NYISO's New York City local reliability rules require that 80% of the electric capacity needs of New York City be provided by "in-City" generators. On February 6, 2006, the NYISO Operating Committee increased the "in-City" generator requirement to 83% beginning in May 2006 through the period ending on April 2007, based in part on the statewide reserve margin of 118% set by the New York State Reliability Council. On February 16, 2006, an appeal was filed with the NYISO Management Committee requesting that the February 6th decision be rejected and that the "in-City" requirement be increased to a larger percentage than 83%. A vote on this appeal is expected to occur at the NYISO Management Committee meeting scheduled for February 28, 2006.

Our Ravenswood Generating Station is an "in-City" generator. As the electric infrastructure in New York City and the surrounding areas continues to change and evolve and the demand for electric power increases, the "in-City" generator requirement could be further modified. Construction of new transmission and generation facilities may cause significant changes to the market for sales of capacity, energy and ancillary services from our Ravenswood Generating Station. Recently 500 MW of

capacity came on line and it is anticipated that another 500 MW of new capacity may be available during 2006 as a result of the completion of an in-City generation project currently under construction. We can not, however, be certain as to when the new power plant will be in operation or the nature of future New York City energy, capacity or ancillary services market requirements or design.

Notwithstanding the foregoing, KeySpan continues to believe that New York City represents a strong capacity market and has entered into an International SWAP Dealers Association Master Agreement for a fixed for float unforced capacity financial swap (the "Agreement") with Morgan Stanley Capital Group Inc. ("Morgan Stanley") dated as of January 18, 2006. The Agreement has a three year term beginning May 1, 2006, (assuming a condition to effectiveness has been satisfied by such date). The notional quantity is 1,800,000kW (the "Notional Quantity") of In-City Unforced Capacity and the fixed price is $7.57/kW-month ("Fixed Price"), subject to adjustment upon the occurrence of certain events. Cash settlement will occur on a monthly basis based on the In-City Unforced Capacity price determined by the relevant New York Independent System Operator Spot Demand Curve Auction Market ("Floating Price"). For each monthly settlement period, the price difference will equal the Fixed Price minus the Floating Price. If such price difference is less than zero, Morgan Stanley will pay KeySpan an amount equal to the product of (a) the Notional Quantity and (b) the absolute value of such price difference. Conversely, if such price difference is greater than zero, KeySpan will pay Morgan Stanley an amount equal to the product of (a) the Notional Quantity and (b) the absolute value of such price difference. KeySpan believes that the average annual monthly capacity market price will settle above the Fixed Price. This derivative instrument will not qualify for hedge accounting treatment under SFAS 133 and will be subject to mark-to-market accounting treatment.

Note 13. KeySpan Gas East Corporation Summary Financial Data

KEDLI is a wholly owned subsidiary of KeySpan. KEDLI was formed on May 7, 1998 and on May 28, 1998 acquired substantially all of the assets related to the gas distribution business of LILCO. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway peninsula of Queens county. KEDLI established a program for the issuance, from time to time, of up to $600 million aggregate principal amount of Medium-Term Notes, which will be fully and unconditionally guaranteed by the parent, KeySpan Corporation. On February 1, 2000, KEDLI issued $400 million of 7.875% Medium-Term Notes due 2010. In January 2001, KEDLI issued an additional $125 million of Medium-Term Notes at 6.9% due January 2008. The following condensed financial statements are required to be disclosed by SEC regulations and set forth those of KEDLI, KeySpan Corporation as guarantor of the Medium-Term Notes and our other subsidiaries on a combined basis.

Statement of Income

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2005	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Revenues	$ 0.6	$1,432.9	$6,229.1	$ (0.6)	$7,662.0
Operating Expenses					
Purchased gas	—	963.0	2,634.3	—	3,597.3
Fuel and purchased power	—	—	752.1	—	752.1
Operations and maintenance	22.0	133.5	1,462.4	—	1,617.9
Intercompany expense	—	4.8	(4.2)	(0.6)	—
Depreciation and amortization	—	76.9	319.7	—	396.6
Operating taxes	0.1	65.9	341.0	—	407.0
Total Operating Expenses	22.1	1,244.1	5,505.3	(0.6)	6,770.9
Gain on sale of property	—	—	1.6	—	1.6
Income from equity investments	—	—	15.1	—	15.1
Operating Income (Loss)	(21.5)	188.8	740.5	—	907.8
Interest charges	(144.5)	(61.9)	(83.9)	21.0	(269.3)
Other income and (deductions)	523.8	2.9	(81.3)	(446.0)	(0.6)
Total Other Income and (Deductions)	379.3	(59.0)	(165.2)	(425.0)	(269.9)
Income Taxes (Benefit)	(32.4)	48.2	223.5	—	239.3
Earnings from Continuing Operations	390.2	81.6	351.8	(425.0)	398.6
Discontinued Operations	—	—	(1.8)	—	(1.8)
Cumulative Change in Accounting Principal	—	(0.2)	(6.4)	—	(6.6)
Net Income	$390.2	$ 81.4	$ 343.6	$(425.0)	$ 390.2

Statement of Income

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2004	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Revenues	$ 0.6	$1,124.4	$5,526.1	$ (0.6)	$6,650.5
Operating Expenses					
Purchased gas	—	664.9	1,999.6	—	2,664.5
Fuel and purchased power	—	—	540.3	—	540.3
Operations and maintenance	5.3	137.8	1,423.9	—	1,567.0
Intercompany expense	—	5.4	(5.4)	—	—
Depreciation and amortization	—	79.9	471.9	—	551.8
Operating taxes	—	65.7	338.4	—	404.1
Goodwill Impairment	—	—	41.0	—	41.0
Total Operating Expenses	5.3	953.7	4,809.7	—	5,768.7
Gain on sale of property	—	—	7.0	—	7.0
Income from equity investments	—	—	46.5	—	46.5
Operating Income (Loss)	(4.7)	170.7	769.9	(0.6)	935.3
Interest charges	(204.5)	(61.5)	(267.7)	202.4	(331.3)
Other income and (deductions)	635.4	0.8	423.9	(723.9)	336.2
Total Other Income and (Deductions)	430.9	(60.7)	156.2	(521.5)	4.9
Income Taxes (Benefit)	(45.5)	35.8	335.2	—	325.5
Earnings from Continuing Operations	471.7	74.2	590.9	(522.1)	614.7
Discontinued Operations	—	—	(151.0)	—	(151.0)
Net Income	$471.7	$ 74.2	$ 439.9	$(522.1)	$ 463.7

Statement of Income

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2003	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Revenues	$ 0.5	$1,046.9	$5,488.6	$ (0.5)	$6,535.5
Operating Expenses					
Purchased gas	—	574.0	1,921.1	—	2,495.1
Fuel and purchased power	—	—	414.6	—	414.6
Operations and maintenance	11.3	137.2	1,474.1	—	1,622.6
Intercompany expense	5.3	3.6	(3.6)	(5.3)	—
Depreciation and amortization	—	77.6	494.1	—	571.7
Operating taxes	—	77.5	340.7	—	418.2
Total Operating Expenses	16.6	869.9	4,641.0	(5.3)	5,522.2
Gain on sale of property	—	14.0	1.1	—	15.1
Income from equity investments	0.1	—	19.1	—	19.2
Operating Income (Loss)	(16.0)	191.0	867.8	4.8	1,047.6
Interest charges	(209.5)	(63.0)	(299.4)	264.2	(307.7)
Other income and (deductions)	621.1	(8.6)	54.3	(699.4)	(32.6)
Total Other Income and (Deductions)	411.6	(71.6)	(245.1)	(435.2)	(340.3)
Income Taxes (Benefit)	(28.7)	40.8	269.2	—	281.3
Earnings from Continuing Operations	424.3	78.6	353.5	(430.4)	426.0
Discontinued Operations	—	—	(1.9)	—	(1.9)
Cumulative Change in Accounting Principle	—	—	(37.4)	—	(37.4)
Net Income	$424.3	$ 78.6	$ 314.2	$(430.4)	$ 386.7

Balance Sheet

(In Millions of Dollars)

DECEMBER 31, 2005	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Assets					
Current Assets					
Cash and temporary cash investments	$ 79.6	$ 3.5	$ 41.4		$ 124.5
Accounts receivable, net	0.6	149.9	822.2		972.7
Other current assets	4.0	368.9	1,550.0		1,922.9
	84.2	522.3	2,413.6	—	3,020.1
Investments and Other	4,571.0	0.7	128.2	(4,457.5)	242.4
Property					
Gas	—	—	7,275.9		7,275.9
Other	—	2,111.3	981.5		3,092.8
Accumulated depreciation and depletion	—	(400.6)	(2,631.2)		(3,031.8)
	—	1,710.7	5,626.2	—	7,336.9
Intercompany Accounts Receivable	2,813.6	44.6	95.6	(2,953.8)	—
Deferred Charges	482.5	316.1	2,414.6		3,213.2
Total Assets	$7,951.3	$2,594.4	$10,678.2	$(7,411.3)	$13,812.6
Liabilities and Capitalization					
Current Liabilities					
Accounts payable	$ 36.4	$ 149.7	$ 900.9		$ 1,087.0
Commercial paper	657.6	—	—		657.6
Other current liabilities	196.2	128.5	85.9		410.6
	890.2	278.2	986.8	—	2,155.2
Intercompany Accounts Payable	51.8	338.3	1,049.8	(1,439.9)	—
Deferred Credits and Other Liabilities					
Deferred income tax	27.2	330.6	800.1		1,157.9
Other deferred credits and liabilities	634.0	225.3	1,240.0		2,099.3
	661.2	555.9	2,040.1	—	3,257.2
Capitalization					
Common shareholders' equity	4,485.4	897.0	3,539.3	(4,457.6)	4,464.1
Long-term debt	1,862.7	525.0	3,046.9	(1,513.8)	3,920.8
Total Capitalization	6,348.1	1,422.0	6,586.2	(5,971.4)	8,384.9
Minority Interest in Consolidated Companies	—	—	15.3	—	15.3
Total Liabilities and Capitalization	$7,951.3	$2,594.4	$10,678.2	$(7,411.3)	$13,812.6

Balance Sheet

(In Millions of Dollars)

DECEMBER 31, 2004	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Assets					
Current Assets					
Cash and temporary cash investments	$ 580.7	$ (0.9)	$ 342.2	$ —	$ 922.0
Accounts receivable, net	0.8	223.6	1,087.6	—	1,312.0
Other current assets	4.5	146.5	650.7	—	801.7
Assets of discontinued operations	—	—	42.9		42.9
	586.0	369.2	2,123.4	—	3,078.6
Investments and Other	4,567.3	2.0	169.1	(4,465.5)	272.9
Property					
Gas	—	1,998.5	4,872.7	—	6,871.2
Other	—	—	2,987.8	—	2,987.8
Accumulated depreciation and depletion	—	(334.5)	(2,465.3)	—	(2,799.8)
Property of discontinued operations	—	—	8.7		8.7
	—	1,664.0	5,403.9	—	7,067.9
Intercompany Accounts Receivable	2,485.7	—	1,292.2	(3,777.9)	—
Deferred Charges	381.3	221.4	2,342.0	—	2,944.7
Total Assets	$8,020.3	$2,256.6	$11,330.6	$(8,243.4)	$13,364.1
Liabilities and Capitalization					
Current Liabilities					
Accounts payable	$ 48.4	$ 111.5	$ 746.7	$ —	$ 906.6
Commercial paper	912.2	—	—	—	912.2
Other current liabilities	294.7	167.2	(62.6)	—	399.3
Liabilities of discontinued operations	—	—	64.2		64.2
	1,255.3	278.7	748.3	—	2,282.3
Intercompany Accounts Payable	—	101.3	2,147.8	(2,249.1)	—
Deferred Credits and Other Liabilities					
Deferred income tax	(83.2)	298.1	909.2	—	1,124.1
Other deferred credits and liabilities	534.5	112.0	964.4	—	1,610.9
	451.3	410.1	1,873.6	—	2,735.0
Capitalization					
Common shareholders' equity	3,940.5	815.6	3,604.2	(4,465.5)	3,894.8
Preferred stock	19.7	—	—	—	19.7
Long-term debt	2,353.5	650.9	2,943.1	(1,528.8)	4,418.7
Total Capitalization	6,313.7	1,466.5	6,547.3	(5,994.3)	8,333.2
Minority Interest in Consolidated Companies	—	—	13.6	—	13.6
Total Liabilities and Capitalization	$8,020.3	$2,256.6	$11,330.6	$(8,243.4)	$13,364.1

Statement of Cash Flows

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2005	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	CONSOLIDATED
Operating Activities				
Net Cash (Used in) Provided by Continuing Operating Activities	$(327.7)	$168.5	$ 562.5	$ 403.3
Investing Activities				
Capital expenditures	—	(113.3)	(426.2)	(539.5)
Cost of removal	—	(2.6)	(25.2)	(27.8)
Proceeds from sale of property and investments	—	(2.1)	49.1	47.0
Derivative margin call	—	—	(8.9)	(8.9)
Net Cash (Used in) Continuing Investing Activities	—	(118.0)	(411.2)	(529.2)
Financing Activities				
Treasury stock issued	41.2	—	—	41.2
Common stock issued associated with MEDS conversion	460.0	—	—	460.0
Issuance (payment) of debt, net	(754.6)	—	(15.0)	(769.6)
Redemption of preferred stock	(75.0)	—	—	(75.0)
Common and preferred stock dividends paid	(308.4)	—	—	(308.4)
Dividend paid to parent	375.0	—	(375.0)	—
Other	(1.6)	—	(3.8)	(5.4)
Net intercompany accounts	90.0	(46.1)	(43.9)	—
Net Cash (Used in) Continuing Financing Activities	(173.4)	(46.1)	(437.7)	(657.2)
Net (Decrease) Increase in Cash and Cash Equivalents	$(501.1)	$ 4.4	$(286.4)	$(783.1)
Net Cash Flow from Discontinued Operations	—	—	(14.4)	(14.4)
Cash and Cash Equivalents at Beginning of Period	580.7	(0.9)	342.2	922.0
Cash and Cash Equivalents at End of Period	$ 79.6	$ 3.5	$ 41.4	$ 124.5

Statement of Cash Flows

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2004	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	CONSOLIDATED
Operating Activities				
Net Cash (Used in) Provided by Continuing Operating Activities	$ (88.7)	$169.5	$ 669.3	$ 750.1
Investing Activities				
Capital expenditures	—	(108.7)	(641.6)	(750.3)
Cost of removal	—	(7.1)	(29.2)	(36.3)
Proceeds from sale of property and investments	—	—	1,021.3	1,021.3
Net Cash (Used in) Provided by Continuing Investing Activities	—	(115.8)	350.5	234.7
Financing Activities				
Treasury stock issued	33.4	—	—	33.4
Issuance (payment) of debt, net	(269.7)	—	(170.7)	(440.4)
Redemption of preferred stock	(8.5)	—	—	(8.5)
Net proceeds from sale/leaseback transaction	—	—	382.0	382.0
Common and preferred stock dividends paid	(291.1)	—	—	(291.1)
Gain on interest rate swap	12.7	—	—	12.7
Dividend paid to parent	447.6	(40.0)	(407.6)	—
Other	27.6	—	8.5	36.1
Net intercompany accounts	619.8	(16.2)	(603.6)	—
Net Cash Provided by (Used in) Continuing Financing Activities	571.8	(56.2)	(791.4)	(275.8)
Net Increase (Decrease) in Cash and Cash Equivalents	$483.1	$ (2.5)	$ 228.4	$ 709.0
Net Cash Flow from Discontinued Operations	—	—	9.6	9.6
Cash and Cash Equivalents at Beginning of Period	97.6	1.6	104.2	203.4
Cash and Cash Equivalents at End of Period	$580.7	$ (0.9)	$ 342.2	$ 922.0

Statement of Cash Flows

				(In Millions of Dollars)
YEAR ENDED DECEMBER 31, 2003	**GUARANTOR**	**KEDLI**	**OTHER SUBSIDIARIES**	**CONSOLIDATED**
Operating Activities				
Net Cash (Used in) Provided by Continuing Operating Activities	$(547.5)	$164.5	$1,606.4	$1,223.4
Investing Activities				
Capital expenditures	—	(130.3)	(879.1)	(1,009.4)
Cost of removal	—	(1.7)	(29.4)	(31.1)
Proceeds from the sale of property and subsidiary stock	—	15.1	294.6	309.7
Investments in subsidiaries	—	—	(211.3)	(211.3)
Issuance of note receivable	(55.0)	—	—	(55.0)
Net Cash (Used in) Continuing Investing Activities	(55.0)	(116.9)	(825.2)	(997.1)
Financing Activities				
Proceeds from equity issuance	473.6	—	—	473.6
Treasury stock issued	96.7	—	—	96.7
Redemption of LIPA promissory notes	(447.0)	—		(447.0)
(Payment) issuance of debt, net	(133.8)	—	110.2	(23.6)
Redemption of preferred stock	—	—	(14.3)	(14.3)
Common and preferred stock dividends paid	(280.6)	—	—	(280.6)
Other	28.9	—	(13.9)	15.0
Net intercompany accounts	874.0	(52.6)	(821.4)	—
Net Cash Provided by (Used in) Continuing Financing Activities	611.8	(52.6)	(739.4)	(180.2)
Net (Decrease) Increase in Cash and Cash Equivalents	$ 9.3	$ (5.0)	$ 41.8	$ 46.1
Net Cash from Discontinued Operations	—	—	(13.3)	(13.3)
Cash and Cash Equivalents at Beginning of Period	88.3	6.5	75.8	170.6
Cash and Cash Equivalents at End of Period	$ 97.6	$ 1.5	$ 104.3	$ 203.4

Note 14. Supplemental Gas and Oil Disclosures (Unaudited)

The following information includes amounts attributable to 100% of Houston Exploration and KeySpan Exploration and Production, LLC at December 31, 2003. Shareholders other than KeySpan had a minority interest of approximately 45% in Houston Exploration at December 31, 2003. Gas and oil operations, and reserves, were located in the United States in 2003. As a result of the disposition of Houston Exploration and the immateriality of KeySpan's ongoing gas exploration and production activities supplemental gas and oil disclosures are not required for 2005 or 2004.

Capitalized Costs Relating to Gas and Oil Producing Activities

	(In Millions of Dollars)
AT DECEMBER 31,	**2003**
Unproved properties not being amortized	$ 142.9
Properties being amortized – productive and nonproductive	2,429.9
Total capitalized costs	2,572.8
Accumulated depletion	(1,159.5)
Net capitalized costs	$1,413.3

Costs Incurred in Property Acquisition, Exploration and Development Activities

	(In Millions of Dollars)
AT DECEMBER 31,	**2003**
Acquisition of properties —	
Unproved properties	$ 61.5
Proved properties	171.3
Exploration	66.3
Development	170.5
Asset retirement obligation	31.8
Total costs incurred	$501.4

Costs included in development costs to develop proved undeveloped reserves for the year ended December 31, 2003 were $49.4 million.

Results of Operations from Gas and Oil Producing Activities*

AT DECEMBER 31,	(In Millions of Dollars) 2003
Revenues	$497.9
Production and lifting costs	63.6
Shipping and handling costs	10.4
Depletion	205.1
Total expenses	279.1
Income before taxes	218.8
Income taxes	76.6
Results of operations	$142.2

* *(Excluding corporate overhead and interest costs)*

Summary of Production and Lifting Costs

AT DECEMBER 31,	(In Millions of Dollars) 2003
Pumping, gauging and other labor	$11.0
Compressors and other rental equipment	5.1
Property taxes and insurance	7.2
Transportation	2.3
Processing fees	2.4
Workover and well stimulation	5.2
Repairs, maintenance and supplies	3.7
Fuel and chemicals	3.1
Environmental, regulatory and other	7.6
Severance taxes	16.0
Total production and lifting costs	$63.6

For December 31, 2003 the gas and oil reserves information reflects Houston Exploration and KeySpan Exploration and Production, LLC. These estimates principally were prepared by independent petroleum consultants. Proved reserves are estimated quantities of natural gas and crude oil which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under existing economic and operating conditions.

Reserve Quantity Information Natural Gas (MMcf)

AT DECEMBER 31,	2003
Proved Reserves	
Beginning of year	614,734
Revisions of previous estimates	(32,433)
Extensions and discoveries	140,632
Production	(100,130)
Purchases of reserves in place	89,380
Proved reserves – End of year (1)	712,183
Proved developed reserves	
Beginning of year	435,629
End of Year (2)	488,012

(1) Includes minority interest of 318,417.

(2) Includes minority interest of 218,190.

Crude Oil, Condensate and Natural Gas Liquids (MBbls)

AT DECEMBER 31,	2003
Proved reserves	
Beginning of Year	9,548
Revisions of previous estimates	(3,542)
Extension and discoveries	117
Production	(1,514)
Purchases of reserves in place	3,753
Proved reserves – End of year (1)	8,362
Proved developed reserves	
Beginning of year	2,413
End of year (2)	4,273

(1) Includes minority interest of 3,739.

(2) Includes minority interest of 1,910.

The standardized measure of discounted future net cash flows was prepared by applying year-end prices of gas and oil adjusted for the effects of KeySpan's hedging program to the proved reserves. The standardized measure does not purport, nor should it be interpreted, to present the fair value of gas and oil reserves. An estimate of fair value would also take into account, among other things, the recovery of reserves not presently classified as proved, anticipated future changes in prices and costs, and a discount factor more representative of the time value of money and the risks inherent in reserve estimates.

Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Gas and Oil Reserves

AT DECEMBER 31,	(In Millions of Dollars) 2003
Future cash flows	$4,375.8
Future costs –	
Production	(769.9)
Development	(378.6)
Future net inflows before income tax	3,227.3
Future income taxes	(853.4)
Future net cash flows	2,373.9
10% discount factor	(853.4)
Standardized measure of discounted future net cash flows (1)	$1,520.5

(1) Includes minority interest of $672,620.

Changes in Standardized Measure of Discounted Future Net Cash Flows from Proved Reserve Quantities

	(In Millions of Dollars)
AT DECEMBER 31,	2003
Standardized measure – beginning of year	$1,103.9
Sales and transfers, net of production costs	(492.3)
Net change in sales and transfer prices, net of production costs	384.3
Extensions and discoveries and improved recovery, net of related costs	434.3
Changes in estimated future development costs	(9.4)
Development costs incurred during the period that reduced future development costs	81.0
Revisions of quantity estimates	(123.9)
Accretion of discount	142.3
Net change in income taxes	(236.5)
Net purchases of reserves in place	254.0
Changes in production rates (timing) and other	(17.2)
Standardized measure – end of year	$1,520.5

Average Sales Prices and Production Costs Per Unit

AT DECEMBER 31,	2003
Average Sales Price*	
Natural gas ($/Mcf)	5.23
Oil, condensate and natural gas liquid ($/Bbl)	28.26
Production cost per equivalent Mcf ($)	0.58

**Represents the cash price received which excludes the effect of any hedging transactions.*

Note 15. Summary of Quarterly Information (Unaudited)

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2005.

				(In Millions of Dollars, Except Per Share Amounts)	
QUARTER ENDED	3/31/2005	6/30/2005	9/30/2005	12/31/2005	
Operating Revenue	2,480.5	1,342.5	1,303.1	2,535.9	
Operating Income	438.7	103.2	102.8	263.1	
Earnings (loss) from continuing operations, less preferred stock dividends	234.4	18.0	22.6	121.4	
Cumulative change in accounting principles, net of tax	—	—	—	(6.6)	(a)
Earnings (loss) from discontinued operations	—	(1.8)	—	—	
Earnings (loss) for common stock	234.4	16.2	22.6	114.8	
Basic earnings per common share from continuing operations less preferred stock dividends	1.45	0.11	0.13	0.70	
Basic earnings per common share from discontinued operations	—	(0.01)	—	—	
Basic earnings per common share from cumulative change in accounting principles	—	—	—	(0.04)	(a)
Basic earnings per common share	1.45	0.10	0.13	0.66	
Diluted earnings per common share	1.44	0.09	0.13	0.65	
Dividends declared	0.455	0.455	0.455	0.455	

(a) Cumulative change in accounting principles for implementation of FASB Interpretation No. 47 ("FIN 47") "Accounting for Conditional Asset Retirement Obligations."

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2004.

					(In Millions of Dollars, Except Per Share Amounts)		
QUARTER ENDED	**3/31/2004**	**6/30/2004**		**9/30/2004**		**12/31/2004**	
Operating Revenue	2,510.6	1,277.8		975.6		1,886.5	
Operating Income	487.6	122.2	(a)	87.6	(c)	237.9	(e)
Earnings (loss) from continuing operations, less preferred stock dividends	246.6	128.5	(a) (b)	(30.1)	(c) (d)	264.1	(e) (f)
Earnings (loss) from discontinued operations (g)	(0.4)	0.8		(87.0)		(64.4)	
Earnings (loss) for common stock	246.2	129.3		(117.1)		199.7	
Basic earnings per common share from continuing operations less preferred stock dividends	1.54	0.81		(0.19)		1.64	
Basic earnings per common share from discontinued operations	—	—		(0.54)		(0.40)	
Basic earnings per common share	1.54	0.81		(0.73)		1.24	
Diluted earnings per common share	1.53	0.80		(0.73)		1.23	
Dividends declared	0.445	0.445		0.445		0.445	

(a) KeySpan's wholly owned gas exploration and production subsidiaries recorded a non-cash impairment charge of $48.2 million ($31.1 million after-tax) or $0.19 per share to recognize the reduced valuation of proved reserves.

(b) In June 2004, KeySpan exchanged 10.8 million shares of common stock of Houston Exploration for 100% of the stock of Seneca-Upshur Petroleum, Inc. We recorded a gain of $150.1 million and were required to record deferred tax expense of $44.1 million. The net gain on the share exchange less the deferred tax provision was $106 million or $0.66 per share. In April 2004, KeySpan recorded a gain of $22.8 million ($10.1 million after-tax) or $0.06 per share, resulting from the sale of 35.9% of our ownership interest in KeySpan Canada.

(c) KeySpan recorded a $14.4 million ($12.6 million after-tax) or $0.08 per share non-cash goodwill impairment charge associated with our continuing investments in the Energy Services segment.

(d) In August 2004, we redeemed approximately $758 million of outstanding debt and recorded a charge of $45.9 million ($29.3 million after-tax) or $0.18 per share representing call premiums incurred on this redemption.

(e) In December 2004, we recorded a $26.5 million ($18.8 million after-tax) or $0.12 per share non-cash impairment charge related to our 50% ownership interest in Premier Transmission Pipeline.

(f) In November 2004, KeySpan decided to sell its remaining 6.6 million shares in Houston Exploration and recorded a gain of $179.6 million ($116.8 million after-tax) or $0.73 per share. In December 2004, KeySpan sold its remaining interest in KeySpan Canada and recorded a gain of $35.8 million ($24.7 million after tax) or $0.15 per share.

(g) At December 31, 2004, KeySpan intended to sell a significant portion of its ownership interest in certain companies within the Energy Services segment, specifically those companies engaged in mechanical contracting activities. As a result, KeySpan recorded a loss in discontinued operations of $151.0 million, or $0.94 per share. This loss reflects $139.9 million after-tax impairment charges, which were recorded in the third and fourth quarters, and operating losses at $11.1 million.

(In Millions of Dollars, Except Per Share Amounts)

YEAR ENDED DECEMBER 31,	2005	2004	2003	2002	2001
Income Summary					
Revenues					
Gas Distribution	$5,390.1	$4,407.3	$4,161.3	$3,163.8	$3,613.6
Electric Services	2,042.8	1,738.7	1,606.0	1,645.7	1,850.4
Energy Services	191.2	182.4	158.9	208.6	243.5
Energy Investments	37.9	322.1	609.3	447.1	498.3
Total revenues	7,662.0	6,650.5	6,535.5	5,465.2	6,205.8
Operating expenses					
Purchased gas for resale	3,597.3	2,664.5	2,495.1	1,653.3	2,171.1
Fuel and purchased power	752.1	540.3	414.6	395.9	538.5
Operations and maintenance	1,617.9	1,567.0	1,622.6	1,631.3	1,704.4
Depreciation, depletion and amortization	396.5	551.8	571.7	513.7	564.0
Operating taxes	407.1	404.2	418.2	380.5	448.9
Impairment Charges	—	41.0	—	—	—
Total operating expenses	6,770.9	5,768.8	5,522.2	4,574.7	5,426.9
Gain on sale of property	1.6	7.0	15.1	4.7	—
Income from equity investments	15.1	46.5	19.2	14.1	13.1
Operating income	907.8	935.3	1,047.6	909.3	792.0
Other income and (deductions)	(269.9)	4.9	(340.3)	(301.4)	(359.5)
Income taxes	239.3	325.5	281.3	229.6	200.5
Earnings from continuing operations	398.6	614.7	426.0	378.3	232.0
Discontinued Operations					
Income (loss) from operations, net of tax	(4.1)	(79.0)	(1.9)	15.7	22.6
Loss on disposal, net of tax	2.3	(72.0)	—	(16.3)	(30.3)
Loss from discontinued operations	(1.8)	(151.0)	(1.9)	(0.6)	(7.7)
Cumulative change in accounting principles	(6.6)	—	(37.4)	—	—
Net income	390.2	463.7	386.7	377.7	224.3
Preferred stock dividend requirements	2.2	5.6	5.8	5.8	5.9
Earnings for common stock	$ 388.0	$ 458.1	$ 380.9	$ 371.9	$ 218.4
Financial Summary					
Earnings per share ($)	2.28	2.86	2.41	2.63	1.58
Cash dividends declared per share ($)	1.82	1.78	1.78	1.78	1.78
Book value per share, year-end ($)	25.60	24.22	22.99	20.67	20.73
Market value per share, year-end ($)	35.69	39.45	36.80	35.24	34.65
Shareholders, year-end	68,421	72,549	75,067	78,281	82,300
Capital expenditures ($)	539.5	750.3	1,009.4	1,057.5	1,059.8
Total assets ($)	13,812.6	13,364.1	14,640.2	12,980.1	11,789.6
Common shareholders' equity ($)	4,464.1	3,894.7	3,670.7	2,944.6	2,890.6
Preferred stock redemption required ($)	—	75.0	75.0	75.0	75.0
Preferred stock no redemption required ($)	—	—	8.6	8.8	9.1
Long-term debt ($)	3,920.8	4,418.7	5,610.9	5,224.1	4,697.6
Total capitalization ($)	8,384.9	8,333.2	9,365.2	8,252.5	7,672.3

KEYSPAN CORPORATION DIRECTORS AND OFFICERS

BOARD OF DIRECTORS

Robert B. Catell
Chairman and
Chief Executive Officer
KeySpan Corporation

Stephen W. McKessy
Lead Director and
Retired Vice Chairman
PricewaterhouseCoopers

Andrea S. Christensen
Special Counsel
Kaye Scholer LLP

Robert J. Fani
President and
Chief Operating Officer
KeySpan Corporation

Alan H. Fishman
President and
Chief Executive Officer
Independence Community Bank

James R. Jones
Co-Chairman and
Chief Executive Officer
Manatt Jones Global Strategies, LLC

Dean James L. Larocca
Distinguished Professor
of Public Policy
Long Island University

Gloria C. Larson
Partner
Foley Hoag LLP

Edward D. Miller
Former President and
Chief Executive Officer
AXA Financial, Inc.

Vikki L. Pryor
President and
Chief Executive Officer
SBLI USA Mutual Life Insurance Company, Inc.

COMMITTEES OF THE BOARD

Executive Committee

Robert B. Catell,
Chairman

Alan H. Fishman
James R. Jones
Stephen W. McKessy
Edward D. Miller

Audit Committee

Alan H. Fishman,
Chairman

Andrea S. Christensen
James L. Larocca
Stephen W. McKessy
Vikki L. Pryor

Compensation and Management Development Committee

Edward D. Miller,
Chairman

James R. Jones
James L. Larocca
Gloria C. Larson
Stephen W. McKessy

Corporate Governance and Nominating Committee

James R. Jones,
Chairman

Andrea S. Christensen
James L. Larocca
Gloria C. Larson
Edward D. Miller
Vikki L. Pryor

PRINCIPAL OFFICERS

Office of the Chairman

Robert B. Catell
Chairman and
Chief Executive Officer

Robert J. Fani
President and
Chief Operating Officer

Wallace P. Parker Jr.
President
Energy Delivery and
Customer Relationship Group

Steven L. Zelkowitz
President
Energy Assets
and Supply Group

Executive Vice Presidents

John J. Bishar, Jr.
Executive Vice President,
General Counsel and
Chief Governance Officer

John A. Caroselli
Executive Vice President
and Chief Strategy Officer

Gerald Luterman
Executive Vice President
and Chief Financial Officer

David J. Manning
Executive Vice President
Corporate Affairs and
Chief Environmental Officer

Anthony Nozzolillo
Executive Vice President
Electric Operations

Lenore F. Puleo
Executive Vice President
Shared Services

Nickolas Stavropoulos
Executive Vice President
KeySpan Energy Delivery

Senior Vice Presidents

Joseph F. Bodanza, Jr.
Senior Vice President
Regulatory Affairs and
Asset Optimization

Coleen A. Ceriello
Senior Vice President
Shared Services

John F. Haran
Senior Vice President
and Chief Engineer
KeySpan Energy Delivery

Michael J. Taunton
Senior Vice President,
Treasurer and
Chief Risk Officer

Anthony J. Sartor
Senior Vice President
KeySpan Services

Elaine Weinstein
Senior Vice President
Human Resources and
Chief Diversity Officer

Other Officers

Theresa A. Balog
Vice President and
Chief Accounting Officer

Lawrence S. Dryer
Vice President and
General Auditor

Joseph E. Hajjar
Vice President and
Controller

Michael A. Walker
Vice President and
Deputy General Counsel.

General Office

KeySpan Corporation
One MetroTech Center
Brooklyn, NY 11201-3850

Annual Meeting of Shareholders

KeySpan's 2006 Annual Meeting of Shareholders, previously scheduled for May 2006, has been postponed until later this year as a result of the proposed acquisition of KeySpan by National Grid. A new date, time and location for the Annual Meeting will be announced at a future time.

Stock Listings

KeySpan common stock is traded primarily on the New York Stock Exchange (NYSE) under the trading symbol 'KSE.' Daily stock quotes are listed in most major newspapers under the heading 'KeySpan'.

KeySpan Investor Program ('Dividend Reinvestment Plan')

The KeySpan Investor Program is an Open Enrollment/Dividend Reinvestment Plan. The Plan offers individuals a convenient and cost-effective way of purchasing KeySpan common stock. This Plan is open to everyone (NOT just existing shareholders). There is no enrollment fee for joining the Plan.

We welcome your participation in the KeySpan Investor Program. If you are interested in receiving Program material, please contact KeySpan's Stock Transfer Agent, Computershare (electronic request line) at 1-866-238-5345 (1-866-2-FULFIL).

To enroll in the Plan, individuals must complete an application and mail in an initial investment of at least $250, or authorize electronic deductions of at least $25. Individuals may also enroll in the Plan via our web site http://investor.keyspanenergy.com.

Parameters

Eligibility: Open Enrollment

Investment Fee: None

Initial Investment	**Ongoing Investment**
Minimum: $250	Minimum: $25
Maximum: $150,000	Maximum: $150,000

Investment Frequency: Weekly on Thursday
Source of Shares: Open Market (as of January 2004)
Sales Frequency: Daily
Sales Fee: $5.00 + 5 cents per share
Full or Partial Reinvestment: Yes
Electronic Debits/Credits: Yes
Safekeeping of Shares: Yes

Dividends

KeySpan paid an annual dividend of $1.82 in 2005. All of the dividends paid during the calendar year 2005 are considered to be ordinary dividend income and are therefore taxable (subject to review by the IRS). Tax Forms 1099-Div were mailed in November 2005. Please consult your tax advisor for further information.

In December 2005, the Company announced a $0.04 per share annual dividend increase to $1.86, to take effect with the first payment of 2006.

Proposed Dividend Payment Dates

Declaration Date	Record Date	Payment Date
Dec. 14, 2005	Jan. 12, 2006	Feb. 1, 2006
Mar. 23, 2006	Apr. 12, 2006	May 1, 2006
Jun. 21, 2006	Jul. 12, 2006	Aug. 1, 2006
Sept. 4, 2006	Oct. 18, 2006	Nov. 1, 2006
Dec. 13, 2006	Jan. 10, 2007	Feb. 1, 2007

Stock Plans Group

Please direct inquiries to:
KeySpan Corporation
Stock Plans Group
One MetroTech Center
22nd Floor
Brooklyn, NY 11201-3850
Or call: 1-718-403-3131 E-mail: financial@keyspanenergy.com

Investor Relations

Inquiries from security analysts, stockbrokers, investment managers and other members of the financial community should be addressed to George Laskaris, Director of Investor Relations, at 1-718-403-2526, or by e-mail, glaskaris@keyspanenergy.com. Company information, including financial reports, is available at **http://investor.keyspanenergy.com.**

Stock Transfer Agent and Registrar

Computershare Trust, N.A.
Investment Plan Services
P.O. Box 43069
Providence, RI 02940-3069
Call: 1-800-482-3638

Annual Report – Form 10-K

The New York Stock Exchange (NYSE) Section 303A.12(a) Chief Executive Officer Certification was filed with the NYSE on May 31, 2005.

KeySpan files reports with the Securities and Exchange Commission (SEC), including annual reports on Form 10-K, quarterly reports on Form 10-Q and any other filings required by the SEC. The most recent certifications by KeySpan's Chief Executive Officer and Chief Financial Officer pursuant to Sections 302 and 906 of the Sarbanes-Oxley Act of 2002, were filed as exhibits to KeySpan's 2005 Form 10-K.

Independent Registered Public Accountants

Deloitte & Touche LLP
2 World Financial Center
New York, NY 10281
1-212-436-2000

Web Address

For more information on KeySpan, or for copies of our press releases and quarterly reports, please visit our web site at **http://investor.keyspanenergy.com**.

Design: MGT Design, Inc. Printing: Georgian Press, NYC Photography: Peter Vidor, Stu Rosner, Eugene Sorensen

This Annual Report is Printed on Recycled Paper

One MetroTech Center
Brooklyn, New York 11201
www.keyspanenergy.com

2006 Annual Report

Ahead of the curve

WHO WE ARE

A member of the Standard & Poor's 500 Index, KeySpan Corporation (NYSE:KSE) is the largest distributor of natural gas in the Northeast, operating regulated gas utilities in New York, Massachusetts and New Hampshire that serve 2.6 million customers. These customer-focused businesses are complemented by a portfolio of service companies that offer energy-related products, services, and solutions to homes and businesses. KeySpan is also the largest electric generator in New York State, with approximately 6,600 megawatts of generating capacity that provides power to 1.1 million customers of the Long Island Power Authority (LIPA) on Long Island and supplying approximately 25 percent of New York City's capacity needs. KeySpan also operates LIPA's transmission and distribution system under long-term contracts to LIPA. In addition to these assets, KeySpan has strategic investments in pipeline transportation, distribution, storage and production. KeySpan has headquarters in Brooklyn, New England and Long Island. For more information, visit KeySpan's Web site at www.keyspanenergy.com.

OUR BUSINESS SEGMENTS

GAS DISTRIBUTION

KeySpan is the largest gas distribution company in the Northeast serving 2.6 million customers. Its subsidiaries include a number of companies providing gas distribution services under the KeySpan brand. KeySpan Energy Delivery New York serves the New York City boroughs of Brooklyn, Staten Island and most of Queens. KeySpan Energy Delivery Long Island provides services on Long Island and the Rockaway Peninsula in Queens. Other subsidiaries, doing business as KeySpan Energy Delivery New England, provide services in Massachusetts and New Hampshire.

ELECTRIC SERVICES

KeySpan's electric services segment is the largest electric generator in New York State. We own and operate electric generation in New York City and Long Island with total capacity of approximately 6,600 megawatts. This segment also manages Long Island's electric transmission and distribution system for 1.1 million customers under long-term contracts with the Long Island Power Authority.

ENERGY SERVICES

The energy services segment includes companies that provide energy-related services to customers located primarily within the Northeastern United States. Subsidiaries in this segment provide residential and small commercial customers with service and maintenance of energy systems and appliances, as well as operation and maintenance, design, engineering, consulting and fiber optic services to commercial, institutional and industrial customers.

ENERGY INVESTMENTS

The energy investments segment consists of strategic investments in natural gas exploration and production, pipeline development, transportation, distribution and storage. These investments primarily include ownership of an interstate liquefied natural gas (LNG) storage facility in Providence, Rhode Island; a 20 percent interest in the Iroquois gas pipeline in the Northeast United States; and a 50 percent and 26 percent interest, respectively, in the Islander East and Millennium pipeline projects.

- *Consolidated earnings were up 9 percent to $434 million.*
- *Gas business achieved $50 million in new gross profit margin.*
- *Debt-to-capitalization ratio reduced to 50 percent.*
- *Annual dividend increased to $1.90 per share.*

TO OUR STAKEHOLDERS,

KeySpan is ahead of the curve. In 2006, we set the stage to join forces with National Grid, one of the world's premier energy delivery companies, while continuing to deliver on our promises to all of you – our stakeholders.

For KeySpan, being ahead of the curve is about the constant drive to build shareholder value, better serve customers, and manage risk in an increasingly competitive and challenge-filled environment. It is an attitude that translates into execution and attainment of one's goals, whatever obstacles come forward. To cite Charles Darwin's theory, *it is about survival of the fittest.*

In our industry, the right combination of companies and assets can deliver competitive advantages and the sustained earnings growth Wall Street and investors demand. At the same time – and just as significantly – consolidation must show clear, enduring benefits to customers.

Our future union with National Grid meets all of these conditions and more. It will:

- Provide permanent savings of more than $500 million to customers in New York State over 10 years, which will significantly reduce the effect of the rate increases we asked for as a stand-alone company.
- Provide the scale necessary to address increasing costs and investments in energy infrastructure to improve reliability.
- Boost customer service through the use of advanced, cutting-edge technologies and shared best practices.
- Provide the foundation for continued growth as part of a new, bigger and stronger global company.
- Unite KeySpan's strong commitment to our communities and the environment with National Grid's pledge to improve the world in which we all live.
- Give KeySpan shareholders $42 per share in cash, a 16 percent premium over the share price at the time the deal was announced.

A YEAR OF SOLID EARNINGS AND OPERATIONAL PERFORMANCE

While we worked diligently to prepare for the integration of the work force and operations of each company in 2006, KeySpan employees stayed focused on running the business to deliver solid earnings and operational performance.

Overall, consolidated earnings were $434 million or $2.48 per share, 9 percent more than 2005. We continued to strengthen our balance sheet by reducing our debt-to-capitalization ratio to 50 percent, reinforcing our "A" quality credit rating and our access to lower interest capital markets. We also increased the dividend for the third year in a row – to $1.90 per share, providing a yield of almost 5 percent.

The operating areas performed strongly in the face of unseasonable weather and higher commodity prices. The gas distribution business' operating income increased $3 million over 2005, despite a much warmer than normal heating season. We cost-effectively completed 48,000 new gas installations, resulting in $50 million in new gross profit margin.

The electric services business' operating income was $293 million, a 14 percent decrease from 2005. New generation capacity in New York City and a cooler than normal summer were the primary drivers in this segment. Our generation fleet, however, had an outstanding year, with overall plant availability during the summer of close to 100 percent. On Long Island, the transmission and distribution system we operate for the Long Island Power Authority (LIPA) ranked as the best among New York State overhead utilities for shortest power outage and fastest restoration times. This area also benefited from our LIPA contracts – revenues from off-system electric sales and emission credits, as well as electric marketing activities.

And the energy services business achieved an operating profit of $5 million, compared to a loss of $3 million in 2005. In addition, the resolution of two protracted tax cases helped the company realize a benefit of $52 million.

I have said this in previous letters, but it bears repeating: KeySpan operates in a territory filled with organic growth potential that is the envy of our industry. Over the years, we acquired the right strategic assets and companies, complementing our core operations. We divested solid, but non-core businesses. We cut costs and reinforced our balance sheet at every opportunity. We built a strong, performance-based culture in the work force. All of these actions added value to our bottom line and made us attractive to potential acquirers.

While our future growth prospects as a stand-alone company are strong, becoming part of National Grid met all of our criteria to achieve the next level of growth while enhancing shareholder value.

That is why, more than ever, I am convinced this combination is a logical, evolutionary step for KeySpan in our growth journey – one that benefits all our stakeholders.

2007 PRIORITIES

As I write, the merger transaction has already received approvals from the Federal Energy Regulatory Commission, Hart Scott Rodino, Committee on Foreign Investment, State of New Jersey Board of Public Utilities and overwhelming approval from shareholders of both companies. And on March 23, LIPA publicly endorsed the merger following negotiations with National Grid and KeySpan.

With these approvals in place, our priorities in 2007 are clear:

- Work with both state regulatory bodies in New York and New Hampshire – the only remaining approvals we need – to complete a judicious, timely review of the merger.
- Ensure we create an organization that can achieve the synergy savings and customer benefits promised in year one and beyond.
- Execute KeySpan's strategic initiatives of efficient organic growth, operational excellence and enhanced customer service through closing, which we expect to occur later this year.

A DEBT OF GRATITUDE

I am fortunate to be part of a business that provides an essential service to customers, and proud that it began in my hometown of Brooklyn and now extends from Montauk Point to the shores of Cape Cod, Massachusetts. The growth of KeySpan continues to be fascinating, exciting and challenging.

I am extremely proud of KeySpan's achievements. Credit, of course, goes to the skillful, dedicated and diverse employees I have had the privilege to work with over the years. They have all contributed uniquely to our success. Today, our 9,500-plus employees, most of whom are shareholders, continue to be our most important competitive advantage. Their knowledge, and their commitment to KeySpan and the local communities in which they live and work, is more than impressive. To keep focused this past year and produce the results we did was indeed a huge accomplishment. I thank them all for their excellent work!

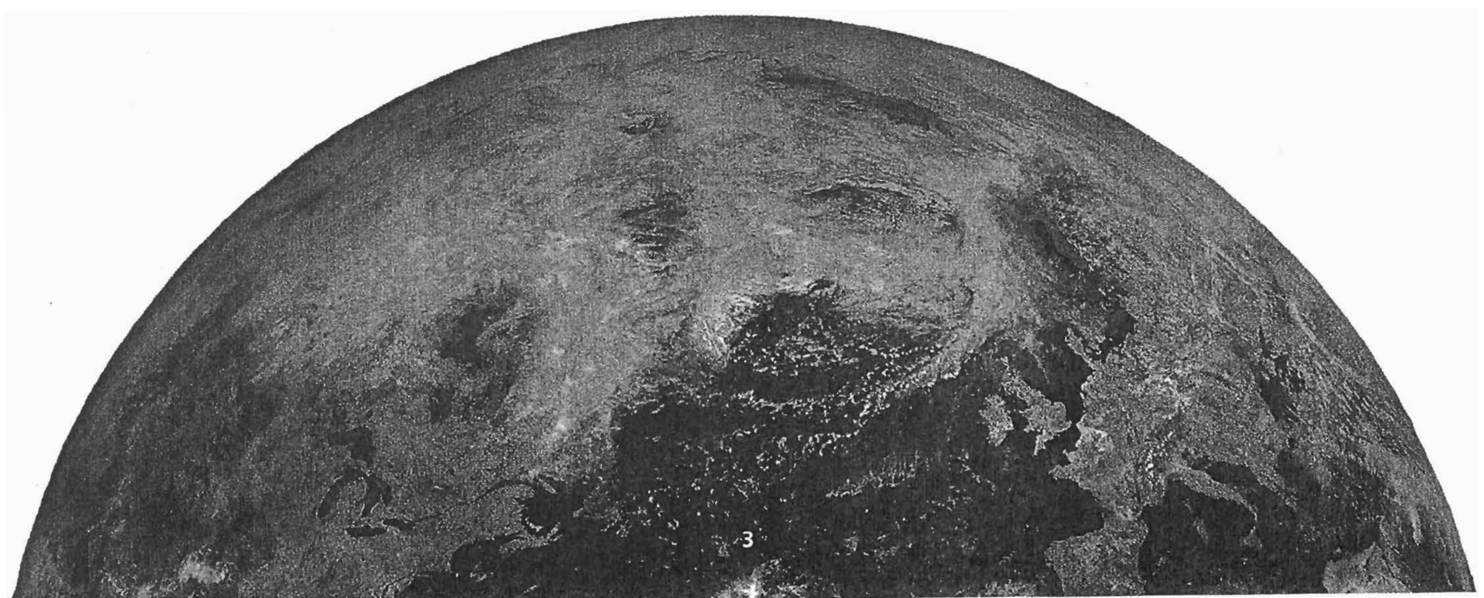
I also want to thank members of KeySpan's Board of Directors, who have given me guidance, knowledge and balance during a particularly fast-paced, changing era.

KeySpan is on the verge of beginning the next exciting, bold chapter in our illustrious history. When we become part of National Grid, our legacy, our values, will live on in a great new company that will continue to build upon our many success stories.

I see progress ahead for all stakeholders; I am grateful to all of you for being such an integral part of KeySpan's evolution to stay ahead of the curve.

Robert B. Catell

Robert B. Catell
Chairman and Chief Executive Officer
March 26, 2007



Financial Review

CONTENTS

5 Financial Review and Analysis

38 Consolidated Financial Statements

44 Notes to Consolidated Financial Statements

85 Selected Financial Data

86 Directors and Officers

87 Shareholder Information

KeySpan Corporation (referred to herein as "KeySpan," "we," "us" and "our") is a holding company under the Public Holding Company Act of 2005 ("PUHCA 2005"). KeySpan operates six regulated utilities that distribute natural gas to approximately 2.6 million customers in New York City, Long Island, Massachusetts and New Hampshire, making KeySpan the fifth largest gas distribution company in the United States and the largest in the Northeast. We also own, lease and operate electric generating plants in Nassau and Suffolk Counties on Long Island and in Queens County in New York City and are the largest electric generation operator in New York State. Under contractual arrangements, we provide power, electric transmission and distribution services, billing and other customer services for approximately 1.1 million electric customers of the Long Island Power Authority ("LIPA"). KeySpan's other operating subsidiaries are primarily involved in gas production and development; underground gas storage; liquefied natural gas storage; retail electric marketing; large energy-system ownership, installation and management; service and maintenance of energy systems; and engineering and consulting services. We also invest and participate in the development of natural gas pipelines, electric generation and other energy-related projects. (See Note 2 to the Consolidated Financial Statements "Business Segments" for additional information on each operating segment.)

On February 25, 2006, KeySpan entered into an Agreement and Plan of Merger (the "Merger Agreement"), with National Grid plc, a public limited company incorporated under the laws of England and Wales ("Parent") and National Grid US8, Inc., a New York Corporation ("Merger Sub"), pursuant to which Merger Sub will merge with and into KeySpan (the "Merger"), with KeySpan continuing as the surviving company and thereby becoming an indirect wholly-owned subsidiary of the Parent. Pursuant to the Merger Agreement, at the effective time of the Merger, each outstanding share of KeySpan common stock, par value $0.01 per share (the "Shares"), other than treasury shares and shares held by the Parent and its subsidiaries, shall be canceled and shall be converted into the right to receive $42.00 in cash, without interest.

Consummation of the Merger is subject to various closing conditions. Assuming receipt of all required approvals, it is currently anticipated that the Merger will be consummated in mid-2007. However, we are unable to predict the outcome of the regulatory proceedings and no assurance can be given that the Merger will occur or the timing of its completion. See the Introduction to the Notes to the Consolidated Financial Statements for additional information regarding the Merger.

At December 31, 2005, KeySpan was a holding company under the Public Utility Holding Company Act of 1935, as amended ("PUHCA 1935"). In August 2005, the Energy Policy Act of 2005 (the "Energy Act") was enacted. The Energy Act is a broad energy bill that places an increased emphasis on the production of energy and promotes the development of new technologies and alternative energy sources and provides tax credits to companies that produce natural gas, oil, coal, electricity and renewable energy. For KeySpan, one of the more significant provisions of the Energy Act was the repeal of PUHCA 1935, which became effective on February 8, 2006. Since that time, the jurisdiction of the Securities and Exchange Commission ("SEC") over certain holding company activities, including the regulation of our affiliate transactions and service companies, has been transferred to the jurisdiction of the FERC pursuant to PUHCA 2005. See the discussion under the caption "Regulation and Rate Matters" for additional information on the Energy Act and PUHCA 2005.

Executive Summary

Below is a table comparing the more significant items impacting earnings from continuing operations and earnings available for common stock for the periods indicated. Management believes that this representation is necessary for a clear understanding of the major drivers impacting comparative results for the periods indicated.

(In Millions of Dollars, Except per Share Amounts)

YEAR ENDED DECEMBER 31,	2006		2005		2004	
	EARNINGS	E.P.S.	EARNINGS	E.P.S.	EARNINGS	E.P.S.
Earnings from continuing operations, less preferred stock dividends	$ 434.2	$ 2.48	$ 396.4	$ 2.33	$ 609.1	$ 3.80
Discontinued operations	—	—	(1.8)	(0.01)	(151.0)	(0.94)
Cumulative change in accounting principle	—	—	(6.6)	(0.04)	—	—
Earnings for Common Stock	$ 434.2	$ 2.48	$ 388.0	$ 2.28	$ 458.1	$ 2.86
Components of Continuing Operations:						
Core operations	$ 395.9	$ 2.27	$ 403.2	$ 2.37	$ 359.4	$2.25
Incremental merger costs	(16.7)	(0.10)	—	—	—	—
Income tax settlements	55.0	0.31	—	—	—	—
Asset sales	—	—	—	—	257.5	1.60
Non core operations	—	—	—	—	83.9	0.52
Impairment charges	—	—	—	—	(62.4)	(0.39)
Debt redemption costs	—	—	(6.8)	(0.04)	(29.3)	(0.18)
Earnings from continuing operations, less preferred stock dividends	$ 434.2	$ 2.48	$ 396.4	$ 2.33	$ 609.1	$ 3.80

Earnings from Continuing Operations 2006 vs 2005

KeySpan's earnings from continuing operations, less preferred stock dividends, for the year ended December 31, 2006 were $434.2 million or $2.48 per share, an increase of $37.8 million, or $0.15 per share compared to $396.4 million, or $2.33 per share realized in 2005. KeySpan's financial results for the year ended December 31, 2006, reflects the following items that had a significant impact on comparative results: (i) incremental pre-tax Merger related costs of $27.1 million, primarily representing investment banking, legal, accounting and other consulting fees; (ii) resolution of certain income tax issues; (iii) the impact of cooler-than-normal summer weather and competition on KeySpan's merchant electric generation operations; and (iv) the impact of warmer-than-normal winter weather on KeySpan's gas distribution businesses.

In 2006, KeySpan resolved its dispute with the New York City Department of Taxation and Finance with respect to income taxes relating to the operations of its merchant electric generating facility. As a result of the favorable settlement of this issue, KeySpan reversed a previously recorded New York City income tax reserve of $11.9 million ($7.1 million after federal income taxes), as well as an interest reserve of $5.9 million ($3.4 million after-tax) established in connection with this dispute. In addition, pursuant to indemnity obligations contained in the Long Island Lighting Company ("LILCO") / KeySpan merger agreement of May 1998, KeySpan had been working with the Internal Revenue Service ("IRS") to resolve certain disputes with regard to LILCO's tax returns for the tax years ended December 31, 1996 through March 31, 1999 and KeySpan's and The Brooklyn Union Gas Company's (d/b/a KEDNY) tax returns for the years ended September 30, 1997 through December 31, 1998. A settlement of the outstanding issues was reached in 2006 and, following IRS procedure, the settlement was submitted to the Joint Committee on Taxation on October 30, 2006 for final approval, which is expected in early 2007. Accordingly, KeySpan reversed $44.5 million of previously established federal income tax reserves.

KeySpan's consolidated results of operations are dependent primarily on the operating results of its Gas Distribution and Electric Services segments. As indicated in the above table, KeySpan's earnings from its core operations decreased $7.3 million or $0.10 per share reflecting, for the most part, lower earnings from the Electric Services segment. The lower operating income in this segment resulted from a decrease in net electric revenues associated with KeySpan's merchant electric generation business, the Ravenswood Generating Station, which was significantly impacted by the entry of competing electric generating units into the New York City energy and capacity markets in 2006 and by comparatively cooler weather during the 2006 summer. A substantial portion of the yearly operating income from this business is realized during its peak electric generating period July through September. As measured in cooling-degree days, weather was 25% cooler during the July – September 2006 time period compared to the same period in 2005, resulting in a comparative adverse impact to realized electric revenues.

Operating income for 2006 from KeySpan's Gas Distribution segment remained consistent with such earnings realized in 2005. KeySpan's gas distribution activities are also impacted by seasonal weather fluctuations. However, certain of KeySpan's gas distribution subsidiaries operate under utility tariffs that contain a weather normalization adjustment that significantly offsets variations in firm net revenues due to fluctuations in weather. Additionally, KeySpan employs weather derivatives to mitigate the adverse impact from warmer-than-normal weather. As measured in heating degree days, weather during the primary heating season of 2006, January-March, was approximately 15% warmer than the same period of 2005 throughout KeySpan's service territories. Additionally, weather during the secondary heating season in 2006, October–December, was approximately 20% warmer than the same period of 2005. The benefits associated with the weather normalization adjustments and weather derivatives, combined with significantly lower operating expenses more than offset the adverse impact from the warm weather during the two heating seasons. See the discussion under the caption "Review of Operating Segments" for additional information on each operating segment.

In addition to the above, interest charges were lower year-over-year, due, for the most part, to lower regulatory carrying charges. Also, income on certain investments increased in 2006 compared to 2005.

Earnings per share in 2006 were adversely impacted by the higher level of common shares outstanding. In May 2005, KeySpan issued 12.1 million shares of common stock upon the conversion of previously held MEDs Equity Units. The dilutive effect on earnings per share for a full year in 2006 from this issuance, in addition to KeySpan's employee stock purchase plans, was approximately $0.07 per share.

Earnings Available for Common Stock 2006 vs 2005

Earnings available for common stock for 2005 also included losses from discontinued operations associated with KeySpan's former mechanical contracting subsidiaries; these companies were discontinued in the fourth quarter of 2004 and sold in early 2005. In the fourth quarter of 2004, KeySpan's investment in its mechanical contracting subsidiaries was written-down to fair value. During 2005, operating losses amounting to $4.1 million after-tax were incurred through the dates of sale of these companies, including, but not limited to, costs incurred for employee related benefits. Partially offsetting these losses was an after-tax gain of $2.3 million associated with the related divestitures, reflecting the difference between the fair value estimates and the financial impact of the actual sale transactions. The net income impact of the operating losses and the disposal gain was a loss of $1.8 million, or $0.01 per share for the year ended December 31, 2005.

Further, earnings available for common stock for 2005 included a $6.6 million, or $0.04 per share, cumulative change in accounting principle charge as a result of implementing the accounting requirements of Financial Accounting Standards Board ("FASB") Interpretation No. 47 ("FIN 47") "Accounting for Conditional Asset Retirement Obligations." This pronouncement required KeySpan to record a liability for the estimated future cost associated with the legal obligation to dispose of long-lived

assets at the time of their retirement or disposal date. Upon initial implementation, December 31, 2005, a cumulative change in accounting principle charge was recorded on KeySpan's Consolidated Statement of Income, representing the present value of KeySpan's future retirement obligation. See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for further information on this charge.

Earnings from Continuing Operations 2005 vs 2004

KeySpan's earnings from continuing operations, less preferred stock dividends, for the year ended December 31, 2005 were $396.4 million or $2.33 per share, a decrease of $212.7 million, or $1.47 per share compared to $609.1 million, or $3.80 per share realized in 2004. KeySpan's financial results for the year ended December 31, 2005 and 2004 reflected the following items that had a significant impact on comparative results: (i) earnings from core operations; (ii) asset sales of non-core subsidiaries recorded in 2004 and their respective results for 2004; (iii) impairment charges recorded in 2004; and (iv) debt redemption charges recorded in both 2005 and 2004.

As indicated in the preceding table, KeySpan's earnings from core operations increased $43.8 million or $0.12 per share in 2005 compared to 2004, primarily reflecting higher earnings from the Electric Services segment, improved results from the Energy Services segment, and a decrease in interest charges. KeySpan's electric services operations benefited from an increase in net electric revenues principally as a result of higher electric prices that were due, in part, to the warm weather during the 2005 summer and to the impact of two hurricanes experienced in 2005. Lower operating losses were incurred at the Energy Services segment as a result of lower operating expenses.

The decrease in interest expense resulted from the benefits attributable to lower outstanding debt resulting from debt redemptions in 2004 and the first quarter of 2005, as well as from the sale of Houston Exploration and KeySpan Canada. These favorable results were somewhat offset by a decrease in operating income from KeySpan's gas distribution operations as a result of higher operating expenses, primarily due to an increase in the provision for uncollectible accounts receivable as a result of increasing gas costs and the adverse impact from collection experience in 2005.

The full benefit to earnings per share from the favorable operating results of the Electric Services and Energy Services segments, as well as the decrease in interest charges was offset by the higher level of common shares outstanding. As noted earlier, on May 16, 2005, KeySpan issued 12.1 million shares of common stock upon the scheduled conversion of the MEDs Equity Units. The dilutive effect of this issuance on earnings per share for the year ended December 31, 2005, was approximately $0.12 per share.

The remaining items impacting comparative earnings from continuing operations – asset sales, impairment charges and debt redemption charges – are discussed below.

During 2004, KeySpan sold its remaining 55% equity interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company based in Houston, Texas. We received cash proceeds of approximately $758 million in two stock transactions that resulted in after-tax gains of $222.7 million, or $1.39 per share. The first transaction occurred in June 2004 and the second transaction was completed in November 2004. The operations of Houston Exploration were fully consolidated in KeySpan's Consolidated Financial Statements during the first five months of 2004, but were then accounted for on the equity method of accounting after the first transaction reduced our ownership interest below 50%.

Also in 2004, KeySpan sold its remaining 60.9% investment in KeySpan Energy Canada Partnership ("KeySpan Canada"), a company that owned certain midstream natural gas assets in Western Canada. We received cash proceeds of approximately $255 million in two transactions that resulted in a total after-tax gain of $34.8 million, or $0.21 per share. The first transaction took place in April 2004 and the second transaction was completed in December 2004. The operations of KeySpan Canada were fully consolidated in KeySpan's Consolidated Financial Statements during the first three months of 2004, but then were accounted for on the equity method of accounting after the first transaction reduced our ownership interest below 50%.

Combined, these asset sales provided KeySpan with approximately $1 billion in cash proceeds and after-tax earnings of $257.5 million, or $1.60 per share. Further, during 2004, KeySpan's share of the after-tax operating earnings of Houston Exploration and KeySpan Canada was $83.9 million or $0.52 per share. See Note 2 to the Consolidated Financial Statements "Business Segments" and the discussions under the caption "Review of Operating Segments" for a more detailed discussion of each of the above noted non-core transactions.

KeySpan recorded three significant impairment charges during 2004: (i) a goodwill impairment charge recorded in the Energy Services segment; (ii) a ceiling test write-down recorded in the Energy Investments segment; and (iii) a carrying value impairment charge also recorded in the Energy Investments segment. These impairment charges resulted in after-tax charges to continuing operations of $62.4 million, or $0.39 per share.

Specifically, during 2004 the Energy Services segment recorded an after-tax non-cash goodwill impairment charge of $12.6 million, or $0.08 per share in continuing operations as a result of an evaluation of the carrying value of goodwill recorded in this segment. That evaluation resulted in a total impairment charge of $152.4 million after-tax, or $0.95 per share – $12.6 million of this charge was attributable to continuing operations, while the remaining $139.9 million, or $0.87 per share, was reflected in discontinued operations. (See Note 10 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for additional details on this charge.)

KeySpan's remaining wholly owned gas production and development subsidiaries recorded a non-cash impairment charge of $48.2 million ($31.1 million after-tax, or $0.19 per share) in 2004 to recognize the reduced valuation of proved reserves. (See Note 9 to the Consolidated Financial Statements "Gas Production and Development Property – Depletion," for additional details on this charge.)

In addition to the asset sales noted previously, in the fourth quarter of 2004, KeySpan anticipated selling its previous 50% ownership interest in Premier Transmission Limited ("Premier"), a gas pipeline from southwest Scotland to Northern Ireland. In the fourth quarter of 2004, KeySpan recorded a non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share, reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value. This investment was accounted for under the equity method of accounting in the Energy Investments segment. The sale of Premier was completed in the first quarter of 2005 and resulted in cash proceeds of approximately $48.1 million and a pre-tax gain of $4.1 million reflecting the difference from earlier estimates. (See Note 2 to the Consolidated Financial Statements "Business Segments" and the discussions under the caption "Review of Operating Segments" for a more detailed discussion of the sale.)

The remaining significant item impacting comparative results, as noted above, was debt redemption costs incurred in both 2005 and 2004. In 2005, KeySpan redeemed $500 million of 6.15% Notes due in 2006. KeySpan incurred $20.9 million in call premiums, which were expensed and recorded in other income and deductions on the Consolidated Statement of Income, and wrote-off $1.3 million of previously deferred financing costs. Further, KeySpan accelerated the amortization of approximately $11.2 million of previously unamortized benefits associated with an interest rate swap on these Notes. The accelerated amortization was recorded as a reduction to interest expense. The net after-tax expense of this debt redemption was $6.8 million or $0.04 per share. In 2004, KeySpan redeemed approximately $758 million of various series of outstanding long-term debt. KeySpan incurred $54.5 million in call premiums associated with these redemptions, of which $45.9 was expensed and recorded in other income and deductions on the Consolidated Statement of Income. The remaining amount of the call premiums have been deferred for future rate recovery. Further, KeySpan wrote-off $8.2 million of previously deferred financing costs which have been reflected in interest expense on the Consolidated Statement of Income. The total after-tax expense of the 2004 debt redemption was $29.3 million or $0.18 per share.

The net impact of the above mentioned items resulted in a decrease to earnings from continuing operations of $6.8 million or $0.04 per share for the year ended December 31, 2005, compared to a gain of $249.7 million, or $1.55 per share, in 2004.

Earnings Available for Common Stock 2005 vs 2004

As noted previously, earnings available for common stock in 2005 also included losses from discontinued operations associated with KeySpan's former mechanical contracting subsidiaries amounting to $1.8 million, or $0.01 per share. Further, as noted, earnings available for common stock for 2005 included a $6.6 million, or $0.04 per share, cumulative change in accounting principle charge as a result of implementing the accounting requirements of FIN 47 "Accounting for Conditional Asset Retirement Obligations."

Also as noted previously, in 2004 KeySpan conducted an evaluation of the carrying value of its investments in the Energy Services segment. As a result of this evaluation, KeySpan recorded a loss in discontinued operations of $151.0 million, or $0.94 per share. This loss reflects a $139.9 million after-tax impairment charge to reflect a reduction to the carrying value of assets associated with our mechanical contracting activities and operating losses of $11.1 million. (See Note 10 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for additional details on these items.)

Consolidated Summary of Results

Operating income by segment, as well as consolidated earnings available for common stock is set forth in the following table for the periods indicated.

(In Millions of Dollars, Except Per Share Amounts)			
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Gas Distribution	$ 568.6	$ 565.7	$ 579.6
Electric Services	293.0	342.3	289.8
Energy Services			
Operations	5.3	(2.7)	(33.9)
Goodwill impairment charge	—	—	(14.4)
Energy Investments			
Operations of continuing companies	15.5	20.6	24.4
Operations of sold companies	—	—	155.0
Ceiling test write-down and impairment charge	—	—	(74.7)
Eliminations and other	(54.9)	(18.1)	9.5
Operating Income	827.5	907.8	935.3
Other Income and (Deductions)			
Interest charges	(256.1)	(269.3)	(331.3)
Gain on sale of subsidiary stock	—	4.1	388.3
Cost of debt redemption	—	(20.9)	(45.9)
Minority interest	(0.8)	(0.4)	(36.8)
Other income and (deductions)	39.1	16.6	30.6
	(217.8)	(269.9)	4.9
Income taxes	(175.5)	(239.3)	(325.5)
Income from Continuing Operations	434.2	398.6	614.7
Loss from discontinued operations	—	(1.8)	(151.0)
Cumulative change in accounting principles	—	(6.6)	—
Net Income	434.2	390.2	463.7
Preferred stock dividend requirements	—	2.2	5.6
Earnings for Common Stock	$ 434.2	$ 388.0	$ 458.1
Basic Earnings per Share:			
Continuing operations, less preferred stock dividends	$ 2.48	$ 2.33	$ 3.80
Discontinued operations	—	(0.01)	(0.94)
Cumulative change in accounting principles	—	(0.04)	—
	$ 2.48	$ 2.28	$ 2.86

Operating Income 2006 vs 2005

As indicated in the above table, operating income decreased $80.3 million, or 9%, for the twelve months ended December 31, 2006 compared to the same period of 2005. As noted earlier, during 2006, KeySpan incurred incremental pre-tax Merger costs of $27.1 million related to its proposed merger with National Grid plc, representing investment banking, legal, accounting and other consulting fees. For reporting purposes, the majority of these costs reside at the holding company level ("eliminations and other") and have not been allocated to the operating segments. The remaining variation is due, for the most part, to a decrease of $49.3 million in the operating income of the Electric Services segment. As noted earlier, the Ravenswood Generating Station was adversely impacted by additional competing electric generating units and the comparatively cooler 2006 summer weather, resulting in a decrease of $110.3 million in net electric margins. However, net electric margins from KeySpan's service agreements with LIPA and its electric marketing operations increased in 2006 compared to 2005, offsetting some of the lost margin from the Ravenswood Generating Station. Further, this segment also recognized a $46.5 million gain on a fixed for floating unforced capacity financial swap which is reflected in the operating results of this segment.

KeySpan's gas distribution business realized a slight increase, $2.9 million, in operating income year-over-year. Operating expenses decreased $54.7 million in 2006 compared to 2005, while net gas revenues decreased $51.8 million over the same time period. The decrease in net gas revenues reflects the significantly warmer weather experienced during the first and fourth quarter winter heating seasons, whereas the decrease in operating expenses was mainly driven by a lower provision for uncollectible accounts receivable resulting from the decrease in firm sales quantities, and from the beneficial impact of a recent regulatory order and improved accounts receivable collection activities. The favorable comparative results from the Energy Services segment were due to higher operating margins on engineering, energy supply and service contracts and lower general and administrative expenses. The decrease in operating income from the Energy Investments segment reflects, in part, lower earnings from KeySpan's investment in the Iroquois Gas Transmission System pipeline, as well as lower earnings from the transportation of liquefied natural gas. (See the discussion under the caption "Review of Operating Segments" for further details on each segment.)

Other income and (deductions) reflects interest charges, costs associated with debt redemptions, income from subsidiary stock transactions and other miscellaneous items. For the twelve months ended December 31, 2006, other income and (deductions) reflects a net expense of $217.8 million compared to a net expense of $269.9 million for the same period of 2005. The favorable variation of $52.1 million is due, in part, to debt redemption costs incurred in 2005. As discussed previously, in 2005, KeySpan redeemed $500 million 6.15% Series Notes due in 2006. KeySpan incurred $20.9 million in call premiums and wrote-off $1.3 million of previously deferred financing costs. In addition, we accelerated the amortization of approximately $11.2 million of previously unamortized benefits associated with an interest rate swap on the redeemed bonds. The write-off of the deferred financing costs and the amortization of the benefits associated with an interest rate swap were recorded to interest expense.

Interest expense for the twelve months ended December 31, 2006 decreased $13.2 million compared to the same period in 2005, reflecting, in part, the reversal of a previously recorded $5.9 million reserve established in connection with an income tax dispute with the New York City Department of Taxation and Finance. In 2006, KeySpan resolved its dispute with the New York City Department of Taxation and Finance with respect to income taxes relating to the operations of the Ravenswood Generating Station. As a result of the favorable settlement of this issue, KeySpan reversed the previously recorded interest reserve. Further, comparative interest expense reflects lower carrying charges on regulatory deferrals in 2006, offset by the benefits recorded in 2005 associated with the amortization of the interest rate swap. The favorable variation in other income and (deductions) for the twelve months ended December 31, 2006, compared to the same period in 2005, also reflects higher income on certain investments.

Other income and (deductions) for the twelve months ended December 31, 2005, includes the sale of KeySpan's 50% interest in Premier Transmission Limited ("Premier"), a gas pipeline from southwest Scotland to Northern Ireland. The sale generated cash proceeds of approximately $48.1 million. In the fourth quarter of 2004, KeySpan reduced its carrying value in Premier to an amount approximating the anticipated cash proceeds from the sale. The final sale of Premier, which took place in the first quarter of 2005, resulted in a pre-tax gain of $4.1 million reflecting the difference from earlier estimates.

Income tax expense decreased $63.8 million in 2006, compared to 2005, primarily reflecting the settlements with the New York City Department of Taxation and Finance and the IRS, as previously noted, amounting to $51.6 million; the remaining decrease reflects lower pre-tax income.

As a result of the items discussed above, earnings available for common stock were $434.2 million, or $2.48 per share for the year ended December 31, 2006, compared to $388.0 million, or $2.28 per share realized in 2005. As noted earlier, earnings available for common stock for the year ended December 31, 2005, included losses of $1.8 million, or $0.01 per share, from discontinued operations, as well as a $6.6 million, or $0.04 per share cumulative change in accounting principles charge.

Operating Income 2005 vs 2004

Operating income decreased $27.5 million, or 3%, for the twelve months ended December 31, 2005 compared to the same period of 2004. The comparative operating results reflect the following two items that had a significant impact on results: (i) operating results of non-core subsidiaries recorded in 2004 and which were sold in 2005; offset by (ii) impairment charges recorded in 2004. As noted earlier, during 2004 KeySpan held equity ownership interests in Houston Exploration and KeySpan Canada.

For the twelve months ended December 31, 2004, KeySpan's share of the combined operating income of Houston Exploration and KeySpan Canada was $155.0 million. KeySpan sold its remaining ownership interest in these non-core operations in the fourth quarter of 2004. Offsetting this income to some extent were pre-tax non-cash impairment charges of $89.1 million recorded in 2004. As noted earlier, KeySpan recorded the following three impairment charges during 2004: (i) a goodwill impairment charge recorded in the Energy Services segment attributable to continuing operations of $14.4 million; (ii) a ceiling test write-down of $48.2 million to recognize the reduced valuation of proved reserves associated with KeySpan's wholly-owned gas production and development subsidiaries; and (iii) a non-cash impairment charge of $26.5 million also recorded in the Energy Investments segment reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value.

The combined impact of the non-core operating income recorded in 2004 offset by the impairment charges contributed $65.9 million to operating income for the twelve months ended December 31, 2004. KeySpan's core businesses, therefore, posted an increase in operating income of $38.4 million for the twelve months ended December 31, 2005, compared to the same period of 2004, primarily reflecting an increase of $52.5 million in the Electric Services segment, partially offset by a $13.9 million decrease in the Gas Distribution segment. The favorable results from KeySpan's electric services operations reflect an increase in net electric revenues as a result of higher electric prices that were due, in part, to the warm weather during the summer of 2005 and the impact of two hurricanes that occurred in the summer of 2005. Gas distribution results, however, were adversely impacted by higher operating expenses, primarily due to an increase in the provision for uncollectible accounts receivable as a result of higher gas costs and by higher property taxes. For the most part, the beneficial impact on comparative operating income from lower net operating losses incurred at the Energy Services segment, was offset by an increase in expenses residing at the holding company level. Further, in 2004 KeySpan reached a settlement with certain of its insurance carriers regarding cost recovery for expenses incurred at a non-utility environmental site and recorded an $11.6 million gain from the settlement as a reduction to expense.

Other income and (deductions) reflects interest charges, costs associated with debt redemptions, income from subsidiary stock transactions, minority interest charges and other miscellaneous items. For the twelve months ended December 31, 2005, other income and (deductions) reflects a net expense of $269.9 million compared to income of $4.9 million for the twelve months ended December 31, 2004. This unfavorable variation of $274.8 million is due to higher gains from asset sales recorded in 2004 compared to 2005 of $384.2 million, offset by a decrease in interest charges of $62.0 million, lower debt redemption costs of $25.0 million and the absence of minority interest expenses of $36.4 million. The following is a discussion of these items.

As noted earlier, in the first quarter of 2005, KeySpan finalized its sale of Premier. The final sale of Premier resulted in a pre-tax gain of $4.1 million reflecting the difference from earlier estimates and what was recorded in the first quarter of 2005. For the twelve months ended December 31, 2004, KeySpan realized pre-tax income of $388.3 million from subsidiary stock transactions associated with Houston Exploration and KeySpan Canada, as discussed earlier.

Interest expense decreased $62.0 million, or 19%, for the twelve months ended December 31, 2005, compared to the same period of 2004, reflecting the benefits attributable to debt redemptions, as well as the sale of Houston Exploration and KeySpan Canada. In addition, as noted earlier, in 2005 KeySpan redeemed $500 million 6.15% Series Notes due 2006. KeySpan incurred $20.9 million in call premiums, wrote-off $1.3 million of previously deferred financing costs and accelerated the amortization of approximately $11.2 million of previously unamortized benefits associated with an interest rate swap on these bonds. The accelerated amortization of the interest rate swap and the write-off of previously deferred financing costs reduced interest expense in 2005 by $9.9 million.

In 2004, KeySpan redeemed approximately $758 million of various series of outstanding debt and incurred $45.9 million in call premiums and wrote-off $8.2 million of previously deferred financing costs. The net impact of the 2005 and 2004 debt redemptions lowered comparative interest expense by $18.1 million.

For the year ended December 31, 2004 other income and (deductions) also includes the effects of minority interest of $36.8 million related to our previous majority ownership interests in Houston Exploration and KeySpan Canada. Finally, other income and (deductions) for the year ended December 31, 2004 reflects a $12.6 million gain recorded on the settlement of a derivative financial instrument entered into in connection with the sale/leaseback transaction associated with the Ravenswood Expansion, a 250 MW combined cycle generating facility located at the Ravenswood Generating Station site, as well as a $5.5 million foreign currency gain.

Income taxes decreased $86.2 million for the year ended December 31, 2005 compared to 2004 due, for the most part, to lower pre-tax earnings. In addition, tax expense for 2004 reflects: (i) a $6.0 million benefit resulting from a revised appraisal associated with property that was disposed of in 2003; (ii) a tax benefit of $12 million related to the repatriation of earnings from KeySpan's foreign investments; and (iii) the beneficial tax treatment afforded to the stock transaction with Houston Exploration.

As noted earlier, earnings available for common stock for the year ended December 31, 2005, also included losses of $1.8 million, or $0.01 per share, from discontinued operations, as well as a $6.6 million, or $0.04 per share cumulative change in accounting principles charge. Earnings available for common stock for the year ended December 31, 2004, included losses of $151.0 million, or $0.94 per share, from discontinued operations.

As a result of the items discussed above, earnings available for common stock were $388.0 million, or $2.28 per share for the year ended December 31, 2005, compared to $458.1 million, or $2.86 per share realized in 2004.

Review of Operating Segments

KeySpan's segment results are reported on an "Operating Income" basis. Management believes that this generally accepted accounting principle ("GAAP") based measure provides a reasonable indication of KeySpan's underlying performance associated with its operations. The following is a discussion of financial results achieved by KeySpan's operating segments presented on an Operating Income basis.

Gas Distribution

The Brooklyn Union Gas Company, doing business as KeySpan Energy Delivery New York ("KEDNY") provides gas distribution service to customers in the New York City Boroughs of Brooklyn, Staten Island and a portion of Queens. KeySpan Gas East Corporation, doing business as KeySpan Energy Delivery Long Island ("KEDLI") provides gas distribution service to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. Four natural gas distribution companies – Boston Gas Company, Essex Gas Company, Colonial Gas Company and EnergyNorth Natural Gas, Inc., each doing business under the name KeySpan Energy Delivery New England ("KEDNE"), provide gas distribution service to customers in Massachusetts and New Hampshire.

The table below highlights certain significant financial data and operating statistics for the Gas Distribution segment for the periods indicated.

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Revenues	$ 5,062.6	$ 5,390.1	$ 4,407.3
Cost of gas	3,336.6	3,607.0	2,664.7
Revenue taxes	60.4	65.8	73.3
Net Gas Revenues	1,665.6	1,717.3	1,669.3
Operating Expenses			
Operations and maintenance	681.4	727.0	672.5
Depreciation and amortization	266.7	276.9	276.5
Operating taxes	148.9	147.8	140.7
Total Operating Expenses	1,097.0	1,151.7	1,089.7
Gain on the sale of property	—	0.1	—
Operating Income	$ 568.6	$ 565.7	$ 579.6
Firm gas sales and transportation (MDTH)	283,693	323,347	324,549
Transportation – Electric Generation (MDTH)	67,273	25,076	27,656
Other sales (MDTH)	190,244	187,805	155,992
Warmer (Colder) than Normal – New York & Long Island	16.0%	(1.0%)	(1.0%)
Warmer (Colder) than Normal – New England	7.6%	(8.6%)	(6.8%)

A MDTH is 10,000 therms and reflects the heating content of approximately one million cubic feet of gas. A therm reflects the heating content of approximately 100 cubic feet of gas. One billion cubic feet (BCF) of gas equals approximately 1,000 MDTH.

Operating Income 2006 vs 2005

Executive Summary

Operating income increased $2.9 million for the twelve months ended December 31, 2006, compared to the same period last year reflecting a decrease in operating expenses of $54.7 million, substantially offset by a decrease in net gas revenues (revenues less the cost of gas and associated revenue taxes) of $51.7 million. The lower operating expenses were primarily due to a decrease in the provision for uncollectible accounts receivable of $60.9 million. The exceptionally warm weather during the first and fourth quarters of 2006 – KeySpan's primary heating seasons – was the primary driver behind the decrease in net gas revenues.

Net Revenues

Net gas revenues from our gas distribution operations decreased $51.7 million, or 3%, for the twelve months ended December 31, 2006, compared to the same period last year. Both the New York and New England based gas distribution operations were adversely impacted by the significantly warmer than normal weather experienced throughout the northeastern United States during the 2006 winter heating seasons – January through April and October through December. As measured in heating degree days, weather in 2006 in our New York and New England service territories was approximately 16% and 7.6% warmer than normal, respectively, and was approximately 16% warmer than last year across KeySpan's service territories.

Net revenues from firm gas customers (residential, commercial and industrial customers) decreased $70.2 million in 2006 compared to 2005. The favorable impact to net gas revenues from load growth additions was more than offset by declining usage per customer due to the extremely warm weather during the winter heating seasons, the use of more efficient gas heating equipment and higher gas costs. KeySpan estimates that the warm weather during the two heating seasons resulted in an adverse impact to net gas revenues of approximately $32 million, net of the benefits from the weather normalization adjustment and weather derivatives discussed below. Further, KeySpan earned $6.5 million less in regulatory incentives for the twelve months ended December 31, 2006, compared to the same period last year.

KEDNY and KEDLI each operate under utility tariffs that contain a weather normalization adjustment that significantly offsets variations in firm net revenues due to fluctuations in weather. These weather normalization adjustments resulted in a benefit to KeySpan of $57 million during the twelve months ended December 31, 2006, but this did not fully mitigate the impact of the loss in revenues due to the extremely warm weather experienced, as previously noted. The New England-based gas distribution subsidiaries do not have weather normalization adjustments. To mitigate the effect of fluctuations in normal weather patterns on KEDNE's results of operations and cash flows, weather derivatives were in place for the 2005/2006 and 2006/2007 winter heating season. Since weather was warmer than normal in November and December of 2006, these derivative instruments resulted in a $9.1 million benefit to net gas revenues in 2006. (See Note 8 to the Consolidated Financial Statements

"Hedging, Derivative Financial Instruments and Fair Values" for further information).

Firm gas distribution rates for KEDNY, KEDLI and KEDNE in 2006, other than for the recovery of gas costs, have remained substantially unchanged from rates charged in 2005.

In our large-volume heating and other interruptible (non-firm) markets, which include large apartment houses, government buildings and schools, gas service is provided under rates that are designed to compete with prices of alternative fuel, including No. 2 and No. 6 grade heating oil. These "dual-fuel" customers can consume either natural gas or fuel oil for heating purposes. Net revenues in these markets increased $18.5 million during the twelve months ended December 31, 2006, compared to the same period last year primarily reflecting higher pricing.

Firm Sales, Transportation and Other Sales Quantities

Firm gas sales and transportation quantities for the twelve months ended December 31, 2006, decreased 12% compared to the same period in 2006 due primarily to the warmer weather this year compared to last year. On a weather normalized basis, firm gas sales and transportation quantities decreased 2.4% in 2006 compared to 2005 due to lower usage per customer. Customer additions and oil-to-gas conversions, however, offset the full impact of the warmer weather and lower usage per customer. Net revenues are not affected by customers opting to purchase their gas supply from other sources, since delivery rates charged to transportation customers generally are the same as delivery rates charged to full sales service customers. Transportation quantities related to electric generation reflect the transportation of gas to our electric generating facilities located on Long Island. Net revenues from these services are not material.

Other sales quantities include on-system interruptible quantities, off-system sales quantities (sales made to customers outside of our service territories) and related transportation. We have a management contract with Merrill Lynch Trading under which KeySpan and Merrill Lynch Trading share the responsibilities for managing KeySpan's upstream gas contracted assets associated with its Massachusetts gas distribution subsidiaries, as well as providing city-gate delivered supply. KeySpan, Merrill Lynch Trading and KeySpan's Massachusetts gas sales customers will share in the profits generated from the optimization of these assets. The Massachusetts Department of Telecommunications and Energy ("MADTE") approved this contract in March 2006 effective April 1, 2006. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

Purchased Gas for Resale

The decrease in gas costs for the twelve months ended December 31, 2006 compared to the same period of 2005 of $270.4 million, or 7%, is reflective of a decrease of 14% in the quantity of gas purchased due to the warm weather during the two winter heating seasons. However, the price per dekatherm of gas used by firm gas sales customers increased 4%, in 2006 compared to 2005. The current gas rate structure of each of our gas distribution utilities includes a gas adjustment clause, pursuant to which variations between actual gas costs incurred for resale to firm sales customers and gas costs billed to firm sales customers are deferred and refunded to or collected from customers in a subsequent period.

Operating Expenses

Operating expenses for the twelve months ended December 31, 2006, compared to the same period of 2005, decreased $54.7 million, or 5%. Operations and maintenance expense decreased $45.6 million, or 6%, in 2006 compared to 2005 primarily as a result of a decrease of $60.9 million in the provision for uncollectible accounts receivable. In December 2005, The Boston Gas Company ("Boston Gas") received a MADTE order, effective January 1, 2006, permitting Boston Gas to fully recover the gas cost component of bad debt write-offs through its cost-of-gas adjustment clause rather than filing for recovery as an exogenous cost. Additionally, in 2006 we recovered the 2005 gas cost component of bad debts as well. These benefits were the primary driver behind the reduction in the provision for uncollectible accounts receivable, combined with a decrease in firm gas sales quantities in 2006 compared to 2005 and improved collection efforts. (See the discussion under the caption "Regulation and Rate Matters – Gas Matters" for additional details of the MADTE order.) Offsetting the favorable impact of the MADTE order, to some extent, was higher employee benefit related expenses, including postretirement costs, and generally higher administrative and general costs.

The decrease in depreciation and amortization charges of $10.2 million, or 4%, for the twelve months ended December 31, 2006 compared to the same period of 2005, reflects a decrease in depreciation charges of $8.4 million and lower regulatory amortization charges of $1.8 million. The decrease in depreciation charges reflects an adjustment to the depreciation allowance to correct for an error in useful lives associated with certain gas distribution assets.

Operating Income 2005 vs 2004

Executive Summary

Operating income decreased $13.9 million, or 2%, for the twelve months ended December 31, 2005, compared to the same period of 2004 due to higher operating expenses. Operating expenses increased $62.0 million reflecting primarily an increase in the provision for uncollectible accounts receivable and higher property taxes totaling $45.8 million. Partially offsetting the higher operating expenses was an increase of $48.0 million in net gas revenues resulting from customer additions and oil-to-gas conversions in our firm gas sales market, as well as from higher net gas revenues in our large-volume heating markets.

Net Revenues

Net gas revenues from our gas distribution operations increased $48.0 million, or 3%, for the twelve months ended December 31, 2005, compared to the same period of 2004. Net gas revenues benefited from

..uuions and oil-to-gas conversions in our firm gas sales market well as from higher net gas revenues in our large-volume heating and :erruptible (non-firm) markets. As measured in heating degree days, eather in 2005 in our New York and New England service territories as approximately 1.0% and 8.6% colder than normal, respectively. mpared to 2004, weather in 2005 was 1.2% colder in KeySpan's New gland service territory, while weather was consistent between years in e New York service territory.

Net revenues from firm gas customers increased $24.3 million for the elve months ended December 31, 2005, compared to same period of 04. Customer additions and oil-to-gas conversions, net of attrition and nservation, added $25.1 million to net gas revenues. Further, we real- d a benefit of $3.8 million as a result of the Boston Gas Performance sed Rate Plan (the "Plan") that was approved by the MADTE in 2003. e Plan provides for firm gas sales rates to be adjusted each year based an inflation factor offset by a productivity factor. (See the caption der "Regulation and Rate Matters" for further information regarding rate filing.)

Offsetting, to some extent, the beneficial impact of the customer litions and oil-to-gas conversions was the adverse impact to compara- net gas revenues from the additional billing day in 2004 due to the year. In 2004, KeySpan realized $5.7 million in additional net gas rev- es from the additional billing day. Further, KeySpan earned $8.7 mil- less in regulatory incentives for the twelve months ended December 2005, compared to the same period of 2004.

Also included in net revenues is the recovery of certain regulatory ns and certain taxes that added $6.6 million to net revenues. However, recovery of these items through revenues does not impact net income a similar amount was expensed as amortization charges and income as appropriate, on the Consolidated Statement of Income. Firm gas ution rates for KEDNY, KEDLI and KEDNE in 2005, other than for overy of gas costs and resulting from the Plan, remained substan- ıchanged from rates charged in 2004.

DNY and KEDLI each operate under a utility tariff that contains a normalization adjustment that significantly offsets variations in evenues due to fluctuations in normal weather. However, the ution operations of our New England based subsidiaries do not ather normalization adjustment. To mitigate the effect of in normal weather patterns on KEDNE's results of operations ws, weather derivatives were in place for the 2004/2005 06 winter heating seasons. These financial derivatives afford- ome protection against warmer than normal weather. the weather fluctuations and financial weather derivatives, $3.2 million favorable impact on comparative net gas

e-volume heating and interruptible (non-firm) markets, ge apartment houses, government buildings and schools,

gas service is provided under rates that are designed to c prices of alternative fuel, including No. 2 and No. 6 grade These "dual-fuel" customers can consume either natural g for heating purposes. Net revenues in these markets increa lion during the twelve months ended December 31, 2005, the same period of 2004, primarily reflecting higher pricing. since weather during January 2004 was significantly colder t KeySpan interrupted service to a segment of its dual-fuel cust a number of days during that month, as permitted under its t ensure reliable service to firm customers. The majority of interr profits earned by KEDLI and KEDNE are returned to firm custon offset to gas costs.

Firm Sales, Transportation and Other Sales Quantities

Both actual firm gas sales and transportation quantities, as well as er normalized sales quantities for the twelve months ended Decem 2005, remained consistent with those quantities realized in 2004. N enues are not affected by customers opting to purchase their gas su from other sources, since delivery rates charged to transportation cu tomers generally are the same as delivery rates charged to full sales s customers. Transportation quantities related to electric generation refl the transportation of gas to our electric generating facilities located or Long Island. Net revenues from transportation services are not material.

Other sales quantities include on-system interruptible quantities, o system sales quantities (sales made to customers outside of our service territories) and related transportation. The increase in these sales quanti ties for the twelve months ended December 31, 2005, compared to the same period of 2004 reflects higher off-system sales. The majority of th profits earned are returned to firm customers as an offset to gas costs. From April 1, 2002 through March 31, 2005, we had an agreement wit Coral Resources, L.P. ("Coral"), a subsidiary of Shell Oil Company, under which Coral assisted in the origination, structuring, valuation and execu tion of energy-related transactions on behalf of KEDNY and KEDLI. Upon expiration of this agreement, these services have been provided by KeySpan employees. KeySpan also provides these services internally for i New Hampshire gas distribution subsidiaries. In 2004 and 2005, we also had a portfolio management contract with Merrill Lynch Trading, under which Merrill Lynch Trading was responsible for managing KeySpan's upstream gas contracted assets associated with its Massachusetts gas dis tribution subsidiaries, as well as providing city-gate delivered supply. As noted above, beginning in April 2006, KeySpan and Merrill Lynch Tradin have a new three-year agreement under which KeySpan and Merrill Lync share the responsibilities for managing KeySpan's upstream gas contracte assets associated with its Massachusetts gas distribution subsidiaries.

for Resale

jas costs for the twelve months ended December 31, l to the same period of 2004, of $942.3 million, or 35%, ase of 23% in the price per dekatherm of gas purchased es customers, as well as an increase in the quantity of for large-volume heating and interruptible (non-firm) e current gas rate structure of each of our gas distribution es a gas adjustment clause, pursuant to which variations ial gas costs incurred for resale to firm sales customers and ed to firm sales customers are deferred and refunded to or m customers in a subsequent period.

g Expenses

elve months ended December 31, 2005, operating expenses $62.0 million, or 6% compared to the same period in 2004. s and maintenance expense increased $54.5 million, or 8%, in ipared to 2004 primarily due to an increase of $38.7 million in sion for uncollectible accounts as a result of increasing gas costs adverse impact from collection experience. Further, the gas distri- perations realized an increase in insurance and regulatory fees, as postretirement expenses in 2005 compared to 2004. In 2004, n recognized a benefit of approximately $3 million, net of amounts to regulatory deferral treatment, associated with the implementa- the Medicare Prescription Drug Improvement and Modernization 2003 (the "Medicare Act") and implementation of Financial nting Standards Board Staff Position ("FSP") 106-2. In addition, in Boston Gas reached an agreement with an insurance carrier for ry of previously incurred environmental expenditures. Insurance ird-party recoveries, after deducting legal fees, are shared between n Gas and its firm gas customers as provided under a previously MADTE rate order. As a result of this insurance settlement, Boston ecorded a $5 million benefit to operations and maintenance se.

Comparative operating taxes increased $7.1 million due to the expi- of a five-year property tax assessment agreement with New York as well as to a $2.5 million property tax refund received in 2004. r depreciation charges of $4.5 million reflecting the continued sion of the gas distribution system were offset by lower regulatory tization charges of $4.1 million.

Supply and Pricing

oan has adequate gas supply available to meet its gas load demand service territories for the 2006/2007 winter heating season as oan's gas storage was 100% full at the start of the winter heating on. The current gas rate structure of each of our gas distribution utili- ncludes a gas adjustment clause, pursuant to which gas costs are recovered in billed sales to regulated firm gas sales customers. Although KeySpan is allowed to "pass through" the cost of gas to its customers, the volatility of natural gas prices can have an adverse impact on customers' gas bills and recovery of customer accounts receivable. High gas prices have led to an increase in customer conservation measures and attrition. The MADTE order, received in the fourth quarter of 2005, permitting Boston Gas regulatory recovery of the gas cost component of net bad debt write-offs has helped to mitigate any increase in bad debt expense.

With KeySpan's continuing strategy of having its storage facilities 100% full at the start of the heating season and through the use of finan- cial derivatives, KeySpan has effectively hedged the price of approximately two-thirds of the gas supply needed to serve its gas heating customers during the 2006/2007 winter heating season. This strategy mitigates the volatility of natural gas prices on customers' winter heating gas bills. Further, KeySpan has programs in place to help customers manage their gas bills, such as balanced billing plans, deferred payment arrangements and the low income home energy assistance program, the expansion of which we supported through the Energy Policy Act of 2005. Management believes that these measures help mitigate the impact of volatile gas prices on customers' bills.

Other Matters

We remain committed to our ongoing gas system expansion strategies. We believe that significant growth opportunities exist on Long Island and in our New England service territories, as well as continued growth in the New York service territory, despite the volatility in gas prices. We estimate that on Long Island approximately 37% of the residential and multi-family markets, and approximately 60% of the commercial market, currently use natural gas for space heating. Further, we estimate that in our New England service territories approximately 50% of the residential and multi- family markets, as well as approximately 60% of the commercial market, currently use natural gas for space heating purposes. We will continue to seek growth, in all of our market segments to serve new housing and commercial construction and to penetrate existing communities where no distribution system exists, as well as through the conversion of residential homes from oil to gas for space heating purposes and the pursuit of opportunities to grow multi-family, industrial and commercial markets.

In order to serve the anticipated market requirements in our New York service territories, KeySpan and Spectra Energy Corporation (formerl a part of Duke Energy Corporation) formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Once in service, the pipeline is expected to have the capacity to transport up to 260,000 DTH of natur gas to the Long Island and New York City energy markets, enough nat gas to heat 600,000 homes. In addition, KeySpan has a 26.25% intere in the Millennium Pipeline development project which is anticipated to transport up to 525,000 DTH of natural gas a day to the Algonquin pipeline. KEDLI has executed a Precedent Agreement for 175,000 DTH

natural gas per day of transportation capacity from the Millennium Pipeline system, increasing to 200,000 DTH in the second year of the pipeline being in service. These pipeline projects will allow KeySpan to diversify the geographic sources of its gas supply. See the discussion under the caption "Energy Investments" for additional information regarding these pipeline projects.

Electric Services

The Electric Services segment primarily consists of subsidiaries that own, lease and operate oil and gas-fired electric generating plants in the Borough of Queens (including the "Ravenswood Generating Station" which comprises the Ravenswood Facility and Ravenswood Expansion) and the counties of Nassau and Suffolk on Long Island. In addition, through long-term contracts of varying lengths, we (i) provide to the Long Island Power Authority ("LIPA") all operation, maintenance and construction services and significant administrative services relating to the Long Island electric transmission and distribution ("T&D") system pursuant to a Management Services Agreement (the "1998 MSA"); (ii) supply LIPA with electric generating capacity, energy conversion and ancillary services from our Long Island generating units pursuant to a Power Supply Agreement (the "1998 PSA"); and (iii) manage all aspects of the fuel supply for our Long Island generating facilities, as well as all aspects of the capacity and energy owned by or under contract to LIPA pursuant to an Energy Management Agreement (the "1998 EMA"). The 1998 MSA, 1998 PSA and 1998 EMA all became effective on May 28, 1998 and are collectively referred to herein as the "1998 LIPA Agreements."

On February 1, 2006, KeySpan and LIPA entered into (i) an amended and restated Management Services Agreement (the "2006 MSA"), pursuant to which KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island through 2013; (ii) a new Option and Purchase and Sale Agreement (the "2006 Option Agreement"), to replace the Generation Purchase Rights Agreement (the "GPRA"), pursuant to which LIPA had the option, through December 15, 2005, to acquire substantially all of the electric generating facilities owned by KeySpan on Long Island; and (iii) a Settlement Agreement (the "2006 Settlement Agreement") resolving outstanding issues between the parties regarding the 1998 LIPA Agreements. The 2006 MSA, the 2006 Option Agreement and the 2006 Settlement Agreement are collectively referred to herein as the "2006 LIPA Agreements." These agreements will become effective following approval by the New York State Comptroller's Office and the New York State Attorney General. (For a further discussion on these LIPA agreements see the discussion under the caption "Electric Services – LIPA Agreements" and Note 11 to the Consolidated Financial Statements "2006 LIPA Settlement"). The Electric Services segment also provides retail marketing of electricity to commercial customers.

Selected financial data for the Electric Services segment is set forth in the table below for the periods indicated.

(In Millions of Dollars)

YEAR ENDED DECEMBER 31,	2006	2005	2004
Revenues	$ 1,834.2	$ 2,047.3	$ 1,738.7
Purchased fuel	548.4	751.4	539.6
Net Revenues from Operations	1,285.8	1,295.9	1,199.1
Derivative Financial Instrument	46.5	—	—
Net Electric Revenues	1,332.3	1,295.9	1,199.1
Operating Expenses			
Operations and maintenance	750.8	684.5	653.3
Depreciation	102.1	91.7	88.3
Operating taxes	186.9	178.6	169.7
Total Operating Expenses	1,039.8	954.8	911.3
Gain on the sale of property	0.5	1.2	2.0
Operating Income	$ 293.0	$ 342.3	$ 289.8
Electric sales (MWH)*	4,480,996	6,364,279	6,232,190
Capacity(MW)*	2,450	2,450	2,450
Cooling degree days	1,130	1,472	1,045

**Reflects the operations of the Ravenswood Generating Station only.*

Operating Income 2006 vs 2005

Executive Summary

Operating income decreased $49.3 million, or 14%, for the twelve months ended December 31, 2006, compared to the same period last year, due primarily to a decrease in net revenues from the Ravenswood Generating Station of $110.3 million as a result of lower energy margins and lower capacity revenues, partially offset by higher revenues associated with KeySpan's service agreements with LIPA and its electric marketing activities of $10.6 million. KeySpan also recognized a gain of $46.5 million on a fixed for floating unforced capacity financial swap.

Net Revenues

Total electric net revenues realized in 2006 were $36.4 million higher than such revenues realized in 2005.

KeySpan has entered into an International SWAP Dealers Association Master Agreement for a fixed for floating unforced capacity financial swap with Morgan Stanley Capital Group Inc. ("Swap Agreement"). This agreement has a three year term that began on May 1, 2006. For the twelve months ended December 31, 2006 KeySpan recognized a gain of $46.5 million from this derivative financial instrument. (See Note 8 to the Consolidated Financial Statements, "Hedging, Derivative Financial Instruments and Fair Values," for further information on this swap agreement.)

Net revenues for the twelve months ended December 31, 2006 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $96.6 million compared to the same period of 2005. The increase is due, for the most part, to recovery of operations and maintenance charges billed to LIPA of approximately $76 million and the recovery of depreciation

ty taxes of approximately $14 million. These recoveries
)perating income since actual expenses increased by a
fore, only approximately $7 million of the increase in
:ed in a benefit to operating income. This increase in
the LIPA service agreements was driven by higher
: energy sales and emission credit sales, as well as the
n past service costs, offset by lower performance
)6, KeySpan earned $9.0 million associated with non-cost
entives provided for under these agreements, compared
earned in 2005, due to the discontinuation of certain
:entives contained in the MSA.
ues associated with KeySpan's electric marketing activities
million during the twelve months ended December 31,
ed to the same period of 2005.
ues from the Ravenswood Generating Station decreased
, or 25% for the twelve months ended December 31, 2006,
the same period of 2005 reflecting lower capacity revenues of
and a decrease in energy margins of $29.8 million. The
apacity revenues was primarily due to the planned installation
gawatts of additional electric capacity in New York City in 2006.
crease in energy margins in 2006 reflects, in part, a 50%
realized "spark-spreads" (the selling price of electricity less the
, exclusive of hedging gains or losses). Further, the level of
hours ("MWh") sold into the NYISO energy market decreased
o increased competition and cooler weather in the summer of
pared to the summer of 2005 – the peak cooling season. As
in cooling-degree days, weather was 25% cooler during the
2006 compared to the summer of 2005, and 2% warmer than
ombined, these two items reduced energy margins by $124.9
63%. It should be noted, that in 2005 KeySpan benefited from
differential between number 6-grade fuel oil and natural gas
e Ravenswood Generating Station. Due to the dual-fuel capabili-
Ravenswood Generating Station, KeySpan was able to take
of the ability to switch to cheaper fuel as the gap between
grade fuel oil and gas prices spread during the later part of the
mer. The two hurricanes which occurred in the summer of 2005
f Coast of the United States contributed to the gap between
-grade fuel oil and natural gas prices.
ally offsetting these adverse impacts to comparative energy
were the benefits recognized from derivative financial instru-
e employ derivative financial instruments to economically hedge
flow variability for a portion of forecasted purchases of natural
uel oil consumed at the Ravenswood Generating Station, as
r a portion of forecasted electric energy sales. These derivative
nts, the impacts of which are reflected in net electric margins,
n a comparative gain of $95.1 million year-over-year. Hedging
lized in 2006 were $79.1 million compared to hedging losses of
llion realized in 2005.

The Ravenswood Generating Station is a dual-fuel electric facility that can burn either number 6-grade fuel oil or natural gas to generate electricity. To take full advantage of the dual-fuel capability of the Ravenswood Generating Station, KeySpan uses the cheaper of the two fuels in the generation of electricity and, as a result, KeySpan may not be able to apply hedge accounting treatment for all of its aforementioned risk management strategies in the future and therefore may experience some degree of fluctuations in its recorded net electric revenues due to changes in the market value of outstanding derivative instruments and the related underlying commodity. (See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" as well as Item 7A. Quantitative and Qualitative Disclosures about Market Risk for further information on KeySpan's hedging strategies.)

The rules and regulations for capacity, energy sales and the sale of certain ancillary services to the NYISO energy markets continue to evolve and there are several matters pending with the Federal Energy Regulatory Commission ("FERC"). See the discussion under the caption "Regulatory Issues and the Competitive Environment" for further details on these matters.

Operating Expenses

For the twelve months ended December 31, 2006, operating expenses increased $85.0 million compared to the same period of 2005. Operations and maintenance expenses increased $66.3 million during the twelve months ended December 31, 2006, compared to the same period of 2005 reflecting a $76 million increase in costs recovered from LIPA. As noted previously, this increase had no impact on operating income since revenues increased by a similar amount. Therefore, the operations and maintenance expenses that impacted operating income actually decreased approximately $10 million due to a decrease in overhaul costs and non-outage maintenance work on the Ravenswood Generating Station and our Long Island based electric generating units.

Depreciation expense and operating taxes increased $18.7 million in 2006 compared to 2005. Of this amount, approximately $14 million is associated with KeySpan's Long Island based electric generating units and are fully recoverable from LIPA, as noted above. The remaining increase in these line items is associated with the Ravenswood Generating Station and did impact comparative operating income.

Operating Income 2005 vs 2004

Executive Summary

For the twelve months ended December 31, 2005, operating income increased $52.5 million, or 18%, compared to the same period of 2004 primarily due to an increase in net revenues from the Ravenswood Generating Station of $78.7 million mainly as a result of improved pric
The increase in net revenues was partially offset by an increase in oper
ing expenses associated with the Ravenswood Generating Station of $11.8 million, as well as lower net revenues associated with KeySpan'
retail electric marketing activities of $7.6 million.

.. Revenues

otal electric net revenues realized during the twelve months ended ecember 31, 2005, were $96.8 million, or 8% higher than such revnues realized during the corresponding period of 2004.

For the year ended December 31, 2005, net revenues from the avenswood Generating Station increased $78.7 million, or 22%, comared to the same period in 2004 reflecting higher energy margins of 66.0 million, as well as increased capacity revenues of $12.7 million. ne increase in capacity revenues reflected the operation of the avenswood Expansion which went into full commercial operation in lay 2004, as well as load growth in New York City.

The increase in energy margins for 2005 reflects an increase of 54% "spark-spreads" (the selling price of electricity less the cost of fuel, clusive of hedging gains or losses), as well as from an increase of 2% in e level of MWh sold into the NYISO energy market. These favorable nergy results were primarily driven by the pricing differential between umber 6-grade fuel oil and natural gas used in the Ravenswood enerating Station in 2005. As noted previously, due to the dual-fuel ture of the Ravenswood Generating Station, KeySpan was able to take lvantage of the ability to switch to cheaper fuel as the gap between umber 6 grade fuel oil and gas prices spread during the later part of the 05 summer. Further, in 2005 KeySpan received $9.2 million from the 'ISO to settle billing issues regarding the sale of energy provided by the venswood Generating Station to the NYISO in May 2000. Weather for 05, as measured in cooling degree days, was 40% warmer than 2004 d 28% warmer than normal.

As mentioned previously, we employ derivative financial hedging truments to hedge the cash flow variability for a portion of forecasted chases of natural gas and fuel oil consumed at the Ravenswood erating Station as well as a portion of forecasted electric energy sales. e derivative instruments resulted in hedging losses, which are reflectnet electric margins, of $16.0 million in 2005, compared to hedging of $23.0 million in 2004.

let revenues for the twelve months ended December 31, 2005, e service agreements with LIPA, including the power purchase ents associated with two electric peaking facilities, increased $25.7 ompared to the corresponding period of 2004. The increase was art, to recovery of operating expenses billed to LIPA of approxi- 4 million and the recovery of depreciation charges and property pproximately $8 million. These recoveries had no impact on ncome since actual expenses increased by a like amount. The ncrease primarily reflects an increase in emission credits earned revenues, which are a function of electric generation output. 2004, we earned a total of $16.4 million associated with formance incentives provided for under these agreements. nues associated with KeySpan's retail electric marketing ased $7.6 million in 2005 compared to 2004, due to a signent in these activities. In 2005, KeySpan terminated all indexed price contracts and elected to maintain only its fixec tracts. As a result, the retail electric marketing business had a 40 MW under contract during 2005.

Operating Expenses

For the twelve months ended December 31, 2005, operating e› increased $43.5 million, or 5%, compared to the same period o Operations and maintenance expense in 2005 increased $31.2 n 5% over 2004 reflecting an increase of $7.5 million in operating costs associated with our financing arrangement for the Ravensw Expansion, as well as an increase in overhaul work and plant retire costs associated with the Ravenswood Generating Station amounti approximately $8 million. The remaining increase reflected operatin billed to LIPA of approximately $14 million.

Depreciation expense and operating taxes increased $12.3 milli 2005 compared to 2004. Of this amount, approximately $8 million w associated with KeySpan's Long Island based electric generating units were fully recoverable from LIPA, as noted above. The remaining increa in these line items was associated with the Ravenswood Generating Station.

Other Matters

In 2003, the New York State Board on Electric Generation Siting and the Environment issued an opinion and order which granted a certificate of environmental capability and public need for a 250 MW combined cycle electric generating facility in Melville, Long Island, which is final and nonappealable. Also in 2003, LIPA issued a Request for Proposal ("RFP") seeking bids from developers to either build and operate a Long Island generating facility, and/or a new cable that will link Long Island to power from a non-Long Island source of between 250 to 600 MW of electricity by no later than the summer of 2007. KeySpan filed a proposal in response to LIPA's RFP. In 2004, LIPA selected proposals submitted by two other bidders in response to the RFP. KeySpan remains committed to the Melville project and the benefits to Long Island's energy future that this project would supply. The project has received New York State Article X approval by having met all operational and environmental permitting requirements. Further, the project is strategically located in close proximity to both the high voltage power transmission grid and the high pressure gas distribution network. In addition, given the intense public pressure to reduce emissions from existing generating facilities, development of the Melville project is possible as a means to "virtually re-power" older, less efficient generating units. Specifically, KeySpan believes that it would be able to reduce emissions on Long Island in a cost effective manner by developing the Melville project and retiring an older, less efficient generating facility. Additionally, in August 2006, the NYISO included the Melville project in its Reliability Report as one of the market solutions to help address the longterm reliability of New York State's electric grid. At December 31, 2006, total capitalized costs associated with the siting, permitting and procurement of equipment for the Melville facility were $63.6 million.

Energy Services

The Energy Services segment includes companies that provide energy-related services to customers located primarily within the northeastern United States. Subsidiaries in this segment provide residential and small commercial customers with service and maintenance of energy systems and appliances, as well as operation and maintenance, design, engineering, consulting and fiber optic services to commercial, institutional and industrial customers.

The table below highlights selected financial information associated with the Energy Services segment.

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Revenues	$ 213.0	$ 202.0	$ 193.9
Less: Operating expenses	207.7	204.7	227.8
Goodwill impairment	—	—	14.4
Operating Income (Loss)	$ 5.3	$ (2.7)	$ (48.3)

Operating Income 2006 vs 2005

The Energy Services segment posted an operating profit of $5.3 million for the twelve months ended December 31, 2006, compared to an operating loss of $2.7 million incurred during the twelve months ended December 31, 2005. The improved performance reflects higher operating margins on engineering contracts, as well as favorable billings under a long-term energy service and energy supply contract. KeySpan's fiber optic operations realized a benefit to operating income from an increase in bandwidth sales and the successful completion of certain projects. Finally, general and administrative expenses were lower in 2006 compared to 2005 as a result of the implementation of cost containment measures.

Operating Income 2005 vs 2004

In January and February of 2005, KeySpan sold its mechanical contracting subsidiaries in this segment and exited such businesses. In the fourth quarter of 2004, KeySpan's investment in its discontinued mechanical contracting subsidiaries was written-down to an estimated fair value. (See Note 2 to the Consolidated Financial Statements "Business Segments" for additional details on the sale of the mechanical companies.)

The Energy Services segment incurred an operating loss of $2.7 million in 2005, compared to a loss of $48.3 million in 2004. In 2004, KeySpan recorded a non-cash goodwill impairment charge in continuing operations of $14.4 million as a result of an evaluation of the carrying value of goodwill recorded in this segment. That evaluation resulted in a total pre-tax impairment charge of $208.6 million ($152.4 million, or $0.95 per share after-tax) – $14.4 million of this charge was attributable to continuing operations, while the remaining $194.2 million ($139.9 million after-tax, or $0.87 per share), was reflected in discontinued operations. (See Note 10 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for additional details on this charge.)

For 2005, the improved performance over 2004, excluding the goodwill impairment charge, primarily reflected a reduction in operating expenses. In 2004, charges associated with the write-off of accounts receivable and contract revenues on certain projects that were determined to be uncollectible, were incurred as well as the write-down of inventory balances. Further, this segment experienced an increase in gross profit margins and generally lower administrative costs in 2005.

Energy Investments

The Energy Investments segment consists of our gas production and development investments, as well as certain other domestic energy-related investments. KeySpan's gas production and development activities include its wholly-owned subsidiaries Seneca Upshur Petroleum, Inc. ("Seneca-Upshur") and KeySpan Exploration and Production, LLC ("KeySpan Exploration"). Seneca-Upshur is engaged in gas production and development activities primarily in West Virginia. KeySpan Exploration is involved in a joint venture with Merit Energy Corporation, an independent oil and gas producer, which acquired its interest in the joint-venture from Houston Exploration.

This segment is also engaged in pipeline development activities. KeySpan and Spectra Energy Corporation (formerly a part of Duke Energy Corporation) each own a 50% interest in Islander East. Islander East was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Shoreham, Long Island. Further, KeySpan has a 26.25% interest in the Millennium Pipeline Company LLC, the developer of the Millennium pipeline project which is expected to have the capacity to transport up to 525,000 DTH of natural gas a day from Corning, New York to Ramapo, New York, where it will connect to an existing pipeline. Additionally, subsidiaries in this segment hold a 20% equity interest in the Iroquois Gas Transmission System LP, a pipeline that transports Canadian gas supply to markets in the northeastern United States. These investments are accounted for under the equity method of accounting. Accordingly, equity income from these investments is reflected as a component of operating income in the Consolidated Statement of Income.

KeySpan also owns a 600,000 barrel liquefied natural gas ("LNG") storage and receiving facility in Providence, Rhode Island, through its wholly owned subsidiary KeySpan LNG, the operations of which are fully consolidated.

Selected financial data and operating statistics for these energy-related investments are set forth in the following table for the periods indicated.

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	2006	2005	2004
Revenues	$ 40.3	$ 43.0	$ 58.9
Less: Operation and maintenance			
expense	26.3	26.5	33.5
Ceiling test write-down	—	—	48.2
Impairment charge	—	—	26.5
Other operating expenses	11.9	11.1	15.3
Add: Equity earnings	13.1	15.1	25.8
Sale of assets	0.3	0.1	5.0
Operating Income (Loss)	$ 15.5	$ 20.6	$ (33.8)

Operating income above reflects 100% of KeySpan Canada's results from January 1, 2004 through April 1, 2004.

Operating Income 2006 vs 2005

For the twelve months ended December 31, 2006, operating income decreased $5.1 million compared to the same period in 2005 due, in part, to lower earnings from KeySpan's investment in the Iroquois Gas Transmission System. In 2005, the Iroquois Gas Transmission System realized a benefit from a court settlement relating to a gas supply contract that was defaulted on by a counterparty in an earlier period. Further, a KeySpan subsidiary engaged in the transportation of liquefied natural gas realized lower earnings due to the warm weather during the two winter seasons in calendar year 2006. Finally, comparative equity earnings were adversely impacted by the sale of Premier Transmission Limited in March 2005.

Operating Income 2005 vs 2004

As noted previously, in the first quarter of 2005, KeySpan sold its 50% interest in Premier, a gas pipeline from southwest Scotland to Northern Ireland pursuant to a Share Sale and Purchase Agreement with BG Energy Holdings Limited and Premier Transmission Financing Public Limited Company ("PTFPL"), under which all of the outstanding shares of Premier were to be purchased by PTFPL. On March 18, 2005, the sale was completed and generated cash proceeds of $48.1 million. In the fourth quarter of 2004, KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value. The final sale of Premier resulted in a pre-tax gain of $4.1 million reflecting the difference from earlier estimates. This gain was recorded in other income and (deductions) on the Consolidated Statement of Income.

During the first quarter of 2004, KeySpan had an approximate 61% investment in certain midstream natural gas assets in Western Canada through KeySpan Canada. These assets included 14 processing plants and associated gathering systems that produced approximately 1.5 BCFe of natural gas daily and provided associated natural gas liquids fractionation. These operations were fully consolidated in KeySpan's Consolidated Financial Statements. On April 1, 2004, KeySpan and KeySpan Facilities Income Fund (the "Fund"), an open-ended income trust which previously owned a 39% interest in KeySpan Canada, consummated a transaction that reduced KeySpan's ownership interest in KeySpan Canada to 25%. The transaction resulted in a gain of $22.8 million ($10.1 million after-tax, or $0.06 per share). Effective April 1, 2004, KeySpan Canada's earnings and our ownership interest in KeySpan Canada were accounted for on the equity method of accounting.

In July 2004, the Fund issued an additional 10.7 million units, the proceeds of which were used to fund the acquisition of the midstream assets of Chevron Canada Midstream Inc. This transaction had the effect of further diluting KeySpan's ownership of KeySpan Canada to 17.4%.

In December 2004, KeySpan sold its remaining 17.4% interest in KeySpan Canada to the Fund and received net proceeds of approximately $119 million and recorded a pre-tax gain of $35.8 million, which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was approximately $24.7 million, or $0.15 per share. (See Note 2 to the Consolidated Financial Statements "Business Segments" for additional details regarding this transaction.)

For the twelve months ended December 31, 2005, operating income for this segment increased $54.4 million compared to the same period of 2004, reflecting non-cash impairment charges recorded in 2004 of $74.7 million. In 2004, KeySpan's wholly owned gas production and development subsidiaries that remained with KeySpan after the transaction with Houston Exploration, discussed below, recorded a non-cash impairment charge of $48.2 million to recognize the reduced valuation of proved reserves. (See Note 1 to the Consolidated Financial Statements "Summary of Significant Accounting Policies" Item F "Gas Production and Development Property – Depletion" for further information on this charge.) Further, as mentioned, in 2004 KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value.

Operating income for the twelve months ended December 31, 2004, also includes $16.5 million in earnings from KeySpan Canada. The remaining activities reflected a decrease in operating income of $3.8 million primarily due to the sale of real property in 2004.

Houston Exploration

Selected financial data and operating statistics for Houston Exploration for 2004 are set forth in the following table.

	(In Millions of Dollars)
YEAR ENDED	DECEMBER 31, 2004
Revenues	$ 268.1
Depletion and amortization expense	104.6
Other operating expenses	45.7
Add: Equity Earnings	20.7
Operating Income	$ 138.5

During the first five months of 2004, our gas production and development investments included a 55% equity interest in Houston Exploration, the operations of which were consolidated in KeySpan's Consolidated Financial Statements. On June 2, 2004, KeySpan exchanged 10.8 million shares of common stock of Houston Exploration for 100% of the stock of Seneca-Upshur, previously a wholly owned subsidiary of Houston Exploration. This transaction reduced our interest in Houston Exploration from 55% to 23.5%. Effective June 2, 2004, Houston Exploration's earnings and our ownership interest in Houston Exploration were accounted for on the equity method of accounting. KeySpan follows an accounting policy of income statement recognition for parent company gains or losses from common stock transactions initiated by its subsidiaries. As a result, this transaction resulted in a gain to KeySpan of $150.1 million. The deconsolidation of Houston Exploration required the recognition of certain deferred taxes on our remaining investment, resulting in a net deferred tax expense of $44.1 million. Therefore, the net gain on the share exchange less the deferred tax provision was $106 million, or $0.66 per share.

In November 2004, KeySpan sold its remaining 23.5% interest in Houston Exploration (6.6 million shares) and received cash proceeds of approximately $369 million. KeySpan recorded a pre-tax gain of $179.6 million which was reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was $116.8 million or $0.73 per share.

Other Matters

In order to serve the anticipated market requirements in our New York service territories, KeySpan and Spectra Energy Corporation (formerly a part of Duke Energy Corporation) formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Islander East is owned 50% by KeySpan and 50% by Spectra Energy Corporation, and was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Shoreham, Long Island. Applications for all necessary regulatory authorizations were filed in 2000 and 2001. Islander East has received a final certificate from the FERC and all necessary permits from the State of New York. The State of Connecticut denied Islander East's request for a consistency determination under the Coastal Zone Management Act ("CZMA") and application for a permit under Section 401 of the Clean Water Act. Islander East appealed the State of Connecticut's determination on the CZMA issue to the United States Department of Commerce which overrode Connecticut's denial and granted the CZMA authorization. The determination of the Secretary of Commerce was appealed to the United States District Court for the District of Columbia by the State of Connecticut and a decision from that court is pending. Following an appeal filed by Islander East, the Second Circuit Court of Appeals ruled on October 5, 2006 that, among other things, the Connecticut Department of Environmental Protection ("CTDEP") acted arbitrarily and capriciously in denying the Clean Water Act permit. The Court remanded the matter to CTDEP to either provide sufficient evidence to support the denial or otherwise take any action necessary in furtherance of the development of the project. In December 2006, the CTDEP issued an order again denying the Clean Water Act permit. Islander East filed a motion for review with the Second Circuit Court of Appeals, which is pending. KeySpan anticipates that this pipeline will be in service in late 2008. As of December 31, 2006, KeySpan's total capitalized costs associated with the siting and permitting of the Islander East pipeline were approximately $30.3 million.

As noted, KeySpan also owns a 26.25% ownership interest in the Millennium Pipeline Company LLC, the developer of the Millennium Pipeline project. The other partners in the Millennium Pipeline are Columbia Gas Transmission Corp. ("Columbia Transmission"), a unit of NiSource Incorporated and DTE Energy Company. The Millennium Pipeline project is anticipated to have the capacity to transport up to 525,000 DTH of natural gas a day from Corning to Ramapo, New York, interconnecting with the pipeline systems of various other utilities in New York. The project received a FERC certificate to construct, acquire and operate the facilities in 2002, subject to certain conditions. On August 1, 2005, the project filed an application to amend the FERC certificate requesting, among other things, authority to phase in over time the construction of the proposed pipeline system, approval of a reduction in capacity and maximum allowable operating pressure, minor route modifications, the addition of certain facilities and the acquisition of certain facilities from Columbia Transmission. In December 2006 the FERC issued an order granting the amended certificate. Additionally, Consolidated Edison, KEDLI and Columbia Transmission have each entered into amended precedent agreements to purchase capacity on the pipeline. KEDLI has agreed to purchase 175,000 DTH per day from the Millennium Pipeline system, increasing to 200,000 DTH in the second year of the pipeline being in service. This will provide KEDLI with new, competitively priced supplies of natural gas from Canada and other North American supply basins. The conditions in the precedent agreements are subject to, among other things, the receipt of necessary regulatory approvals and financing. Millennium is in the process of securing all remaining environmental permits, financing and the finalization of certain agreements prior to actual construction. Subject to the receipt of remaining permits and financing, Millennium expects that the first phase of the project will be in service by November 2008. As of December 31, 2006, KeySpan's investment in the Millennium Pipeline project was $18.2 million.

In 2005, KeySpan LNG entered into a precedent agreement with BG LNG Services, a subsidiary of British Gas, to provide liquefied natural gas terminalling service. KeySpan LNG proposed to upgrade the liquefied natural gas facility to accept marine deliveries and to triple vaporization (or regasification) capacity to provide these services. In June 2005, the FERC denied KeySpan LNG's application to expand the facility citing concerns that the proposed upgraded facility would not meet current federal new construction and safety standards. KeySpan sought a rehearing with FERC, and on January 20, 2006, the FERC denied such request, although the order provided that KeySpan LNG could file an amendment to its original application addressing a revised expansion project which would differ

substantially from that originally proposed by KeySpan. Any amended application would need to include a detailed analysis of the new project scope, including upgrades to the existing facilities and alternative plans for any service disruptions that may be necessary during construction of a new expanded project. KeySpan has filed a petition for judicial review of the FERC order with the United States Circuit Court for the District of Columbia. The Court is expected to issue a decision affirming or vacating the FERC orders by the second quarter of 2007.

In addition to the proceeding at FERC, KeySpan LNG also is involved in seeking other required regulatory approvals and the resolution of certain litigation regarding such approvals. In February 2005, KeySpan LNG filed an action in Federal District Court in Rhode Island seeking a declaratory judgment that it is not required to obtain a "Category B Assent" from the State of Rhode Island and an injunction preventing the Rhode Island Coastal Resources Management Council ("CRMC") from enforcing the Category B assent requirements. In April 2005, the Rhode Island Attorney General also filed on behalf of the state a complaint against KeySpan LNG in Rhode Island State Superior Court raising substantially the same issues as the federal court action. KeySpan LNG removed that action to federal court and moved for summary judgment. The Court stayed the litigation pending resolution of the FERC appeal process discussed above. As of December 31, 2006, our investment in this project was $18.4 million, a portion of which may be subject to reimbursement from BG LNG pursuant to the terms of the precedent agreement.

Allocated Costs

We are subject to the jurisdiction of the FERC under PUHCA 2005. As part of the regulatory provisions of PUHCA 2005, the FERC regulates various transactions among affiliates within a holding company system. In accordance with regulations under PUHCA 2005 and regulations and policies of the New York State Public Service Commission, the Massachusetts Department of Telecommunications and Energy and the New Hampshire Public Utility Commission, we established service companies that provide: (i) traditional corporate and administrative services; (ii) gas and electric transmission and distribution system planning, marketing, and gas supply planning and procurement; and (iii) engineering and surveying services to subsidiaries. The operating income variation as reflected in "elimination and other" is due primarily to costs residing at KeySpan's holding company level such as incremental costs associated with the anticipated Merger with National Grid plc, as well as corporate advertising expenses. Also, KeySpan entered into confidential settlement agreements with certain of its insurance carriers for recovery of environmental costs associated with investigation and remediation of gas plant sites and non-utility sites. KeySpan recorded a $5.5 million benefit in its Consolidated Statement of Income for the twelve months ended December 31, 2006, associated with these settlement agreements.

The operating income variation between 2005 and 2004 was due primarily to costs residing at KeySpan's holding company level such as corporate advertising and strategic review costs. Further, in 2004 KeySpan reached a settlement with its insurance carriers regarding cost recovery for expenses incurred at a non-utility environmental site and recorded an $11.6 million gain from the settlement as a reduction to operating expenses.

Liquidity

Cash flow from operations increased $655.3 million for the twelve months ended December 31, 2006 compared to the same period last year primarily due to favorable working capital requirements of approximately $520 million and lower income tax payments. The favorable working capital requirements were primarily driven by receipt of customer payments associated with the 2005 fourth quarter winter heating season gas sales and lower payments for inventory requirements. Outstanding accounts receivable balances associated with KeySpan's gas distribution activities at December 31, 2005 were unusually high due to strong gas sales in 2005 and high natural gas prices. The collection of these balances in 2006, and improved collection experience, resulted in a significant cash flow benefit to KeySpan. Further, due to the impact of the warm weather experienced during the two winter heating seasons in 2006, KeySpan purchased less natural gas in 2006 than it did 2005 to refill its inventory supplies. Also, the average unit price associated with gas purchased for inventory purposes was lower in 2006 compared to 2005. Both of these events had a favorable impact to KeySpan's cash flows in 2006.

Additionally, KeySpan's income tax payments were $23 million lower during the twelve months ended December 31, 2006, compared to the same period last year. In 2005, the IRS published new regulations related to the capitalization of costs of self-constructed property for income tax purposes that were detrimental to KeySpan. As a result, in 2006 KeySpan adopted a new tax methodology related to the capitalization of costs of self-constructed property that resulted in lower income tax payments in 2006 compared to 2005.

Cash flow from operations decreased $346.8 million, or 46%, for the twelve months ended December 31, 2005 compared to 2004, reflecting, in part, the absence of Houston Exploration and KeySpan Canada which combined contributed approximately $230 million to consolidated operating cash flow in 2004. It should be noted that in prior years, Houston Exploration funded its gas exploration and development activities, in part, from available cash flow from operations. In addition, due to the significant increase in natural gas prices in 2005, KeySpan's gas distribution utilities paid approximately $215 million more in 2005 compared to 2004 for the purchase of natural gas that was put in inventory. As noted previously, the current gas rate structure of each of our gas distribution utilities includes a gas adjustment clause, pursuant to which variations between actual gas costs incurred for sale to firm customers and gas costs billed to firm customers are deferred and refunded to or collected from customers in a subsequent period. Further, in 2005 the IRS published new regulations related to the capitalization of costs of self-constructed property for income tax purposes. As a result of these regulations, KeySpan incurred approximately $77 million in higher income tax payments for the twelve months ended December 31, 2005 compared to the same period in 2004. These adverse impacts to cash flow from operations were partially offset by lower interest payments and higher core earnings.

At December 31, 2006, we had cash and temporary cash investments of $210.9 million. During 2006, we repaid $572.6 million of commercial paper and, at December 31, 2006, $85.0 million of commercial paper was outstanding at a weighted-average annualized interest rate of 5.43%. We had the ability to borrow up to an additional $1.4 billion at December 31, 2006, under the terms of our credit facility.

KeySpan has two credit facilities which total $1.5 billion – $920 million available through 2010, and $580 million available through 2009 – which continue to support KeySpan's commercial paper program for ongoing working capital needs.

The fees for the facilities are based on KeySpan's current credit ratings and are increased or decreased based on a downgrading or upgrading of our ratings. The current annual facility fee is 0.07% based on our credit rating of A3 by Moody's Investor Services and A by Standard & Poor's for each facility. Both credit facilities allow KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin that is tied to our applicable credit ratings. ABR loans are based on the higher of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders. We do not anticipate borrowing against these facilities; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The facilities contain certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its utility property to any lien, as well as certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 65% as of the last day of any fiscal quarter. Violation of these covenants could result in the termination of the facilities and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements. At December 31, 2006, KeySpan's consolidated indebtedness was 49.9% of its consolidated capitalization and KeySpan was in compliance with all covenants.

Subject to certain conditions set forth in the credit facility, KeySpan has the right, at any time, to increase the commitments under the $920 million facility up to an additional $300 million. In addition, KeySpan has the right to request that the termination date be extended for an additional period of 365 days prior to each anniversary of the closing date. This extension option, however, requires the approval of lenders holding more than 50% of the total commitments to such extension request. Under the agreements, KeySpan has the ability to replace non-consenting lenders with other pre-approved banks or financial institutions. Upon effectiveness of PUHCA 2005, KeySpan's ability to issue commercial paper was no longer limited by the SEC. Accordingly, subject to compliance with the foregoing conditions, KeySpan is currently able to issue up to $1.5 billion of commercial paper.

A substantial portion of consolidated revenues are derived from the operations of businesses within the Electric Services segment, that are largely dependent upon two large customers – LIPA and the NYISO. Accordingly, our cash flows are dependent upon the timely payment of amounts owed to us by these counterparties. (See the discussion under the caption "Electric Services – LIPA Agreements" for information regarding the proposed settlement between KeySpan and LIPA regarding the current contractual agreements.)

We satisfy our seasonal working capital requirements primarily through internally generated funds and the issuance of commercial paper. We believe that these sources of funds are sufficient to meet our seasonal working capital needs.

Capital Expenditures and Financing

Construction Expenditures

The table below sets forth our construction expenditures by operating segment for the periods indicated:

	(In Millions of Dollars)	
YEAR ENDED DECEMBER 31,	**2006**	**2005**
Gas Distribution	$ 400.5	$ 410.3
Electric Services	78.9	88.8
Energy Investments	18.7	22.6
Energy Services and other	25.9	17.8
	$ 524.0	$ 539.5

Construction expenditures related to the Gas Distribution segment are primarily for the renewal, replacement and expansion of the distribution system. Construction expenditures for the Electric Services segment reflect costs to maintain our generating facilities.

Construction expenditures for 2007 are estimated to be approximately $570 million, including estimated expenditures for the Islander East and Millennium pipelines. KeySpan and its partners are currently evaluating various options for the financing of these projects. The amount of future construction expenditures is reviewed on an ongoing basis and can be affected by timing, scope and changes in investment opportunities.

Financing

In November 2006, KeySpan issued $400 million Senior Unsecured Notes at KEDNY and $100 million Senior Unsecured Notes at KEDLI pursuant to a private placement that was exempt from registration under the Securities Act of 1933. The Notes bear interest at a rate of 5.60% annually and mature in 2016. The net proceeds from the issuance of the Notes were used by KEDNY and KEDLI to refinance existing intercompany indebtedness and for general working capital purposes. KeySpan utilized a $125 million treasury lock, at 4.77%, to hedge the 5-year US Treasury component of the underlying notes and a $125 million treasury lock, at 4.82%, to hedge the 10-year US Treasury component of the underlying notes. These derivative instruments settled on October 25, 2006 at which time KeySpan paid $0.2 million to the counterparty to the contracts. The loss on the settlement of these contracts has been deferred for future collection from firm gas sales customers consistent with regulatory requirements.

does not anticipate issuing permanent financing in 2007.
ᵢwing table represents the ratings of our long-term debt at
, 2006. During the fourth quarter of 2004 Standard & Poor's
; ratings on KeySpan's and its subsidiaries' long-term debt
l its negative outlook. Further in the second quarter of 2005,
s revised its ratings on KeySpan's and its subsidiaries'
ıebt to positive outlook. Moody's Investor Services, however,
o maintain its negative outlook ratings on KeySpan's and its
s' long-term debt.

	MOODY'S INVESTOR SERVICES	STANDARD & POOR'S	FITCH RATINGS
:orporation	A3	A	A-
	N/A	A+	A+
	A2	A+	A
ɔas	A2	A	N/A
Gas	A2	A+	N/A
ı Generation	A3	A	N/A

ɜalance Sheet Arrangements

antees

pan had a number of financial guarantees with its subsidiaries at
ɘmber 31, 2006. KeySpan has fully and unconditionally guaranteed: (i)
5 million of medium-term notes issued by KEDLI; (ii) the obligations of
Span Ravenswood, LLC, which is the lessee under the $425 million
ster Lease associated with the Ravenswood Facility and the lessee
ler the $385 million sale/leaseback transaction for the Ravenswood
ansion including future decommission costs of $19 million; and (iii) the
ment obligations of our subsidiaries related to $128 million of tax-
mpt bonds issued through the Nassau County and Suffolk County
ustrial Development Authorities for the construction of two electric-
ıeration peaking facilities on Long Island. The medium-term notes, the
ster Lease and the tax-exempt bonds are reflected on the Consolidated
ance Sheet; the sale/leaseback obligation is not recorded on the
nsolidated Balance Sheet. Further, KeySpan has guaranteed: (i) up to
5.2 million of surety bonds associated with certain construction projects
rently being performed by former subsidiaries; (ii) certain supply con-
cts, margin accounts and purchase orders for certain subsidiaries in an
gregate amount of $64.6 million; and (iii) $80.3 million of subsidiary
ters of credit. These guarantees are not recorded on the Consolidated
lance Sheet. KeySpan's guarantees on certain performance bonds
ating to current construction projects of the discontinued mechanical
ntracting companies will remain in place throughout the construction
ɛriod for these projects. KeySpan has received an indemnity bond issued
a third party to offset potential exposure related to a significant portion
the continuing guarantee. At this time, we have no reason to believe
at our subsidiaries or former subsidiaries will default on their current
ɔligations. However, we cannot predict when or if any defaults may take
place or the impact such defaults may have on our consolidated results of operations, financial condition or cash flows. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees, as well as Note 10 "Energy Services – Discontinued Operations" for additional information on the discontinued mechanical contracting companies.)

Contractual Obligations

KeySpan has certain contractual obligations related to its outstanding long-term debt, outstanding credit facility borrowings, outstanding commercial paper borrowings, various leases, and demand charges associated with certain commodity purchases. KeySpan's outstanding short-term and long-term debt issuances are explained in more detail in Note 6 to the Consolidated Financial Statements "Long-Term Debt and Commercial Paper." KeySpan's leases, as well as its demand charges are more fully detailed in Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies." The table below reflects maturity schedules for KeySpan's contractual obligations at December 31, 2006. Included in the table is the long-term debt that has been consolidated as part of the variable interest entity associated with the Ravenswood Master Lease.

(In Millions of Dollars)

CONTRACTUAL OBLIGATIONS	TOTAL	1 – 3 YEARS	4 – 5 YEARS	AFTER 5 YEARS
Long-term Debt	$ 4,422.9	$ 717.3	$ 1,130.0	$ 2,575.6
Capital Leases	9.8	3.4	2.6	3.8
Operating Leases	549.8	215.1	133.1	201.6
Master Lease Payments	71.2	71.2	—	—
Sale/Leaseback Arrangement	549.1	92.0	78.7	378.4
Interest Payments	2,940.7	731.8	350.7	1,858.2
Demand Charges	449.0	449.0	—	—
Total Contractual Cash Obligations	$ 8,992.5	$ 2,279.8	$ 1,695.1	$ 5,017
Commercial Paper	$ 85.0	Revolving		

For information regarding projected postretirement contribution see Note 4 to the Consolidated Financial Statements "Postretirement Benefits." For information regarding asset retirement obligations, see Note 7 to the Consolidated Financial Statements "Contractual Oblig Financial Guarantees and Contingencies."

Discussion of Critical Accounting Policies and Assumptions

In preparing our financial statements, the application of certain accounting policies requires difficult, subjective and/or complex judgments. The circumstances that make these judgments difficult, subjective and/or complex have to do with the need to make estimates about the impact of matters that are inherently uncertain. Actual effects on our financial position and results of operations may vary significantly from expected results if the judgments and assumptions underlying the estimates prove to be inaccurate. The critical accounting policies requiring such subjectivity are discussed below.

Valuation of Goodwill

KeySpan records goodwill on purchase transactions, representing the excess of acquisition cost over the fair value of net assets acquired. In testing for goodwill impairment under Statement of Financial Accounting Standard ("SFAS") 142 "Goodwill and Other Intangible Assets," significant reliance is placed upon a number of estimates regarding future performance that require broad assumptions and significant judgment by management. A change in the fair value of our investments could cause a significant change in the carrying value of goodwill. The assumptions used to measure the fair value of our investments are the same as those used by us to prepare annual operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set annual budgetary guidelines.

As prescribed in SFAS 142, KeySpan is required to compare the fair value of a reporting unit to its carrying amount, including goodwill. This evaluation is required to be performed at least annually, unless facts and circumstances indicate that the evaluation should be performed at an interim period during the year. At December 31, 2006, KeySpan had $1.7 billion of recorded goodwill and has concluded that the fair value of the business units that have recorded goodwill exceed their carrying value.

As noted previously, during 2004, KeySpan conducted an evaluation of the carrying value of goodwill recorded in its Energy Services segment. As a result of this evaluation, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on the Energy Services segment's continuing operations; and (ii) $93.9 million as discontinued operations reflecting the impairment on the mechanical contracting companies. (See Note 10 to the Consolidated Financial Statements "Energy Services – Discontinued Operations" for further details.)

Also as noted previously, at the end of 2004, KeySpan anticipated selling its then 50% interest in Premier. This investment was accounted for under the equity method of accounting in the Energy Investments segment. In the fourth quarter of 2004 KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share. The impairment charge reflected the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value at that time and was recorded as a reduction to goodwill.

Accounting for the Effects of Rate Regulation on Gas Distribution Operations

The financial statements of the Gas Distribution segment reflect the ratemaking policies and orders of the New York Public Service Commission ("NYPSC"), the New Hampshire Public Utilities Commission ("NHPUC"), and the Massachusetts Department of Telecommunications and Energy ("MADTE").

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas and EnergyNorth Natural Gas Inc.) are subject to the provisions of SFAS 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the actions of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies.

In separate orders issued by the MADTE relating to the acquisition by Eastern Enterprises of Colonial Gas Company and Essex Gas Company, the base rates charged by these companies have been frozen at their current levels for a ten-year period ending 2009 and 2008 respectively. Due to the length of these base rate freezes, Colonial Gas Company and Essex Gas Company had previously discontinued the application of SFAS 71.

SFAS 71 allows for the deferral of expenses and income on the Consolidated Balance Sheet as regulatory assets and liabilities when it is probable that those expenses and income will be allowed in the rate setting process in a period different from the period in which they would have been reflected in the consolidated statements of income of an unregulated company. These deferred regulatory assets and liabilities are then recognized in the Consolidated Statement of Income in the period in which the amounts are reflected in rates.

In the event that regulation significantly changes the opportunity for us to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of our existing regulatory assets and liabilities could result. If we were unable to continue to apply the provisions of SFAS 71 for any of our rate regulated subsidiaries, we would apply the provisions of SFAS 101 "Regulated Enterprises – Accounting for the Discontinuation of Application of FASB Statement No. 71." We estimate that the write-off of our net regulatory assets at December 31, 2006, before consideration of removal cost recovered, could result in a charge to net income of approximately $630.4 million or $3.60 per share, which would be classified as an extraordinary item. In management's opinion, our regulated subsidiaries that currently are subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

As is further discussed under the caption "Regulation and Rate Matters," in October 2003 the MADTE rendered its decision on the Boston Gas base rate case and Performance Based Rate Plan proposal submitted to the MADTE in April 2003. The rate plans previously in effect for KEDNY and KEDLI have expired and the rates established in those plans remain in effect. EnergyNorth Natural Gas Inc.'s base rates continue as set by the NHPUC in 1993. The continued application of SFAS 71 to record

the activities of these subsidiaries is contingent upon the actions of regulators with regard to future rate plans. As part of its application for approval of the KeySpan / National Grid plc Merger, KeySpan has filed proposed rate plans for KEDNY and KEDLI with the NYPSC. In addition, individual applications for a proposed annual increase in revenues for KEDNY and KEDLI were filed. The ultimate resolution of any future rate plans could have a significant impact on the application of SFAS 71 to these entities and, accordingly, on our financial position, results of operations and cash flows. However, management believes that currently available facts support the continued application of SFAS 71 and that all regulatory assets and liabilities are recoverable or refundable through the regulatory environment.

Pension and Other Postretirement Benefits

As discussed in Note 4 to the Consolidated Financial Statements, "Postretirement Benefits," KeySpan participates in both non-contributory defined benefit pension plans, as well as other post-retirement benefit ("OPEB") plans (collectively "postretirement plans"). KeySpan's reported costs of providing pension and OPEB benefits are dependent upon numerous factors resulting from actual plan experience and assumptions of future experience. Pension and OPEB costs (collectively "postretirement costs") are impacted by actual employee demographics, the level of contributions made to the plans, earnings on plan assets, and health care cost trends. Changes made to the provisions of these plans may also impact current and future postretirement costs. Postretirement costs may also be significantly affected by changes in key actuarial assumptions, including, anticipated rates of return on plan assets and the discount rates used in determining the postretirement costs and benefit obligations. Actual results that differ from our expected results are amortized to expense over ten years.

Certain gas distribution subsidiaries are subject to SFAS 71, and, as a result, changes in postretirement expenses are deferred for future recovery from or refund to gas sales customers. (However, KEDNY, although subject to SFAS 71, does not have a recovery mechanism in place for changes in postretirement costs.) Further, changes in postretirement expenses associated with subsidiaries that service the LIPA Agreements are also deferred for future recovery from or refund to LIPA.

For 2006, the assumed long-term rate of return on our postretirement plans' assets was 8.5% (pre-tax), net of expenses. This is an appropriate long-term expected rate of return on assets based on KeySpan's investment strategy, asset allocation and the historical performance of equity and fixed income investments over long periods of time. The actual 10 year compound annual rate of return for the KeySpan Plans is greater than 8.5%.

KeySpan's master trust investment allocation policy target is 70% equity and 30% fixed income. At December 31, 2006, the actual investment allocation was in line with the target. In an effort to maximize plan performance, actual asset allocation will fluctuate from year to year depending on the then current economic environment.

Based on the results of an asset and liability study projecting asset returns and expected benefit payments over a 10-year period, KeySpan has developed a multiyear funding strategy for its postretirement plans. KeySpan believes that it is reasonable to assume assets can achieve or outperform the assumed long-term rate of return with the target allocation as a result of historical performance of equity investments over long-term periods.

A 25 basis point increase or decrease in the assumed long-term rate of return on plan assets would have impacted 2006 expense by approximately $6 million, before deferrals.

The year-end December 31, 2006 assumed discount rate used to determine postretirement obligations was 6.00%. Our discount rate assumption is based upon the Citigroup above-median pension discount curve. A 25 basis point increase or decrease in the assumed year-end discount rate would have had no impact on 2006 expense. A year-end discount rate of 5.75% would have required an additional $144 million increase to the pension and other postretirement reserve balance and a debit to accumulated other comprehensive income before taxes and deferrals.

At January 1, 2006, the assumed discount rate used to determine postretirement obligations was 5.75%. A 25 basis point increase or decrease in the assumed discount rate at the beginning of the year would have impacted 2006 expense by approximately $16 million, before deferrals.

Our health care cost trend assumptions are developed based on historical cost data, the near-term outlook and an assessment of likely long-term trends. The salary growth assumptions reflect our long-term outlook.

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At December 31, 2006, we had a funding credit balance in excess of the ERISA minimum funding requirements and as a result KeySpan was not required to make any contributions to its qualified pension plans in 2006. Although the KeySpan qualified pension and other postretirement plans were not required to make a contribution in 2006, the pension plans are under-funded on a projected benefit obligation basis. During 2006, KeySpan contributed $131 million to its postretirement plans.

The Pension Protection Act of 2006 was passed in August 2006 and provided a comprehensive overhaul of pension funding rules. KeySpan will implement several pension plan changes effective January 2008 based on the new requirements. During 2006, KeySpan performed a stochastic projection analyses of its pension plan's assets and liabilities and concluded, at the 50% percentile, that its current funding policy is sufficient for existing ERISA rules and will meet the requirements of the Pension Protection Act of 2006 for approximately the next ten years.

For 2007, KeySpan expects to contribute approximately $131 million to its funded and under funded post-retirement plans. Future funding requirements are heavily dependent on actual return on plan assets and prevailing interest rates.

Valuation of Derivative Instruments

We employ derivative instruments to hedge a portion of our exposure to commodity price risk and interest rate risk, to partially hedge the cash flow variability associated with our electric energy sales from the Ravenswood Generation Station, as well as to economically hedge certain other commodity exposures.

For those derivative instruments designated as cash flow hedges, changes in the market value are recorded in accumulated other comprehensive income, (in line with effectiveness measurements) and are not recorded through earnings until the derivative positions are settled. With respect to those derivative instruments that are not designated as hedging instruments, such derivatives are accounted for on the Consolidated Balance Sheet at fair value, with all changes in fair value reported in earnings.

When available, quoted market prices are used to record a contract's fair value. However, market values for certain derivative contracts may not be readily available or determinable. A number of our commodity related derivative instruments are exchange traded and, accordingly, fair value measurements are based on available quotes. Additionally, we use market quoted forward prices for commodities that are not exchange traded, such as No. 6 grade fuel oil and electric power swaps. The fair value of our electric capacity hedge is based on published NYISO capacity bidding prices. Further, if no active market exists for a commodity, fair values may be based on pricing models.

SFAS 133 establishes criteria that must be satisfied in order for forward contracts for the physical delivery of commodities to qualify for the normal purchases and sales exception. Those contracts that qualify for the normal purchase and sale exception, and where the exception has been elected, are not recognized in the financial statements until settlement. The distinguishing characteristics between contracts that qualify for the normal purchases and sales exception and those that do not are, at times, subjective and require judgment.

All fair value measurements, whether calculated using available quotes or other valuation techniques, are subjective and subject to fluctuations in commodity prices, interest rates and overall economic market conditions and, as a result, our fair value measurements may not be precise and can fluctuate significantly from period to period.

Dividends

KeySpan's annual dividend rate for 2007 is $1.90 per common share. Our dividend framework is reviewed annually by the Board of Directors. The amount and timing of all dividend payments is subject to the discretion of the Board of Directors and will depend upon business conditions, results of operations, financial conditions and other factors. Based on currently foreseeable market conditions, we intend to maintain the annual dividend at the $1.90 level.

Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to KeySpan is conditioned upon maintenance of a utility capital structure with debt not exceeding 55% and 58%, respectively, of total utility capitalization. In addition, the level of dividends paid by both utilities may not be increased from current levels if a 40 basis point penalty is incurred under the customer service performance program. At the end of KEDNY's and KEDLI's most recent rate years (September 30, 2006 and November 30, 2006, respectively), each company was in compliance with the utility capital structure required by the NYPSC. Additionally, we have met the requisite customer service performance standards.

Regulation and Rate Matters

Gas Distribution

On September 30, 2002, KEDNY's rate agreement with the NYPSC expired. Under the terms of the agreement, the then current gas distribution rates and all other provisions, including the earnings sharing provision (at a 13.25% return on equity), remain in effect until changed by the NYPSC. Under the agreement, KEDNY is subject to an earnings sharing provision pursuant to which it is required to credit firm customers with 60% of any utility earnings up to 100 basis points above a 13.25% return on equity (other than any earnings associated with discrete incentives) and 50% of any utility earnings in excess of 100 basis points above such threshold level. KEDNY did not earn above a 13.25% return on equity in its rate year ended September 30, 2006.

On November 30, 2000, KEDLI's rate agreement with the NYPSC expired. Under the terms of the agreement, the then current gas distribution rates and all other provisions, including the earnings sharing provision, remain in effect until changed by the NYPSC. Under the agreement, KEDLI is subject to an earnings sharing provision pursuant to which it is required to credit to firm customers 60% of any utility earnings for any rate year ended November 30, up to 100 basis points above a return on equity of 11.10% and 50% of any utility earnings in excess of a return on equity of 12.10%. KEDLI did not earn above an 11.10% return on equity in its rate year ended November 30, 2006.

KeySpan has recently filed proposed rate plans for KEDNY and KEDLI with the NYPSC as part of its application for approval of the KeySpan / National Grid plc Merger, as well as individual applications for a proposed annual increase in revenues for KEDNY and KEDLI. See the "Introduction to the Notes to the Consolidated Financial Statements" for additional details on the filings.

Boston Gas, Colonial Gas and Essex Gas operations are subject to Massachusetts' statutes applicable to gas utilities. Rates for gas sales and transportation service, distribution safety practices, issuance of securities and affiliate transactions are regulated by the MADTE.

Effective November 1, 2003, the MADTE approved a $25.9 million increase in base revenues for Boston Gas with an allowed return on equity of 10.2% reflecting an equal balance of debt and equity. On January 27, 2004, the MADTE issued its order on Boston Gas Company's Motion for Recalculation, Reconsideration and Clarification that granted an additional $1.1 million in base revenues, for a total of $27 million. The MADTE also approved a Performance Based Rate Plan (the "Plan") for up to ten years. On November 1, 2006, the MADTE approved a base rate increase of

$8.6 million under the Plan. In addition, an increase of $2.7 million in the local distribution adjustment clause was approved to recover pension and other postretirement costs. The MADTE also approved a true-up mechanism for pension and other postretirement benefit costs under which variations between actual pension and other postretirement benefit costs and amounts used to establish rates are deferred and collected from or refunded to customers in subsequent periods. This true-up mechanism allows for carrying charges on deferred assets and liabilities at the Boston Gas weighted-average cost of capital.

In connection with the Eastern Enterprises acquisition of Colonial Gas in 1999, the MADTE approved a merger and rate plan that resulted in a ten year freeze of base rates to Colonial Gas firm customers. The base rate freeze is subject only to certain exogenous factors, such as changes in tax laws, accounting changes, or regulatory, judicial, or legislative changes. Due to the length of the base rate freeze, Colonial Gas discontinued its application of SFAS 71. Essex Gas is also under a ten-year base rate freeze and has also discontinued its application of SFAS 71. EnergyNorth Natural Gas Inc.'s base rates continue as set by the NHPUC in 1993.

In December 2005, Boston Gas received a MADTE order permitting regulatory recovery of the 2004 gas cost component of bad debt write-offs. This was approved for full recovery as an exogenous cost effective November 1, 2005. In addition, effective January 1, 2006, Boston Gas was permitted to fully recover the gas cost component of bad debt write-offs through its cost-of-gas adjustment clause rather than filing for recovery as an exogenous cost. Both of these favorable recovery mechanisms were reflected in our December 31, 2005 Allowance for Doubtful Accounts reserve requirement and related expense. On October 31, 2006, the MADTE granted Boston Gas recovery of $12 million of the 2005 gas cost component of bad debt write-offs from Boston Gas ratepayers beginning November 1, 2006. This amount is being recovered through the cost-of-gas adjustment clause.

Electric Rate Matters

KeySpan sells to LIPA all of the capacity and, to the extent requested, energy conversion services from our existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC in accordance with the PSA entered into between KeySpan and LIPA in 1998. The original FERC approved rates, which had been in effect since May 1998, expired on December 31, 2003. On October 1, 2004 the FERC approved a settlement reached between KeySpan and LIPA to reset rates effective January 1, 2004. Under the new agreement, KeySpan's rates reflect a cost of equity of 9.5%. The FERC approved updated operating and maintenance expense levels and recovery of certain other costs as agreed to by the parties.

As noted earlier, on February 1, 2006, KeySpan and LIPA entered into (i) an amended and restated Management Services Agreement; (ii) a new Option and Purchase and Sale Agreement, to replace the Generation Purchase Rights Agreement as amended; and (iii) a Settlement Agreement resolving outstanding issues between the parties regarding the 1998 LIPA Agreements. (See Electric Services – "LIPA Agreements" for a discussion of the 2006 settlement between KeySpan and LIPA regarding the current contractual agreements.)

The Energy Policy Act of 2005 and the Public Utility Holding Company Acts of 1935 and 2005

In August 2005, the Energy Policy Act of 2005 (the "Energy Act") was enacted by Congress and signed into law by the President of the United Sates of America. The Energy Act is a broad based energy bill that places an increased emphasis on the production of energy and promotes the development of new technologies and alternative energy sources by providing tax credits to companies that produce natural gas, oil, coal, electricity and renewable energy. For KeySpan, one of the more significant provisions of the Energy Act was the repeal of PUHCA 1935, effective February 8, 2006, and the transfer of certain holding company oversight from the SEC to FERC pursuant to PUHCA 2005.

Pursuant to PUHCA 2005, the SEC no longer has jurisdiction over our holding company activities, other than those traditionally associated with the registration and issuance of our securities under the federal securities laws. FERC now has jurisdiction over certain of our holding company activities, including (i) regulating certain transactions among our affiliates within our holding company system; (ii) governing the issuance, acquisition and disposition of securities and assets by certain of our public utility subsidiaries; and (iii) approving certain utility mergers and acquisitions.

Moreover, our affiliate transactions also remain subject to certain regulations of the NYPSC, MADTE and NHPUC, in addition to FERC.

Electric Services – LIPA Agreements

LIPA is a corporate municipal instrumentality and a political subdivision of the State of New York. On May 28, 1998, certain of LILCO's business units were merged with KeySpan and LILCO's common stock and remaining assets were acquired by LIPA. At the time of this transaction, KeySpan and LIPA entered into three major long-term service agreements that (i) provide to LIPA all operation, maintenance and construction services and significant administrative services relating to the Long Island electric transmission and distribution system ("T&D System") pursuant to the Management Services Agreement (the "1998 MSA"); (ii) supply LIPA with electric generating capacity, energy conversion and ancillary services from our Long Island generating units pursuant to the Power Supply Agreement (the "1998 PSA") and other long-term agreements through which we provide LIPA with approximately one half of its customers' energy needs; and (iii) manage all aspects of the fuel supply for our Long Island generating facilities, as well as all aspects of the capacity and energy owned by or under contract to LIPA pursuant to the Energy Management Agreement (the "1998 EMA"). We also purchase energy, capacity and ancillary services in the open market on LIPA's behalf under the 1998 EMA. The 1998 MSA, 1998 PSA and 1998 EMA all became effective on May 28, 1998 and are collectively referred to as the 1998 LIPA Agreements.

On February 1, 2006, KeySpan and LIPA entered into (i) an amended and restated Management Services Agreement (the "2006 MSA"), pursuant to which KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island; (ii) 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 acquire substantially all of the electric generating facilities owned by KeySpan on Long Island; and (iii) a Settlement Agreement (the "2006 Settlement Agreement") resolving outstanding issues between the parties regarding the 1998 LIPA Agreements. The 2006 MSA, the 2006 Option Agreement and the 2006 Settlement Agreement are collectively referred to herein as the "2006 LIPA Agreements". Each of the 2006 LIPA Agreements will become effective as of January 1, 2006 upon all of the 2006 LIPA Agreements receiving the required governmental approvals; otherwise none of the 2006 LIPA Agreements will become effective. The 2006 LIPA Agreements will become effective following approval by the New York State Comptroller's Office and the New York State Attorney General.

2006 Settlement Agreement. Pursuant to the terms of the 2006 Settlement Agreement, KeySpan and LIPA agreed to resolve issues that have existed between the parties relating to the various 1998 LIPA Agreements. In addition to the resolution of these matters, KeySpan's entitlement to utilize LILCO's available tax credits and other tax attributes will increase from approximately $50 million to approximately $200 million. These credits and attributes may be used to satisfy KeySpan's previously incurred indemnity obligation to LIPA for any federal income tax liability that results from the recent settlement with the IRS regarding the audit of LILCO's tax returns for the years ended December 31, 1996 through March 31, 1999. On October 30, 2006, the IRS submitted the settlement provisions of the recently concluded IRS audit to the Joint Committee on Taxation for approval. Key provisions of the settlement included the resolution of the tax basis of assets transferred to KeySpan at the time of the KeySpan/LILCO merger, the tax deductibility of certain merger related costs and the tax deductibility of certain environmental expenditures. The settlement enabled KeySpan to utilize 100% of the available tax credits. (See Note 3 to the Consolidated Financial Statements "Income Taxes" for additional information of the settlement.) In recognition of these items, as well as for the modification and extension of the 1998 MSA and the amendments to the GPRA, upon effectiveness of the 2006 Settlement Agreement, KeySpan will record a contractual asset in the amount of approximately $160 million, of which approximately $110 million will be attributed to the right to utilize such additional credits and attributes and approximately $50 million will be amortized over the eight year term of the 2006 MSA. In order to compensate LIPA for the foregoing, KeySpan will pay LIPA $69 million in cash and will settle certain accounts receivable in the amount of approximately $90 million due from LIPA.

Generation Purchase Rights Agreement and 2006 Option Agreement. Under the 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 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. The 2006 Option Agreement replaces the GPRA, the expiration of which has been stayed pending effectiveness of the 2006 LIPA Agreements. In the event such agreements do not become effective by reason of failure to secure any of the requisite governmental approvals, the GPRA will be reinstated for a period of 90 days from the date such approval is denied. If LIPA were to exercise the option and purchase one or both of the generation facilities then: (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.

Management Services Agreements. Pursuant to the 1998 MSA, KeySpan manages the day-to-day operations, maintenance and capital improvements of the T&D System. When originally executed, the 1998 MSA had a term expiring on May 28, 2006. In 2002, in connection with an extension of the GPRA term, the 1998 MSA was extended for 31 months through 2008. As a result of the recent negotiations and settlement between KeySpan and LIPA discussed above, the parties entered into the 2006 MSA.

In place of the previous compensation structure (whereby KeySpan was reimbursed for budgeted costs, and earned a management fee and certain performance and cost-based incentives), KeySpan's compensation for managing the T&D System under the 2006 MSA consists of two components: a minimum compensation component of $224 million per year and a variable component based on electric sales. The $224 million component will remain unchanged for three years and then increase annually by 1.7% plus inflation. The variable component, which will comprise no more than 20% of KeySpan's compensation, is based on electric sales on Long Island exceeding a base amount of 16,558 gigawatt

hours, increasing by 1.7% in each year. Above that level, KeySpan will receive approximately 1.34 cents per kilowatt hour for the first contract year, 1.29 cents per kilowatt hour in the second contract year (plus an annual inflation adjustment), 1.24 cents per kilowatt hour in the third contract year (plus an annual inflation adjustment), with the per kilowatt hour rate thereafter adjusted annually by inflation. Subject to certain limitations, KeySpan will be able to retain all operational efficiencies realized during the term of the 2006 MSA.

LIPA will continue to reimburse KeySpan for certain expenditures incurred in connection with the operation and maintenance of the T&D System, and other payments made on behalf of LIPA, including: real property and other T&D System taxes, return postage, capital construction expenditures, conservation expenditures and storm costs.

The 2006 MSA provides for a number of performance metrics measuring various aspects of KeySpan's performance in the operations and customer service areas. Poor performance in any metric may subject KeySpan to financial and other non-cost penalties (such financial penalties not to exceed $7 million in the aggregate for all performance metrics in any contract year). Subject to certain limitations, superior performance in certain metrics can be used to offset underperformance in other metrics. Consistent failure to meet threshold performance levels for two metrics, System Average Interruption Duration Index (two out of three consecutive years) and Customer Satisfaction Index (three consecutive years), will constitute an event of default under the 2006 MSA.

In the event LIPA sells the T&D System to a private entity during the term of the 2006 MSA, LIPA shall have the right to terminate the 2006 MSA, provided that LIPA will be required to pay KeySpan's reasonable transition costs and a termination fee of (a) $28 million if the termination date occurs on or before December 31, 2009, and (b) $20 million if the termination date occurs after December 31, 2009.

Upon approval, the 2006 LIPA Agreements will be effective retroactive to January 1, 2006. KeySpan's reported operating income and net income for 2006, under the 2006 MSA, are substantially the same as they would have been if the terms and provisions of the 1998 MSA had continued to be applied. At this point in time, KeySpan is unable to estimate what the impact would be to its results of operations, financial position and cash flows if the 2006 LIPA Agreements do not become fully effective.

Power Supply Agreements. KeySpan sells to LIPA all of the capacity and, to the extent requested, energy conversion services from our existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC. Since October 1, 2004, pursuant to a FERC approved settlement, the rates reflect a cost of equity of 9.5%. The FERC also approved updated operating and maintenance expense levels and KeySpan's recovery of certain other costs as agreed to by the parties. Rates charged to LIPA include a fixed and variable component. The variable component is billed to LIPA on a monthly per megawatt hour basis and is dependent on the number of megawatt hours dispatched. LIPA has no obligation to purchase energy conversion services from KeySpan and is able to purchase energy or energy conversion services on a least-cost basis from all available sources consistent with existing interconnection limitations of the T&D System. The 1998 PSA provides incentives and penalties that can total $4 million annually for the maintenance of the output capability and the efficiency of the generating facilities. In 2006, we earned $4.0 million in incentives under this agreement.

The 1998 PSA has a term of fifteen years through May 2013, with LIPA having the option to renew the 1998 PSA for an additional fifteen year term. If the 2006 LIPA Agreements receive the requisite governmental approvals and become effective and if LIPA exercises its rights under the 2006 Option Agreement to purchase the two generating plants, then LIPA and KeySpan will enter into an operation and maintenance agreement, pursuant to which KeySpan will continue to operate these facilities for a fixed management fee plus reimbursement for certain costs; and the 1998 PSA will be amended to reflect that the purchased generating facilities would no longer be covered by the 1998 PSA. 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.

Energy Management Agreement. The 1998 EMA provides for KeySpan to procure and manage fuel supplies on behalf of LIPA to fuel the generating facilities under contract to it and perform off-system capacity and energy purchases on a least-cost basis to meet LIPA's needs. In exchange for these services we earn an annual fee of $1.5 million. In addition, we arrange for off-system sales on behalf of LIPA of excess output from the generating facilities and other power supplies either owned or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales. In addition, the 1998 EMA provides incentives and penalties that can total $5 million annually for performance related to fuel purchases and off-system power purchases. In 2006, we earned EMA incentives in an aggregate of $5.0 million.

The original term for the fuel supply service is fifteen years, expiring May 28, 2013, and the original term for the power supply management services described was eight years, which expired on May 28, 2006. In March 2005, LIPA issued a Request for Proposal ("RFP") for system power supply management services beginning May 29, 2006 and fuel management services for certain of its peaking generating units beginning January 1, 2006. KeySpan submitted a bid in response to this RFP in April 2005. LIPA has not yet selected a service provider.

In 2005, the EMA was amended to extend the term for power supply management services through December 31, 2006 and thereafter on a month-to-month basis, unless terminated by LIPA on sixty days notice, but in no event later than December 31, 2007.

In the event LIPA exercises its rights under the 2006 Option Agree-ent, KeySpan and LIPA will enter into an amendment to the 1998 EMA flecting that the facilities that LIPA acquires pursuant to the Option greement are no longer covered under the 1998 EMA and as noted bove, an operation and maintenance agreement, whereby KeySpan will ontinue to operate the newly acquired facilities for a fixed management e plus reimbursement for certain costs. It is anticipated that the fees eceived pursuant to the operation and maintenance agreement will offset e reduction in any fees earned by KeySpan pursuant to the 1998 EMA.

Under the 1998 LIPA Agreements and the 2006 LIPA Agreements, e are required to obtain a letter of credit in the aggregate amount of 60 million supporting our obligations to provide the various services if ur long-term debt is not rated in the "A" range by a nationally recog-ized rating agency.

ower Purchase Agreements. KeySpan-Glenwood Energy Center, LC and KeySpan-Port Jefferson Energy Center LLC each have 25 year ower purchase agreements with LIPA expiring in 2027 (the "2002 LIPA PAs"). Under the terms of the 2002 LIPA PPAs, these subsidiaries sell apacity, energy conversion services and ancillary services to LIPA. Each lant is designed to produce 79.9 MW. Pursuant to the 2002 LIPA PPAs, IPA pays a monthly capacity fee, which guarantees full recovery of each lant's construction costs, as well as an appropriate rate of return on nvestment.

avenswood Generating Station

Ve currently sell capacity, energy and ancillary services associated with the avenswood Generating Station through a bidding process into the NYISO nergy and capacity markets. Energy is sold on both a day-ahead and a eal-time basis. We also have the ability to enter into bilateral transactions o sell all or a portion of the energy produced by the Ravenswood Generating Station to load serving entities, i.e. entities that sell to end-sers or to brokers and marketers.

ther Contingencies

n 2005, LIPA completed its strategic review initiative that it had undertak-en in connection with, among other reasons, its option under the Generation Purchase Rights Agreement with KeySpan. As part of its eview, LIPA engaged a team of advisors and consultants, held public earings and explored its strategic options, including continuing its exist-ng operations, municipalizing, privatizing, selling some, but not all of its ssets, becoming a regulator of rates and services, or merging with one or nore utilities. Upon completion of its strategic review, LIPA determined hat it would continue its existing operations and entered into the renego-iated 2006 LIPA Agreements that were discussed above. Following the nnouncement of the proposed acquisition of KeySpan by National Grid lc, LIPA, National Grid plc and KeySpan have engaged in discussions con-erning the impact of the transaction on LIPA's operations. At this time, ve are unable to determine what impact, if any, such discussions may have on the 2006 LIPA Agreements and the receipt and timing of govern-mental approvals relating thereto.

Pursuant to indemnity obligations contained in the LILCO / KeySpan Merger Agreement, KeySpan had been in discussions with the IRS with regard to LILCO's tax returns for the tax years ended December 31, 1996 through March 31, 1999, and KeySpan's and the Brooklyn Union Gas Company's tax returns for the years ended September 30, 1997 through December 31, 1998. All outstanding issues were resolved in 2006. The IRS submitted the case to the Joint Committee on Taxation on October 30, 2006 for final approval. Additionally, the IRS recently commenced the examination of KeySpan's tax returns for the years ended 2002 and 2003. At this time, we cannot predict the result of these audits. (See Note 3 to the Consolidated Financial Statements "Income Taxes" for additional information.)

Environmental Matters

KeySpan is subject to various federal, state and local laws and regulatory programs related to the environment. Through various rate orders issued by the NYPSC, MADTE and NHPUC, costs related to MGP environmental cleanup activities are recovered in rates charged to gas distribution cus-tomers and, as a result, adjustments to these reserve balances do not impact earnings. However, environmental cleanup activities related to the three non-utility sites are not subject to rate recovery.

We estimate that the remaining cost of our MGP related environ-mental cleanup activities, including costs associated with the Ravenswood Generating Station, will be approximately $361.1 million and we have recorded a related liability for such amount. We have also recorded an additional $11.4 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of December 31, 2006, we have expended a total of $225.3 million on envi-ronmental investigation and remediation activities. (See Note 7 to the Consolidated Financial Statements, "Contractual Obligations, Guarantees and Contingencies" for a further explanation of these matters.)

Market and Credit Risk Management Activities

Market Risk. KeySpan is exposed to market risk arising from potential changes in one or more market variables, such as energy commodity prices, interest rates, volumetric risk due to weather or other variables. Such risk includes any or all changes in value whether caused by commod-ity positions, asset ownership, business or contractual obligations, debt covenants, exposure concentration, currency, weather, and other factors regardless of accounting method. We manage our exposure to changes in market prices using various risk management techniques for non-trading purposes, including hedging through the use of derivative instruments, both exchange-traded and over-the-counter contracts, purchase of insur-ance and execution of other contractual arrangements.

KeySpan is exposed to price risk due to investments in equity and debt securities held to fund benefit payments for various employee pension and other postretirement benefit plans. To the extent that the value of investments held change, or long-term interest rates change, the effect will be reflected in KeySpan's recognition of periodic cost of such employee benefit plans and the determination of contributions to the employee benefit plans.

Credit Risk. KeySpan is exposed to credit risk arising from the potential that our counterparties fail to perform on their contractual obligations. Our credit exposures are created primarily through the sale of gas and transportation services to residential, commercial, electric generation, and industrial customers and the provision of retail access services to gas marketers, by our regulated gas businesses; the sale of commodities and services to LIPA and the NYISO; the sale of power and services to our retail customers by our unregulated energy service businesses; entering into financial and energy derivative contracts with energy marketing companies and financial institutions; and the sale of gas, oil and processing services to energy marketing and oil and gas production companies.

We have regional concentration of credit risk due to receivables from residential, commercial and industrial customers in New York, New Hampshire and Massachusetts, although this credit risk is spread over a diversified base of residential, commercial and industrial customers. Customers' payment records are monitored and action is taken, when appropriate and in accordance with various regulatory requirements.

We also have credit risk from LIPA, our largest customer, and from other energy and financial services companies. Counterparty credit risk may impact overall exposure to credit risk in that our counterparties may be similarly impacted by changes in economic, regulatory or other considerations. We actively monitor the credit profile of our wholesale counterparties in derivative and other contractual arrangements, and manage our level of exposure accordingly. In instances where counterparties' credit quality has declined, or credit exposure exceeds certain levels, we may limit our credit exposure by restricting new transactions with the counterparty, requiring additional collateral or credit support and negotiating the early termination of certain agreements.

Regulatory Issues and the Competitive Environment

We are subject to various other risk exposures and uncertainties associated with our gas and electric operations. Set forth below is a description of these exposures.

The Gas Industry

New York and Long Island

For the last several years, the NYPSC has been monitoring the progress of competition in the energy market. Based upon its findings of the current market and its stated desire to move toward fully competitive markets, the NYPSC, in August 2004, issued companion policy statements regarding its vision for the future of competitive markets and guidelines for separately stating the cost of competitive services currently performed by New York utilities. In the first of these policy statements the NYPSC provided its vision for the future of competitive markets and required, among other items, that utilities' future rate filings must include plans for facilitating customer migration to competitive markets and fully embedded cost of service studies that develop unbundled rates for the utilities' delivery service and all potentially competitive services.

The NYPSC's second policy statement of August 2004 addressed the means by which New York utilities should state separately, or "unbundle," the costs of competitive and potentially competitive services currently performed by utilities from the cost of providing local distribution service. The objective of unbundling is to facilitate competition by providing customers with information as to savings available from purchasing competitive services from third-party providers, and to credit the customer's utility bill for the cost of unbundled services when they migrate to competitive suppliers. In its unbundling policy statement, the NYPSC directed utilities to file with their next base rate proceedings updated cost studies for unbundled competitive services that, once approved by the NYPSC, would replace existing backout credits for these services established in prior proceedings. The NYPSC also asked utilities to file with the unbundled cost studies a lost revenue recovery mechanism that would permit the utility to recover revenue associated with the difference between the cost the utility is able to avoid when a customer migrates to a competitive service provider and the unbundled rate for that service credited to the customer's bill.

In their individual rate cases filed on October 3, 2006, KEDNY and KEDLI filed proposed new unbundled rates. The proposed unbundled supply rates were $0.58/dth and $0.22/dth for KEDNY and KEDLI, respectively, which would replace their current supply function backout credits of $0.21/dth and $0.19/dth. The proposed unbundled billing and payment processing rates are $0.76 per account, per month and $0.65 per account, per month for KEDNY and KEDLI, respectively, which would replace their current billing backout credits, both of which are set at $0.78 per account, per month. Pursuant to a May 2001 Order of the NYSPSC customers that purchase commodity service from third-party providers and receive a consolidated bill from the utility receive a credit on their utility bills for the unbundled billing rate. The utility then invoices the third-party commodity provider for the billing service at the same unbundled billing rate credited to the customer's utility bill, which eliminates the risk of lost revenue. In contrast, there is a risk of lost revenue with respect to the unbundled supply rates if KEDNY and KEDLI are not able to avoid costs, such as credit and collections and promotional advertising expense, at the

same pace as these costs are credited to customers who migrate to competitive gas suppliers. KEDNY and KEDLI proposed to recover any such revenue loss through their respective balancing accounts. KEDNY and KEDLI made the same proposals for new unbundled rates and lost revenue recovery mechanisms in the rate plans filed with the joint petition with National Grid plc on July 20, 2006.

New England

In February 1999, the MADTE issued its order on unbundling of natural gas service. For a five year transition period, the MADTE determined that contractual commitments with local distribution companies ("LDCs") to upstream capacity would be assigned on a mandatory, pro-rata basis to marketers selling gas supply to the LDCs' customers. The approved mandatory assignment method eliminates the possibility that the costs of upstream capacity purchased by the LDCs to serve firm customers will be absorbed by the LDC or other customers through the transition period. The MADTE also found that, through the transition period, LDCs would retain primary responsibility for upstream capacity planning and procurement to assure that adequate capacity is available to support customer requirements and growth. Since November 1, 2000, all Massachusetts gas customers have the option to purchase their gas supplies from third party sources other than the LDCs.

In January 2004, the MADTE began a proceeding to re-examine whether the upstream capacity market has been sufficiently competitive to allow voluntary capacity assignment. On June 6, 2005, the MADTE issued an order in its continuing investigation into gas unbundling and found that mandatory capacity assignment should be continued.

Beginning on November 1, 2001, the NHPUC has required gas utilities to offer transportation only services to all commercial and residential customers. The New Hampshire unbundling program provides for mandatory capacity assignment similar to the Massachusetts rules.

In September 2006, Boston Gas filed its third annual Performance Based Rate ("PBR") compliance in accordance with the PBR rate plan approved by the MADTE. In October, 2006, the DTE issued an order that (1) allowed the Boston Gas proposed inflation-based increase of 2.72% or $8.6 million, (2) allowed exogenous cost recovery of $12 million in bad debt expense through the cost of gas adjustment clause and (3) disallowed an exogenous cost recovery request related to new gate box maintenance requirements pursuant to Massachusetts law. In November, 2006, Boston Gas filed a motion for reconsideration of the exogenous cost decisions along with a motion to extend the time for filing an appeal to the Massachusetts Supreme Judicial Court. The MADTE has not ruled on the Boston Gas motion.

Electric Industry

10-Minute Spinning and Non-Spinning Reserves

Due to the volatility in the market clearing price of 10-minute spinning and non-spinning reserves during the first quarter of 2000, the NYISO requested that FERC approve a bid cap on such reserves, as well as requiring a refunding of so called alleged "excess payments" received by sellers, including the Ravenswood Facility. On May 31, 2000, FERC issued an order that granted approval of a $2.52 per MWh bid cap for 10-minute non-spinning reserves, plus payments for the opportunity cost of not making energy sales. The NYISO's other requests, such as a bid cap for spinning reserves, retroactive refunds, recalculation of reserve prices, etc., were rejected.

The NYISO, The Consolidated Edison Company of New York ("Con Edison"), Niagara Mohawk Power Corporation and Rochester Gas and Electric each individually appealed FERC's order in federal court. The appeals were consolidated into one case and on November 7, 2003, the United States Court of Appeals for the District of Columbia (the "Court") issued its decision in the case of Consolidated Edison Company of New York, Inc., v. Federal Energy Regulatory Commission (the "Decision"). Essentially, the Court found errors in FERC's order and remanded some issues back to FERC for further explanation and action.

On June 25, 2004, the NYISO submitted a motion to FERC seeking refunds as a result of the Decision. KeySpan and others submitted statements of opposition opposing the refunds. On March 4, 2005, FERC issued an order upholding its original decision not to order refunds. FERC also provided the further explanation requested by the Court as to why refunds were not being ordered. The NYISO and various New York Transmission Owners requested rehearing of FERC's latest order and on November 17, 2005, FERC denied those requests. The NYISO and various New York Transmission Owners appealed FERC's November 17, 2005 order to the United States Court of Appeals for the District of Columbia.

On September 25, 2006, the Court issued a briefing schedule, which was revised on November 1, 2006. The NYISO and various New York Transmission Owners filed their brief on December 11, 2006. FERC filed its response on February 9, 2007, and KeySpan will file its brief on February 26, 2007.

The Ravenswood Generating Station and our New York City Operations

On February 9, 2006, the NYISO Operating Committee increased the "in-City" locational capacity requirements (LCR) from 80% to 83% beginning in May 2006 through the period ending April 2007, based, in part, on the statewide reserve margin of 118% set by the New York State Reliability Council. However, in early March 2006, the NYISO discovered data inconsistencies in the input files used in the Multi Area Reliability Simulation (MARS) computer program that is used to determine the statewide installed reserve margin (Statewide IRM) and the corresponding minimum LCRs for New York City and Long Island. Revisions to the data, and rerun-

ning the MARS computer program resulted in a shift in the relationship between the Statewide IRM and the minimum LCRs. On March 20, 2006, the New York State Reliability Council voted to retain the Statewide IRM of 118% and reported the corresponding revised minimum LCRs to the NYISO. On March 28, 2006, the NYISO Operating Committee approved revised minimum LCRs of 80% and 99% for New York City and Long Island, respectively. For New York City, this action effectively returned the locational requirement to the minimum level used for the last six years (80%) and negated the increase to 83%.

KeySpan appealed this decision to the NYISO Board of Directors claiming the revised study was hastily prepared and that there were historic factors that justified using 83% as the New York City LCR. The NYISO Board of Directors denied KeySpan's appeal on April 3, 2006 and the "in-City" locational capacity requirement beginning May 1, 2006 through the period ending April 30, 2007 is currently 80%.

Our Ravenswood Generating Station is an "in-City" generator. As the electric infrastructure in New York City and the surrounding areas continues to change and evolve and the demand for electric power increases, the "in-City" generator requirement could be further modified. Construction of new transmission and generation facilities may cause significant changes to the market for sales of capacity, energy and ancillary services from our Ravenswood Generating Station. Approximately, 1000 MW of additional capacity came on line in 2006. We can not be certain as to the nature of future New York City energy, capacity or ancillary services market requirements or design.

NYISO In-City Capacity Mitigation

The NYPSC, Con Edison and other load serving entities ("LSEs") complained to the NYISO that in-City capacity market clearing prices during the summer of 2006 did not decline as they had expected with the introduction of additional supply in the New York City market. The NYISO issued a letter to FERC indicating that no tariff violations occurred and that prices were as it expected. Nevertheless, the NYISO stated that if changes to the market are warranted, the NYISO would consider making revisions as necessary.

Accordingly, the NYPSC and Con Edison developed additional mitigation measures that would apply to certain in-City generation owned by KeySpan. These mitigation measures essentially would reduce the capacity offer cap on bids by the Ravenswood Generating Station and certain other generation owners of capacity into the NYISO Spot Demand Curve Auction Market. The current offer cap is $105/kW-year and is proposed to be reduced to $82/kW-year plus 3%.

The reduced offer cap would be implemented using a conduct and impact test on the offers of capacity from the Ravenswood Generating Station and other owners of Consolidated Edison divested generation units. Under the proposal, if an offer to sell capacity is 3% or more above $82/kW-year, then the offer is subject to possible mitigation. To determine if mitigation will be applied, a second test, an impact test, is utilized. If the unmitigated offer raises the total market cost of capacity by 3% or more as compared to the total cost of capacity derived using those generators' $82/kW-year reference bid, then the offer will be mitigated to $82/kW-year.

The NYISO's Management Committee and NYISO's Board of Directors approved the above proposal, notwithstanding KeySpan's analysis and objections. The NYISO filed the mitigation measures with the FERC for approval. KeySpan intervened and protested the filing, which is pending at FERC. At this time, we are unable to predict the outcome of this proceeding and what effect it will have on our financial condition, results of operations, and cash flows. However, adoption and implementation of the proposal in its current form could materially adversely affect the revenue realized by KeySpan from the sale of capacity from the Ravenswood Generating Station, as well as the potential revenue that could be realized in connection with the fixed for floating financial Swap Agreement.

NYISO May 2006 In-City Capacity Market Error

On December 1, 2006, the NYISO filed a complaint against SCS/Astoria Energy LLC ("Astoria"), an in-City electric generating unit, alleging that it did not follow the NYISO tariff rules related to the certification and sale of capacity in relation to its auctions for the sale of capacity to the NYISO market. As a result, a certain amount of capacity that was sold in the May 2006 auctions was determined by the NYISO to be ineligible. In its complaint, the NYISO proposes to impose a deficiency charge against Astoria for the improperly-certified capacity. The NYISO could then award additional capacity payments to another in-City supplier (including the Ravenswood Generating Station) because that supplier would have sold additional capacity if not for for the Astoria discrepancy. A decision by the FERC is pending.

Summer 2002 Capacity Under Procurement Complaint

On January 12, 2007, the Court of Appeals for the District of Columbia Circuit ("Court") issued its decision related to a KeySpan complaint against the NYISO related to capacity procurement activities during the summer of 2002. KeySpan had complained to FERC that the NYISO violated its tariff and as a result received $23.3 million less than it would have if the NYISO had followed the tariff. The Court vacated rulings by the FERC that denied KeySpan's complaint. The Court determined that the NYISO did in fact violate its tariff but remanded two issues back to the FERC for further consideration. The two issues relate to whether FERC should grant KeySpan's requested relief for the tariff violation. At this time, we are unable.to predict the outcome of this proceeding and what effect it will have on KeySpan's results of operations, financial position and cash flows.

Quantitative and Qualitative Disclosures About Market Risk

Commodity Derivative Instruments – Hedging Activities: From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas distribution operations, gas production and development activities and its electric generating facilities. Our gas distribution operations utilize over-the-counter ("OTC") natural gas and fuel oil swaps to hedge the cash-flow variability of specified portions of gas purchases and sales associated with certain large-volume customers when economically appropriate to do so. Seneca-Upshur utilizes OTC natural gas swaps to hedge cash flow variability associated with forecasted sales of natural gas.

Commodity Derivative Instruments that are not Accounted for as Hedges: The Ravenswood Generating Station uses derivative financial instruments to financially hedge the cash flow variability associated with the purchase of a portion of natural gas and oil that will be consumed during the generation of electricity. The Ravenswood Generating Station also financially hedges the cash flow variability associated with a portion of electric energy sales using OTC electricity swaps. KeySpan has also, entered into an International SWAP Dealers Association Master Agreement for a fixed for floating unforced capacity financial swap with Morgan Stanley Capital Group Inc., as well as a gas distribution asset optimization contract that employs derivative financial instruments.

The following tables set forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2006.

TYPE OF CONTRACT GAS	YEAR OF MATURITY	VOLUMES (MMCF)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($ MILLIONS)
Swaps/Futures – Long Natural Gas	2007	8,565	7.68 – 11.94	5.84 – 7.93	(17.3)
	2008	670	9.08 – 9.82	7.45 – 8.90	(0.5)
OTC Swaps – Short Natural Gas	2007	1,770	5.86 – 5.97	5.84 – 8.56	(2.3)
	2008	1,614	6.77 – 6.85	7.45 – 8.90	(2.5)
	2009	1,314	7.60 – 10.90	7.21 – 8.89	0.9
Optimization Contract	2007	—	—	—	1.4
		13,933			(20.3)

TYPE OF CONTRACT OIL	YEAR OF MATURITY	VOLUMES (BARRELS)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($ MILLIONS)
Swaps – Long Fuel Oil	2007	726,708	50.35 – 69.08	45.74 – 57.11	(6.9)
	2008	59,123	60.00 – 67.60	57.11	(0.5)
		785,831			(7.4)

TYPE OF CONTRACT ELECTRICITY	YEAR OF MATURITY	MWh	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($ MILLIONS)
Swaps – Energy	2007	1,154,018	66.25 – 150.50	57.00 – 118.32	22.4
	2008	35,536	70.10	69.08	(0.3)
		1,189,554			22.1

The following tables detail the changes in and sources of fair value for the above derivatives:

CHANGE IN FAIR VALUE OF DERIVATIVE HEDGING INSTRUMENTS	(In Millions of Dollars) 2006
Fair value of contracts at January 1, 2006	$ (18.1)
Net (gains) on contracts realized	(73.6)
Increase in fair value of all open contracts	86.1
Fair value of contracts outstanding at December 31,	$ (5.6)

	(In Millions of Dollars) FAIR VALUE OF CONTRACTS		
SOURCES OF FAIR VALUE	MATURITY IN 12 MONTHS	THEREAFTER	TOTAL FAIR VALUE
Prices actively quoted	$ (15.0)	$ (2.1)	$ (17.1)
Local published indicies	12.3	(0.8)	$ 11.5
	$ (2.7)	$ (2.9)	$ (5.6)

We measure the commodity risk of our derivative hedging instruments (indicated in the above table) using a sensitivity analysis. Based on a sensitivity analysis as of December 31, 2006 a 10% increase/decrease in natural gas prices would decrease/increase the value of derivative instruments maturing in one year by $2.4 million.

Commodity Derivative Instruments – Regulated Utilities: We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. The accounting for these derivative instruments is subject to SFAS 71 "Accounting for the Effects of Certain Types of Regulation." Therefore, changes in the fair value of these derivatives have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements.

The following table sets forth selected financial data associated with these derivative financial instruments that were outstanding at December 31, 2006.

TYPE OF CONTRACT GAS	YEAR OF MATURITY	VOLUMES (MMCF)	CEILING ($)	FIXED PRICE ($)	CURRENT PRICE ($)	FAIR VALUE ($ MILLIONS)
Options	2007	3,900	7.00 – 8.00	—	6.30 – 6.60	2.7
Swaps	2007	62,792	—	6.81 – 12.28	6.30 – 8.90	(169.2)
	2008	28,475	—	7.16 – 11.64	7.25 – 8.90	(25.6)
		95,167				(192.1)

See Note 8 to the Consolidated Financial Statements "Hedging, Derivative Financial Instruments and Fair Values" for a further description of all our derivative instruments.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of KeySpan Corporation:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that KeySpan Corporation and subsidiaries (the "Company") maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended December 31, 2006 of the Company and our report dated February 22, 2007 expressed an unqualified opinion on those financial statements and included an explanatory paragraph regarding the adoption of Statement of Financial Accounting Standards No. 158 "Employers' Accounting for Defined Benefit Pensions and Other Postretirement Benefit Plans," referred to in Notes 1 and 4.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
New York, New York
February 22, 2007

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of KeySpan Corporation:

We have audited the accompanying Consolidated Balance Sheets and the Consolidated Statements of Capitalization of KeySpan Corporation and subsidiaries (the "Company") as of December 31, 2006 and 2005, and the related Consolidated Statements of Income, Retained Earnings, Comprehensive Income and Cash Flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of KeySpan Corporation and subsidiaries as of December 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Notes 1 and 4 to the consolidated financial statements, on December 31, 2006, the Company adopted Statement of Financial Accounting Standards No. 158 "Employers' Accounting for Defined Benefit Pensions and Other Postretirement Benefit Plans." As discussed in Notes 1 and 7, on December 31, 2005, the Company adopted Financial Accounting Standards Board Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations."

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 22, 2007 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Deloitte & Touche LLP

DELOITTE & TOUCHE LLP
New York, New York
February 22, 2007

ONSOLIDATED BALANCE SHEET

CEMBER 31,	2006	2005
		(In Millions of Dollars)
SETS		
rrent Assets		
Cash and temporary cash investments	$ 210.9	$ 124.5
Restricted cash	7.9	13.2
Accounts receivable	943.7	1,035.6
Unbilled revenue	531.2	685.6
Allowance for uncollectible accounts	(56.9)	(62.8)
Gas in storage, at average cost	646.0	766.9
Material and supplies, at average cost	137.1	140.5
Derivative contracts	54.1	142.8
Prepayments	236.2	95.8
Other	76.8	78.0
	2,787.0	3,020.1
quity Investments and Other	269.7	242.4
operty		
Gas	7,639.4	7,275.9
Electric	2,575.4	2,492.3
Other	441.5	416.3
Accumulated depreciation	(3,151.2)	(2,922.6)
Gas production and development, at cost	186.9	184.2
Accumulated depletion	(113.7)	(109.2)
	7,578.3	7,336.9
eferred Charges		
Regulatory assets:		
Miscellaneous assets	937.5	688.3
Derivative contracts	196.3	30.9
Goodwill and other intangible assets, net of amortization	1,666.3	1,666.3
Derivative contracts	127.3	75.2
Other	875.1	752.5
	3,802.5	3,213.2
tal Assets	$ 14,437.5	$ 13,812.6

accompanying Notes to the Consolidated Financial Statements.

DECEMBER 31,	2006	2005
		(In Millions of Dollars)
LIABILITIES AND CAPITALIZATION		
Current Liabilities		
Accounts payable and other liabilities	$ 1,026.0	$ 1,087.0
Commercial paper	85.0	657.6
Current maturities of long-term debt and capital leases	1.2	13.0
Taxes accrued	200.8	176.3
Dividends payable	83.3	81.1
Customer deposits	33.5	39.1
Interest accrued	58.5	53.8
Other current liability, derivative contracts	219.7	47.3
	1,708.0	2,155.2
Deferred Credits and Other Liabilities		
Regulatory liabilities:		
Miscellaneous liabilities	43.4	69.9
Removal costs recovered	556.2	516.4
Derivative accounts	120.6	175.4
Asset retirement obligations	47.3	47.4
Deferred income tax	1,176.4	1,157.9
Postretirement benefits and other reserves	1,667.3	1,118.4
Derivative contracts	43.1	44.3
Other	121.6	127.5
	3,775.9	3,257.2
Commitments and Contingencies (See Note 7)	—	—
Capitalization		
Common stock	3,994.0	3,975.9
Retained earnings	973.7	866.9
Accumulated other comprehensive loss	(175.3)	(74.8)
Treasury stock	(273.6)	(303.9)
Total common shareholders' equity	4,518.8	4,464.1
Long-term debt and capital leases	4,419.1	3,920.8
Total Capitalization	8,937.9	8,384.9
Minority Interest in Consolidated Companies	15.7	15.3
Total Liabilities and Capitalization	$ 14,437.5	$ 13,812.6

See accompanying Notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENT OF INCOME

		(In Millions of Dollars, Except Per Share Amounts)	
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Revenues			
Gas Distribution	**$ 5,062.6**	$ 5,390.1	$ 4,407.3
Electric Services	**1,880.6**	2,042.7	1,738.7
Energy Services	**203.4**	191.2	182.4
Houston Exploration	**—**	—	268.1
Energy Investments	**35.0**	38.0	54.0
Total Revenues	**7,181.6**	7,662.0	6,650.5
Operating Expenses			
Purchased gas for resale	**3,331.5**	3,597.3	2,664.5
Fuel and purchased power	**548.6**	752.1	540.3
Operations and maintenance	**1,680.0**	1,617.9	1,567.0
Depreciation, depletion and amortization	**397.5**	396.5	551.8
Operating taxes	**411.2**	407.1	404.2
Impairment charges	**—**	—	41.0
Total Operating Expenses	**6,368.8**	6,770.9	5,768.8
Gain on sale of property	**1.6**	1.6	7.0
Income from equity investments	**13.1**	15.1	46.5
Operating Income	**827.5**	907.8	935.3
Other Income and (Deductions)			
Interest charges	**(256.1)**	(269.3)	(331.3)
Sale of subsidiary stock	**—**	4.1	388.3
Cost of debt redemption	**—**	(20.9)	(45.9)
Minority interest	**(0.8)**	(0.4)	(36.8)
Other	**39.1**	16.6	30.6
Total Other Income and (Deductions)	**(217.8)**	(269.9)	4.9
Income Taxes			
Current	**57.9**	206.6	201.9
Deferred	**117.6**	32.7	123.6
Total Income Taxes	**175.5**	239.3	325.5
Earnings from Continuing Operations	**434.2**	398.6	614.7
Discontinued Operations			
Income (loss) from operations, net of tax	**—**	(4.1)	(79.0)
Gain (loss) on disposal, net of tax	**—**	2.3	(72.0)
Loss from Discontinued Operations	**—**	(1.8)	(151.0)
Cumulative Change in Accounting Principles, net of tax	**—**	(6.6)	—
Net Income	**434.2**	390.2	463.7
Preferred stock dividend requirements	**—**	2.2	5.6
Earnings for Common Stock	**$ 434.2**	$ 388.0	$ 458.1
Basic Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 2.48**	$ 2.33	$ 3.80
Discontinued Operations	**—**	(0.01)	(0.94)
Cumulative Change in Accounting Principles	**—**	(0.04)	—
Basic Earnings Per Share	**$ 2.48**	$ 2.28	$ 2.86
Diluted Earnings Per Share			
Continuing Operations, less preferred stock dividends	**$ 2.46**	$ 2.32	$ 3.78
Discontinued Operations	**—**	(0.01)	(0.94)
Cumulative Change in Accounting Principles	**—**	(0.04)	—
Diluted Earnings Per Share	**$ 2.46**	$ 2.27	$ 2.84
Average Common Shares Outstanding (000)	**175,040**	169,940	160,294
Average Common Shares Outstanding – Diluted (000)	**176,151**	170,801	161,277

See accompanying Notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENT OF CASH FLOWS

YEAR ENDED DECEMBER 31,	2006	2005	2004
			(In Millions of Dollars)
Operating Activities			
Net income	**$ 434.2**	$ 390.2	$ 463.7
Adjustments to reconcile net income to net cash provided by (used in) operating activities			
Depreciation, depletion and amortization	**397.5**	396.5	551.8
Deferred income tax	**117.6**	32.7	123.6
Income from equity investments	**(13.1)**	(15.1)	(46.5)
Dividends from equity investments	**8.9**	9.3	14.2
Amortization of financing fees / interest rate swaps	**8.2**	(1.4)	(14.9)
Gain on sale of investments and property	**(1.6)**	(5.6)	(395.3)
Hedging (gain)/losses	**2.9**	(3.2)	2.5
Amortization of property taxes	**146.3**	126.2	101.9
Impairment charges	**—**	—	41.0
Loss from discontinued operations	**—**	1.8	151.0
Cumulative change in accounting principle	**—**	6.6	—
Minority interest	**0.8**	0.4	36.8
Changes in assets and liabilities			
Accounts receivable	**317.9**	(305.7)	(234.2)
Materials and supplies, fuel oil and gas in storage	**(5.7)**	(268.4)	(39.0)
Accounts payable and accrued expenses	**(163.4)**	196.3	159.5
Prepaid property taxes	**(150.5)**	(136.2)	(112.1)
Reserve payments	**(51.2)**	(35.7)	(37.3)
Insurance settlements	**16.6**	21.1	—
Other	**(6.8)**	(6.5)	(16.6)
Net Cash Provided by Continuing Operating Activities	**1,058.6**	403.3	750.1
Investing Activities			
Construction expenditures	**(524.0)**	(539.5)	(750.3)
Cost of removal	**(32.6)**	(27.8)	(36.3)
Net proceeds from sale of property and investments	**1.6**	47.0	1,021.3
Derivative margin call	**(33.9)**	(8.9)	—
Net Cash (Used in) Provided by Continuing Investing Activities	**(588.9)**	(529.2)	234.7
Financing Activities			
Treasury stock issued	**30.1**	41.2	33.4
Common stock issuance	**—**	460.0	—
Issuance of long-term debt	**500.0**	—	49.3
Payment of long-term debt	**(13.0)**	(515.0)	(920.1)
Issuance / (payment) of commercial paper	**(572.6)**	(254.6)	430.4
Redemption of preferred stock	**—**	(75.0)	(8.5)
Net proceeds from sale/leaseback transaction	**—**	—	382.0
Common and preferred stock dividends paid	**(325.3)**	(308.4)	(291.1)
Gain on interest rate swap	**—**	—	12.7
Other	**(2.5)**	(5.4)	36.1
Net Cash (Used in) Continuing Financing Activities	**(383.3)**	(657.2)	(275.8)
Net Increase (Decrease) in Cash and Cash Equivalents	**$ 86.4**	$(783.1)	$ 709.0
Cash Flow from Discontinued Operations – Operating Activities	**—**	(3.8)	8.1
Cash Flow from Discontinued Operations – Investing Activities	**—**	(10.6)	1.3
Cash Flow from Discontinued Operations – Financing Activities	**—**	—	0.2
Cash and Cash Equivalents at Beginning of Period	**124.5**	922.0	203.4
Cash and Cash Equivalents at End of Period	**$ 210.9**	$ 124.5	$ 922.0
Interest Paid	**$ 256.9**	$ 262.7	$ 336.5
Income Tax Paid	**$ 175.7**	$ 198.8	$ 122.0

See accompanying Notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

YEAR ENDED DECEMBER 31,	2006	2005	2004
			(In Millions of Dollars)
Balance at Beginning of Period	**$ 866.9**	$ 792.2	$ 621.4
Net Income for Period	**434.2**	390.2	463.7
	1,301.1	1,182.4	1,085.1
Deductions:			
Cash dividends declared on common stock	**327.4**	313.3	287.3
Cash dividends declared on preferred stock	**—**	2.2	5.6
Balance at End of Period	**$ 973.7**	$ 866.9	$ 792.2

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

YEAR ENDED DECEMBER 31,	2006	2005	2004
			(In Millions of Dollars)
Net Income	**$ 434.2**	$ 390.2	$ 463.7
Other comprehensive income, net of tax			
Reclassification of (gains) losses included in net income	**(47.8)**	23.8	(0.3)
Unrealized gains (losses) on derivative financial instruments	**55.4**	(35.1)	15.4
Deconsolidation of certain subsidiaries	**—**	—	9.3
Foreign currency translation adjustments	**—**	(5.0)	(21.5)
Unrealized gains (losses) on marketable securities	**2.0**	(0.5)	7.1
Premium on derivative instrument	**—**	—	3.4
Accrued unfunded pension obligation	**37.9**	(3.7)	(7.8)
Other comprehensive income (loss), net of tax	**47.5**	(20.5)	5.6
Comprehensive Income	**$ 481.7**	$ 369.7	$ 469.3
Related tax (benefit) expense			
Reclassification of (gains) losses included in net income	**(25.8)**	12.8	(0.2)
Unrealized gains (losses) on derivative financial instruments	**31.5**	(20.7)	8.2
Deconsolidation of certain subsidiaries	**—**	—	5.0
Foreign currency translation adjustments	**—**	(2.7)	(11.6)
Unrealized gains (losses) on marketable securities	**1.1**	(0.2)	3.8
Premium on derivative instrument	**—**	—	1.9
Accrued unfunded pension obligation	**20.4**	(2.1)	(4.2)
Total Tax Expense (Benefit)	**$ 27.2**	$ (12.9)	$ 2.9

See accompanying Notes to the Consolidated Financial Statements.

CONSOLIDATED STATEMENT OF CAPITALIZATION

				(In Millions of Dollars)
	DECEMBER 31,		DECEMBER 31,	
	2006	2005	2006	2005
	SHARES ISSUED			
Common Shareholders' Equity				
Common stock, $0.01 par value	**184,864,124**	184,864,124	**$ 1.8**	$ 1.8
Premium on capital stock			**3,992.2**	3,974.1
Retained earnings			**973.7**	866.9
Accumulated other comprehensive loss			**(175.3)**	(74.8)
Treasury stock	**(9,451,408)**	(10,495,743)	**(273.6)**	(303.9)
Total Common Shareholders' Equity	**175,412,716**	174,368,381	**4,518.8**	4,464.1
Long - Term Debt	INTEREST RATE	MATURITY		
Medium and Long Term Notes	4.65% – 9.75%	2008 – 2035	**2,925.4**	2,437.2
Gas Facilities Revenue Bonds	Variable	2020 – 2026	**230.0**	230.0
	4.70% – 6.95%	2020 – 2026	**410.5**	410.5
Total Gas Facilities Revenue Bonds			**640.5**	640.5
Promissory Notes to LIPA				
Pollution Control Revenue Bonds	5.15%	2016 – 2025	**108.0**	108.0
Electric Facilities Revenue Bonds	5.30%	2023 – 2025	**47.4**	47.4
Total Promissory Notes to LIPA			**155.4**	155.4
Industrial Development Bonds	5.25%	2027	**128.3**	128.3
First Mortgage Bonds	6.34% – 8.80%	2008 – 2028	**95.0**	95.0
Authority Financing Notes	Variable	2027 – 2028	**66.0**	66.0
Ravenswood Master Lease & Capital Leases		2007 – 2014	**422.1**	423.0
Subtotal			**4,432.7**	3,945.4
Unamortized interest rate hedge and debt discount			**(29.2)**	(30.4)
Derivative impact on debt			**16.8**	18.8
Less: current maturities			**1.2**	13.0
Total Long-Term Debt			**4,419.1**	3,920.8
Total Capitalization			**$ 8,937.9**	$ 8,384.9

See accompanying Notes to the Consolidated Financial Statements.

Introduction to the Notes to the Consolidated Financial Statements

KeySpan Corporation (referred to herein as "KeySpan," "we," "us" and "our") is a holding company under the Public Holding Company Act of 2005 ("PUHCA 2005"). KeySpan operates six regulated utilities that distribute natural gas to approximately 2.6 million customers in New York City, Long Island, Massachusetts and New Hampshire, making KeySpan the fifth largest gas distribution company in the United States and the largest in the Northeast. We also own, lease and operate electric generating plants in Nassau and Suffolk Counties on Long Island and in Queens County in New York City and are the largest electric generation operator in New York State. Under contractual arrangements, we provide power, electric transmission and distribution services, billing and other customer services for approximately 1.1 million electric customers of the Long Island Power Authority ("LIPA"). KeySpan's other operating subsidiaries are primarily involved in gas production and development; underground gas storage; liquefied natural gas storage; retail electric marketing; large energy-system ownership, installation and management; service and maintenance of energy systems; and engineering and consulting services. We also invest and participate in the development of natural gas pipelines, electric generation and other energy-related projects. (See Note 2 to the Consolidated Financial Statements "Business Segments" for additional information on each operating segment.)

On February 25, 2006, KeySpan entered into an Agreement and Plan of Merger (the "Merger Agreement"), with National Grid plc, a public limited company incorporated under the laws of England and Wales ("Parent") and National Grid US8, Inc., a New York Corporation ("Merger Sub"), pursuant to which Merger Sub will merge with and into KeySpan (the "Merger"), with KeySpan continuing as the surviving company and thereby becoming an indirect wholly-owned subsidiary of the Parent. Pursuant to the Merger Agreement, at the effective time of the Merger, each outstanding share of KeySpan common stock, par value $0.01 per share (the "Shares"), other than treasury shares and shares held by the Parent and its subsidiaries, shall be canceled and shall be converted into the right to receive $42.00 in cash, without interest.

Consummation of the Merger is subject to various closing conditions, including but not limited to the receipt of requisite regulatory approvals from certain United States federal and state public utility, antitrust and other regulatory authorities, all of which have been filed and many of which have been obtained. Specifically, we filed our application for approval of the Merger pursuant to the Federal Power Act in May 2006 and in October the requisite approval was obtained from the Federal Energy Regulatory Commission ("FERC"). In early July 2006, we cleared review by the Federal Trade Commission under the Hart-Scott-Rodino Antitrust Improvement Act and received notification that the Committee on Foreign Investment in the U.S. has determined that there are no issues of national security sufficient to warrant an investigation of the transaction. On July 20, 2006 we filed an application for approval of the transaction with the New York Public Service Commission ("NYPSC"). KeySpan has also sought approval of the Merger from the New Hampshire Public Utility Commission. In October 2006, the State of New Jersey Board of Public Utilities approved a change of control of KeySpan Communication Corp., which provides telecommunications services in New Jersey. In addition, the Merger was approved by our shareholders at our Annual Meeting on August 17, 2006. Shareholders of National Grid plc approved the Merger at a meeting held on July 31, 2006.

In addition to seeking approval of the Merger, the application filed with the NYPSC also contained proposed ten-year rate plans for KeySpan Energy Delivery of New York ("KEDNY") and KeySpan Energy Delivery of Long Island ("KEDLI"), as well as proposals concerning corporate structure and affiliate rules, the rate treatment for synergy savings and for low income and energy efficiency programs, among others. Specifically, the rate plan proposals provide for, among other things, a freeze of base delivery rates for KEDNY and KEDLI for 18 months. Thereafter, KEDNY's and KEDLI's gas adjustment clauses would be increased to recover, on a prospective basis, estimated gas commodity-related costs of $68.6 million for KEDNY and $28.7 million for KEDLI that would no longer be included in base rates. In addition, KEDNY and KEDLI base delivery rates would be increased by an average of 2.5% ($62.4 million) and 2.3% ($39.4 million), respectively in years 3, 5, 7 and 9 of the rate plans. The proposed rate plans contemplate an allowed return on equity of 11.0% for each entity. Cumulative earnings above 11.75% would be shared between gas sales customers and KeySpan over the rate plan period. On October 3, 2006 National Grid plc filed testimony and exhibits with the NYPSC that further explains the exhibits and attachments that were previously submitted as part of the July 20, 2006 petition.

Separately from the merger application, on October 3, 2006, KEDNY and KEDLI filed with the NYPSC individual applications for proposed annual increases in revenues, which applications assumed that KEDNY and KEDLI remained as stand-alone companies. The proposed revenue increases are for approximately 9.1% and 10.9% for KEDNY and KEDLI, respectively. KEDNY's last base rate increase took effect October 1, 1993 and since then base rates have been reduced twice – once in 1996 and again in 1998. KEDLI's last base rate increase took effect December 1, 1995. Since that time, KEDLI's base rates were reduced twice in 1998. The principal factors creating the need for rate relief are increases in operating and maintenance expenses, increases in rate base, increased property taxes and depreciation expense, and the need to commence recovery of previously deferred costs such as pension and post retirement benefits, environmental expenditures and property taxes.

The total projected increase in revenues is comprised of two components; (i) an increase in base rates of $180.7 million for KEDNY and $145 million for KEDLI; and (ii) projected increases of $32.8 million and $13.6 million for KEDNY and KEDLI, respectively, for gas-related expenses that will be recovered through the Gas Adjustment Clause ("GAC") and/or the Transportation Adjustment Clause ("TAC"). The proposed rate of return on equity is 11.0% for both KEDNY and KEDLI.

The NYPSC may suspend the implementation of the proposed tariff changes for up to eleven months, which would mean, absent other intervening events, an effective date of September 3, 2007 for new rates. Although KEDNY and KEDLI proposed the new rates described above in these tariff filings, it will not be necessary to implement the rate increases

proposed therein if the NYPSC approves the Merger between National Grid plc and KeySpan and approves the related ten-year rate plan previously noted, or some variation thereof.

On February 20, 2007, NYPSC Staff filed its direct testimony in the merger proceeding. NYSPSC Staff opposed the current terms of the Merger on policy grounds, but suggested that it could support the Merger under certain circumstances. KeySpan and National Grid plc intend to file testimony responding to the positions taken by Staff. In addition, on January 29, 2007, Staff filed its direct testimony in the rate case proceedings and our rebuttal testimony was filed on February 21, 2007. In connection with each of these proceedings, hearings before an administrative law judge (ALJ) are scheduled to begin in late March. Unless a settlement among the parties is otherwise reached, the ALJ will issue its recommended decision to the NYPSC following such hearings. Ultimately, the NYPSC may accept, reject, or modify all or any part of the ALJ's recommended decision.

KeySpan and National Grid plc will continue to pursue all required approvals and continue to anticipate that the Merger will be consummated in mid-2007. However, we are unable to predict the outcome of these regulatory proceedings and no assurance can be given that the Merger will occur or the timing of its completion.

Note 1. Summary of Significant Accounting Policies

A. Organization of the Company

KeySpan Corporation, a New York corporation, was formed in May 1998, as a result of the business combination of KeySpan Energy Corporation, the parent of The Brooklyn Union Gas Company, and certain businesses of the Long Island Lighting Company ("LILCO"). On November 8, 2000, KeySpan acquired Eastern Enterprises ("Eastern"), a Massachusetts business trust, and the parent of several gas utilities operating in Massachusetts. Also on November 8, 2000, Eastern acquired EnergyNorth, Inc. ("ENI"), the parent of a gas utility operating in central New Hampshire.

At December 31, 2005, KeySpan was a holding company under the Public Utility Holding Company Act of 1935, as amended ("PUHCA 1935"). In August 2005, the Energy Policy Act of 2005 (the "Energy Act") was enacted. The Energy Act is a broad energy bill that places an increased emphasis on the production of energy and promotes the development of new technologies and alternative energy sources and provides tax credits to companies that produce natural gas, oil, coal, electricity and renewable energy. For KeySpan, one of the more significant provisions of the Energy Act was the repeal of PUHCA 1935, which became effective on February 8, 2006. Since that time, the jurisdiction of the Securities and Exchange Commission ("SEC") over certain holding company activities, including the regulation of our affiliate transactions and service companies, has been transferred to the FERC pursuant to PUHCA 2005.

Pursuant to PUHCA 2005, the SEC no longer has jurisdiction over our holding company activities, other than those associated with the registration and issuance of our securities under the federal securities laws. FERC now has jurisdiction over certain of our holding company activities, including (i) regulating certain transactions among our affiliates within our holding company system; (ii) governing the issuance, acquisition and disposition of securities and assets by certain of our public utility subsidiaries; and (iii) approving certain utility mergers and acquisitions.

Moreover, our affiliate transactions also remain subject to certain regulations of the Public Service Commission of the State of New York ("NYPSC"), the Massachusetts Department of Telecommunications and Energy ("MADTE") and the New Hampshire Public Utility Commission ("NHPUC") in addition to FERC.

Under our holding company structure, we have no independent operations or source of income of our own and conduct all of our operations through our subsidiaries and, as a result, we depend on the earnings and cash flow of, and dividends or distributions from, our subsidiaries to provide the funds necessary to meet our debt and contractual obligations. Furthermore, a substantial portion of our consolidated assets, earnings and cash flow is derived from the operations of our regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation by state regulatory authorities.

Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to KeySpan is conditioned upon maintenance of a utility capital structure with debt not exceeding 55% and 58%, respectively, of total utility capitalization. In addition, the level of dividends paid by both utilities may not be increased from current levels if a 40 basis point penalty is incurred under the customer service performance program.

KeySpan's businesses are engaged in gas distribution, electric services and generation and other energy related activities. KeySpan's gas distribution operations are conducted by our six regulated gas utility subsidiaries: The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York ("KEDNY") and KeySpan Gas East Corporation d/b/a KeySpan Energy Delivery Long Island ("KEDLI") distribute gas to customers in the Boroughs of Brooklyn, Staten Island, a portion of the Borough of Queens in New York City, and the counties of Nassau and Suffolk on Long Island and the Rockaway Peninsula in Queens, respectively; Boston Gas Company, Colonial Gas Company and Essex Gas Company, each doing business as KeySpan Energy Delivery New England ("KEDNE"), distribute gas to customers in southern, eastern and central Massachusetts; and EnergyNorth Natural Gas, Inc., d/b/a KeySpan Energy Delivery New England distributes gas to customers in central New Hampshire. Together, these companies distribute gas to approximately 2.6 million customers throughout the Northeast.

We own, lease and operate electric generating plants on Long Island and in New York City. Under contractual arrangements, we provide electric power, electric transmission and distribution services, billing and other customer services for approximately 1.1 million electric customers of the Long Island Power Authority ("LIPA"). On February 1, 2006, KeySpan and LIPA entered into agreements to extend, amend and restate these contractual arrangements. See Note 11 "2006 LIPA Settlement" for a discussion of the settlement.

Our other subsidiaries are involved in gas production and development; gas storage; liquefied natural gas storage; retail electric marketing; appliance service; fiber optic services; and engineering and consulting services. We also invest in, and participate in the development of natural gas pipelines, electric generation, and other energy-related projects.

(See Note 2, "Business Segments" for additional information on each operating segment.)

B. Basis of Presentation

The Consolidated Financial Statements presented herein reflect the accounts of KeySpan and its subsidiaries. Most of our subsidiaries are fully consolidated in the financial information presented, except for certain subsidiary investments in the Energy Investments segment which are accounted for on the equity method as we do not have a controlling voting interest or otherwise have control over the management of such companies. All intercompany transactions have been eliminated.

The preparation of financial statements in conformity with generally accepted accounting principles ("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.

C. Accounting for the Effects of Rate Regulation

The accounting records for our six regulated gas utilities are maintained in accordance with the Uniform System of Accounts prescribed by the NYPSC, the NHPUC, and the MADTE. Our electric generation subsidiaries are not subject to state rate regulation, but they are subject to FERC regulation. Our financial statements reflect the ratemaking policies and actions of these regulators in conformity with GAAP for rate-regulated enterprises.

Four of our six regulated gas utilities (KEDNY, KEDLI, Boston Gas Company and EnergyNorth Natural Gas, Inc.) and our Long Island based electric generation subsidiaries are subject to the provisions of Statement of Financial Accounting Standards ("SFAS") 71, "Accounting for the Effects of Certain Types of Regulation." This statement recognizes the ability of regulators, through the ratemaking process, to create future economic benefits and obligations affecting rate-regulated companies. Accordingly, we record these future economic benefits and obligations as regulatory assets and regulatory liabilities on the Consolidated Balance Sheet, respectively.

In separate merger related orders issued by the MADTE, the base rates charged by Colonial Gas Company and Essex Gas Company have been frozen at their current levels for ten-year periods ending 2009 and 2008, respectively. Due to the length of these base rate freezes, the Colonial and Essex Gas companies had previously discontinued the application of SFAS 71.

The following table presents our net regulatory assets at December 31, 2006 and December 31, 2005.

	(In Millions of Dollars)	
DECEMBER 31,	**2006**	**2005**
Regulatory Assets		
Regulatory tax asset	$ 30.2	$ 33.4
Property and other taxes	95.0	53.8
Environmental costs	416.7	454.7
Postretirement benefits	364.6	109.3
Costs associated with the KeySpan/LILCO transaction	15.6	27.3
Derivative financial instruments	196.3	30.9
Other	15.4	9.8
Total Regulatory Assets	1,133.8	719.2
Regulatory Liabilities		
Derivative financial instruments	(120.6)	(175.4)
Miscellaneous	(43.4)	(69.9)
Total Regulatory Liabilities	(164.0)	(245.3)
Net Regulatory Assets	969.8	473.9
Removal Costs Recovered	(556.2)	(516.4)
	$ 413.6	$ (42.5)

The regulatory assets above are not included in utility rate base. However, we record carrying charges on the property tax and costs associated with the KeySpan/LILCO transaction cost deferrals. We also record carrying charges on our regulatory liabilities except for the current market value of our derivative financial instruments. The remaining regulatory assets represent, primarily, costs for which expenditures have not yet been made, and therefore, carrying charges are not recorded. We anticipate recovering these costs in our gas rates concurrently with future cash expenditures. If recovery is not concurrent with the cash expenditures, we will record the appropriate level of carrying charges. Deferred gas costs of $46.3 million and $11.3 million at December 31, 2006 and December 31, 2005, respectively are reflected in accounts receivable on the Consolidated Balance Sheet. Deferred gas costs are subject to current recovery from customers.

D. Revenues

Gas Distribution: Utility gas customers are billed monthly or bi-monthly on a cycle basis. Revenues include unbilled amounts related to the estimated gas usage that occurred from the most recent meter reading to the end of each month.

The cost of gas used is recovered when billed to firm customers through the operation of gas adjustment clauses ("GAC") included in utility tariffs. The GAC provision requires periodic reconciliation of recoverable gas costs and GAC revenues. Any difference is deferred pending recovery from or refund to firm customers. Further, net revenues from tariff gas balancing services, off-system sales and certain on-system interruptible sales are refunded, for the most part, to firm customers subject to certain sharing provisions.

The New York and Long Island gas utility tariffs contain weather normalization adjustments that largely offset shortfalls or excesses of firm net revenues (revenues less gas costs and revenue taxes) during a heating season due to variations from normal weather. Revenues are adjusted

each month the clause is in effect and are generally included in rates in the following month. The New England gas utility rate structures contain no weather normalization feature, therefore their net revenues are subject to weather related demand fluctuations. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate the effect of fluctuations from normal weather on our financial position and cash flows, we may enter into weather related derivative instruments from time to time. (See Note 8 "Hedging, Derivative Financial Instruments and Fair Values" for additional information on these derivatives.)

In December 2005, The Boston Gas Company ("Boston Gas") received a MADTE order permitting regulatory recovery of the 2004 gas cost component of bad debt write-offs. This was approved for full recovery as an exogenous cost effective November 1, 2005. In addition, effective January 1, 2006 Boston Gas was permitted to fully recover the gas cost component of bad debt write-offs through its cost-of-gas adjustment clause rather than filing for recovery as an exogenous cost. On October 31, 2006, the MADTE granted Boston Gas recovery of $12 million of the 2005 gas cost component of bad debt write-offs from Boston Gas ratepayers beginning November 1, 2006. This amount will also be recovered through the cost-of-gas adjustment clause.

Electric Services: Electric revenues are primarily derived from: (i) billings to LIPA for management of LIPA's transmission and distribution system ("T&D System"), electric generation, and procurement of fuel, and (ii): subsidiaries that own, lease and operate the 2,200 megawatt ("MW") Ravenswood electric generation facility ("Ravenswood Facility") and the 250 MW combined cycle generating facility located at the Ravenswood facility site ("Ravenswood Expansion"). Collectively, the Ravenswood Facility and Ravenswood Expansion are referred to as the Ravenswood Generating Station.

LIPA Agreements:

In 1998, KeySpan and LIPA entered into three major long-term service agreements that (i) provide to LIPA all operation, maintenance and construction services and significant administrative services relating to the Long Island electric T&D System pursuant to the Management Services Agreement (the "1998 MSA"); (ii) supply LIPA with electric generating capacity, energy conversion and ancillary services from our Long Island generating units pursuant to the Power Supply Agreement (the "1998 PSA"); and (iii) manage all aspects of the fuel supply for our Long Island generating facilities, as well as all aspects of the capacity and energy owned by or under contract to LIPA pursuant to the Energy Management Agreement (the "1998 EMA"). The 1998 MSA, 1998 PSA and 1998 EMA all are collectively referred to as the 1998 LIPA Agreements and are discussed in greater detail below.

On February 1, 2006, KeySpan and LIPA entered into (i) an amended and restated Management Services Agreement (the "2006 MSA"), pursuant to which KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island; (ii) 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; and (iii) a Settlement Agreement (the "2006 Settlement Agreement") resolving outstanding issues between the parties regarding the 1998 LIPA Agreements. The 2006 MSA, the 2006 Option Agreement and the 2006 Settlement Agreement are collectively referred to herein as the "2006 LIPA Agreements." Each of the 2006 LIPA agreements will become effective upon all of the 2006 LIPA Agreements receiving the required governmental approvals; otherwise none of the 2006 LIPA Agreements will become effective. These agreements will become effective following approval by the New York State Comptroller's Office and the New York State Attorney General. Following the announcement of the proposed acquisition of KeySpan by National Grid plc, LIPA, National Grid plc and KeySpan have engaged in discussions concerning the impact of the transaction on LIPA's operations. At this time, we are unable to determine what impact, if any, the results of such discussions may have on the 2006 LIPA Agreements and the receipt and timing of governmental approvals relating thereto. See Note 11, "2006 LIPA Settlement" for additional details on these agreements.

In place of the previous compensation structure under the 1998 MSA (whereby KeySpan was reimbursed for budgeted costs, and earned a management fee and certain performance and cost-based incentives), KeySpan's compensation for managing the electric transmission and distribution system owned by LIPA under the 2006 MSA consists of two components: a minimum compensation component of $224 million per year and a variable component based on electric sales. The $224 million component will remain unchanged for three years and then increase annually by 1.7%, plus inflation. The variable component, which will comprise no more than 20% of KeySpan's compensation, is based on electric sales on Long Island exceeding a base amount of 16,558 gigawatt hours, increasing by 1.7% in each year. Above that level, KeySpan will receive approximately 1.34 cents per kilowatt hour for the first contract year, 1.29 cents per kilowatt hour in the second contract year (plus an annual inflation adjustment), 1.24 cents per kilowatt hour in the third contract year (plus an annual inflation adjustment), with the per kilowatt hour rate thereafter adjusted annually by inflation.

In addition, KeySpan sells to LIPA under the 1998 PSA all of the capacity and, to the extent requested, energy conversion services from its existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC. Rates charged to LIPA include a fixed and variable component. The variable component is billed to LIPA on a monthly per megawatt hour basis and is dependent on the number of megawatt hours dispatched. The 1998 PSA provides incentives and penalties that can total $4 million annually for the maintenance of the output capability and the efficiency of the generating facilities.

KeySpan also procures and manages fuel supplies on behalf of LIPA, under the 1998 EMA, to fuel the generating facilities under contract to it and perform off-system capacity and energy purchases on a least-cost

basis to meet LIPA's needs. In exchange for these services KeySpan earns an annual fee of $1.5 million. In addition, we arrange for off-system sales on behalf of LIPA of excess output from the generating facilities and other power supplies either owned or under contract to LIPA. LIPA is entitled to two-thirds of the profit from any off-system energy sales. In addition, the 1998 EMA provides incentives and penalties that can total $5 million annually for performance related to fuel purchases and off-system power purchases. The 1998 EMA is expected to be in effect through 2013 for the procurement of fuel supplies. In 2005, the EMA was amended to extend the term for off-system power purchases through December 31, 2006 and thereafter on a month-to-month basis unless terminated by LIPA on sixty days notice, but in no event later than December 31, 2007.

KeySpan Glenwood Energy Center, LLC and KeySpan Port Jefferson Energy Center, LLC have entered into 25 year Power Purchase Agreements with LIPA (the "PPAs"). Under the terms of the PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Each plant is designed to produce 79.9 MW. Under the PPAs, LIPA pays a monthly capacity fee, which guarantees full 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.

The Electric Services segment also conducts retail marketing of electricity to commercial customers. Energy sales made by our electric marketing subsidiary are recorded upon delivery of the related commodity.

Ravenswood Generating Station:
In addition, electric revenues are derived from our investment in the 2,200 MW Ravenswood electric generation facility ("Ravenswood Facility"), (which KeySpan acquired in June 1999). KeySpan has an arrangement with a variable interest entity through which we lease a portion of the Ravenswood Facility. Further, in May 2004 KeySpan completed construction of a 250 MW combined cycle generating facility located at the Ravenswood facility site ("Ravenswood Expansion"). To finance the Ravenswood Expansion, KeySpan entered into a leveraged lease financing arrangement. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for a description of the financing arrangements associated with the Ravenswood Generating Station.) The Ravenswood Generating Station earns revenues through the sale, at wholesale, of energy, capacity, and ancillary services to the New York Independent System Operator ("NYISO"). Energy and ancillary services are sold through a bidding process into the NYISO energy markets on a day ahead or real time basis.

Energy Services: Revenues earned by our Energy Services segment for service and maintenance contracts associated with small commercial and residential appliances are recognized as earned or over the life of the service contract, as appropriate. Revenues earned for engineering services are derived from services rendered under fixed price and cost-plus contracts and generally are recognized on the percentage-of-completion method. Fiber optic service revenue is recognized upon delivery of service access. We have unearned revenue recorded in deferred credits and other liabilities – other on the Consolidated Balance Sheet totaling $30.3 million and $29.3 million as of December 31, 2006, and December 31, 2005, respectively. These balances represent primarily unearned revenues for service contracts and are generally amortized to income over a one year period.

KeySpan completed its sale of its mechanical contracting companies in the first quarter of 2005, and therefore, no longer has revenues from mechanical contracting operations. (See Note 10 "Energy Services – Discontinued Operations" for additional details on the mechanical contracting companies.)

Gas Production and Development: Natural gas and oil revenues earned by our gas production and development activities are recognized using the entitlements method of accounting. Under this method of accounting, income is recorded based on the net revenue interest in production or nominated deliveries. Production gas volume imbalances are incurred in the ordinary course of business. Net deliveries in excess of entitled amounts are recorded as liabilities, while net under deliveries are recorded as assets. Imbalances are reduced either by subsequent recoupment of over and under deliveries or by cash settlement, as required by applicable contracts. Production imbalances are marked-to-market at the end of each month using the market price at the end of each period. During 2004 KeySpan disposed of its interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company. KeySpan continues to maintain, on a significantly smaller scale, gas production and development activities. (See Note 2 "Business Segments" for a discussion on the disposition of Houston Exploration and KeySpan's remaining gas production and development activities.)

E. Utility and Other Property – Depreciation and Maintenance
Property, principally utility gas property is stated at original cost of construction, which includes allocations of overheads, including taxes, and an allowance for funds used during construction. The rates at which KeySpan subsidiaries capitalized interest for the year ended December 31, 2006 ranged from 1.88% to 7.02%. Capitalized interest for 2006, 2005 and 2004 was $2.5 million, $1.4 million and $7.4 million, respectively.

Depreciation is provided on a straight-line basis in amounts equivalent to composite rates on average depreciable property. In 2006, an adjustment to the depreciation allowance was recorded to correct for an error in useful lives associated with certain gas distribution assets. The cost of property retired is charged to accumulated depreciation.

KeySpan recovers cost of removal through rates charged to customers as a portion of depreciation expense. At December 31, 2006 and 2005, KeySpan had costs recovered in excess of costs incurred totaling $556.2 million and $516.4 million, respectively. These amounts are reflected as a regulatory liability.

The cost of repair and minor replacement and renewal of property is charged to maintenance expense. The composite rates on average depreciable property were as follows:

YEAR ENDED DECEMBER 31,	2006	2005	2004
Electric	3.86%	3.75%	3.87%
Gas	3.14%	3.72%	3.55%

We also had $441.5 million of other property at December 31, 2006, consisting of assets held primarily by our corporate service subsidiary of $307.6 million and $104.2 million in Energy Services assets. The corporate service assets consist largely of land, buildings, office equipment and furniture, vehicles, computer and telecommunications equipment and systems. These assets have depreciable lives ranging from three to 40 years. We allocate the carrying cost of these assets to our operating subsidiaries through our filed allocation methodology. Energy Services assets consist largely of computer equipment and fiber optic cable and related electronics and have service lives ranging from seven to 40 years.

KeySpan's repair and maintenance costs, including planned major maintenance in the Electric Services segment for turbine and generator overhauls, are expensed as incurred unless they represent replacement of property to be capitalized. Planned major maintenance cycles primarily range from seven to eight years. Smaller periodic overhauls are performed approximately every 18 months.

KeySpan capitalizes costs incurred in connection with its projects to develop and build energy facilities after a project has been determined to be probable of completion.

F. Gas Production and Development Property – Depletion

KeySpan maintains gas production and development activities through its two wholly-owned subsidiaries – KeySpan Exploration and Production, LLC ("KeySpan Exploration") and Seneca-Upshur Petroleum, Inc. ("Seneca-Upshur"). At December 31, 2006, these subsidiaries had net production and development property in the amount of $73.2 million. These assets are accounted for under the full cost method of accounting. Under the full cost method, costs of acquisition and development of natural gas and oil reserves plus asset retirement obligations are capitalized into a "full cost pool" as incurred. Unproved properties and related costs are excluded from the depletion and amortization base until a determination is made as to the existence of proved reserves. Properties are depleted and charged to operations using the unit of production method using proved reserve quantities.

To the extent that such capitalized costs (net of accumulated depletion) less deferred taxes exceed the present value (using a 10% discount rate) of estimated future net cash flows from proved natural gas and oil reserves and the lower of cost or fair value of unproved properties, less deferred taxes, such excess costs are charged to operations, but would not have an impact on cash flows. Once incurred, such impairment of gas properties is not reversible at a later date even if gas prices increase.

The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, held flat over the life of the reserves. We use derivative financial instruments that qualify for hedge accounting under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," to hedge the volatility of natural gas prices. In accordance with current SEC guidelines, we have included estimated future cash flows from our hedging program in ceiling test calculations.

As of December 31, 2006, we estimated that our capitalized costs did not exceed the ceiling test limitation. We used an average wellhead price of $6.15 per MCF, adjusted for derivative instruments.

As a result of the disposition of Houston Exploration in 2004, during 2004 KeySpan calculated the ceiling test on KeySpan Exploration and Production's and Seneca-Uphsur's assets independently of Houston Exploration's assets. Based on a report furnished by an independent reservoir engineer during the second quarter of 2004, it was determined that the remaining proved undeveloped oil reserves held in the joint venture required a substantial investment in order to develop. Therefore, KeySpan and Houston Exploration elected not to develop these oil reserves. As a result, in the second quarter of 2004, we recorded a $48.2 million non-cash impairment charge to write down our wholly-owned gas production and development subsidiaries' assets. This charge was recorded in depreciation, depletion and amortization on the Consolidated Statement of Income.

Natural gas prices continue to be volatile and the risk that a write down to the full cost pool increases when, among other things, natural gas prices are low or there are significant downward revisions in our estimated proved reserves.

In 2004, Houston Exploration capitalized interest related to unevaluated natural gas and oil properties, as well as some properties under development which were not being amortized. For the year ended December 31, 2004, capitalized interest was $3.4 million.

G. Goodwill and Other Intangible Assets

The balance of goodwill and other intangible assets was $1.7 billion at December 31, 2006 and December 31, 2005, representing primarily the excess of acquisition cost over the fair value of net assets acquired. Goodwill and other intangible assets reflect the Eastern and EnergyNorth acquisitions, the KeySpan/LILCO transaction, as well as acquisitions of non-utility energy-related service companies and also relates to certain ownership interests of 50% or less in energy-related investments, which are accounted for under the equity method.

The table below summarizes the goodwill and other intangible assets balance for each segment at December 31, 2006 and 2005:

	(In Millions of Dollars)	
AT DECEMBER 31,	**2006**	**2005**
Operating Segment		
Gas Distribution	$1,436.9	$1,436.9
Energy Services	65.2	65.2
Energy Investments and other	164.2	164.2
	$1,666.3	$1,666.3

As prescribed in SFAS 142 "Goodwill and Other Intangible Assets," KeySpan is required to compare the fair value of a reporting unit to its carrying amount, including goodwill. This evaluation is required to be performed at least annually, unless facts and circumstances indicated that the evaluation should be performed at an interim period during the year. At December 31, 2006, KeySpan had $1.7 billion of recorded goodwill and has concluded that the fair value of the business units that have recorded goodwill exceed their carrying value.

During 2004, KeySpan conducted an evaluation of the carrying value of goodwill recorded in its Energy Services segment. As a result of this evaluation, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on Energy Services segment's continuing operations; and (ii) $93.9 million as discontinued operations reflecting the impairment on the mechanical contracting companies. (See Note 10 "Energy Services – Discontinued Operations" for further details.)

In 2004, KeySpan entered into an agreement to sell its then 50% interest in Premier Transmission Limited ("Premier"). This investment was accounted for under the equity method of accounting in the Energy Investments segment. In the fourth quarter of 2004 KeySpan recorded a partial pre-tax non-cash impairment charge of $26.5 million – $18.8 million after-tax or $0.12 per share. The impairment charge reflected the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value at that time and was recorded as a reduction to goodwill.

H. Hedging and Derivative Financial Instruments

From time to time, we employ derivative instruments to hedge a portion of our exposure to commodity price risk, interest rate risk and weather fluctuations as well as to hedge cash flow variability associated with a portion of our peak electric energy sales. Whenever hedge positions are in effect, we are exposed to credit risk in the event of nonperformance by counter-parties to derivative contracts, as well as nonperformance by the counter-parties of the transactions against which they are hedged. We believe that the credit risk related to the futures, options and swap instruments is no greater than that associated with the primary commodity contracts which they hedge.

Financially-Settled Commodity Derivative Instruments: We employ derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with forecasted purchases and sales of various energy-related commodities. All such derivative instruments are accounted for pursuant to the requirements of SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS 149, "Amendment of Statement 133 Derivative Instruments and Hedging Activities" (collectively, "SFAS 133"). With respect to those commodity derivative instruments that are designated and accounted for as cash flow hedges, the effective portion of periodic changes in the fair market value of cash flow hedges is recorded as other comprehensive income on the Consolidated Balance Sheet, while the ineffective portion of such changes in fair value is recognized in earnings. Unrealized gains and losses (on such cash flow hedges) that are recorded as other comprehensive income are subsequently reclassified into earnings concurrent when hedged transactions impact earnings. With respect to those commodity derivative instruments that are not designated as hedging instruments, such derivatives are accounted for on the Consolidated Balance Sheet at fair value, with all changes in fair value reported in earnings.

Firm Gas Sales Derivatives Instruments – Regulated Utilities: We use derivative financial instruments to reduce cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. The accounting for these derivative instruments is subject to SFAS 71. Therefore, the fair value of these derivatives is recorded as current or deferred assets and liabilities, with offsetting positions recorded as regulatory assets and regulatory liabilities on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements.

Physically-Settled Commodity Derivative Instruments: Certain of our contracts for the physical purchase of natural gas were assessed as no longer being exempt from the requirements of SFAS 133 as normal purchases. As such, these contracts are recorded on the Consolidated Balance Sheet at fair market value. However, since such contracts were executed for the purchases of natural gas that is sold to regulated firm gas sales customers, and pursuant to the requirements of SFAS 71, changes in the fair market value of these contracts are recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet.

Weather Derivatives: The utility tariffs associated with our New England gas distribution operations do not contain weather normalization adjustments. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. To mitigate the effect of fluctuations from normal weather on our financial position and cash flows, we may enter into derivative instruments from time to time. Based on the terms of the contracts, we account for these

instruments pursuant to the requirements of Emerging Issues Task Force ("EITF") 99-2 "Accounting for Weather Derivatives." In this regard, we account for weather derivatives using the "intrinsic value method" as set forth in such guidance.

Interest Rate Derivative Instruments: We continually assess the cost relationship between fixed and variable rate debt. Consistent with our objective to minimize our cost of capital, we periodically enter into hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable or variable to fixed. Payments made or received on these derivative contracts are recognized as an adjustment to interest expense as incurred. Hedging transactions that effectively convert the terms of underlying debt obligations from fixed to variable are designated and accounted for as fair-value hedges pursuant to the requirements of SFAS 133. Hedging transactions that effectively convert the terms of underlying debt obligations from variable to fixed are considered cash flow hedges.

I. Equity Investments and Other

Certain subsidiaries own as their principal assets, investments (including goodwill), representing ownership interests of 50% or less in energy-related businesses that are accounted for under the equity method. None of these current investments are publicly traded. Additionally, KeySpan has corporate assets recorded on the Consolidated Balance Sheet representing funds designated for Supplemental Executive Retirement Plans. These funds are invested in corporate owned life insurance policies. KeySpan records changes in the value of these assets in accordance with FAS Technical Bulletin 85-4 "Accounting for the Purchase of Life Insurance." As such, increases and decreases in the value of these assets are recorded through earnings in the Consolidated Statement of Income concurrent with the change in the value of the underlying assets.

J. Income and Excise Tax

Upon implementation of SFAS 109, "Accounting for Income Taxes," certain of our regulated subsidiaries recorded a regulatory asset and a net deferred tax liability for the cumulative effect of providing deferred income taxes on certain differences between the financial statement carrying amounts of assets and liabilities, and their respective tax bases. This regulatory asset continues to be amortized over the lives of the individual assets and liabilities to which it relates. Additionally, investment tax credits which were available prior to the Tax Reform Act of 1986, were deferred and generally amortized as a reduction of income tax over the estimated lives of the related property.

We report our collections and payments of excise taxes on a gross basis. Gas distribution revenues include the collection of excise taxes, while operating taxes include the related expense. For the years ended December 31, 2006, 2005 and 2004, excise taxes collected and paid were $60.4 million, $65.8 million and $73.3 million, respectively.

K. Subsidiary Common Stock Issuances to Third Parties

We follow an accounting policy of income statement recognition for parent company gains or losses from issuances of common stock by subsidiaries to unaffiliated third parties.

L. Foreign Currency Translation

We followed the principles of SFAS 52, "Foreign Currency Translation," for recording our investments in foreign affiliates. Under this statement, all elements of the financial statements are translated by using a current exchange rate. Translation adjustments result from changes in exchange rates from one reporting period to another. At December 31, 2006 and 2005, SFAS 52 was not applicable to KeySpan since we completed the sale of our remaining foreign investment in the first quarter of 2005.

M. Earnings Per Share

Basic earnings per share ("EPS") is calculated by dividing earnings for common stock by the weighted average number of shares of common stock outstanding during the period. No dilution for any potentially anti-dilutive securities is included. Diluted EPS assumes the conversion of all potentially dilutive securities and is calculated by dividing earnings for common stock, as adjusted, by the sum of the weighted average number of shares of common stock outstanding plus all potentially dilutive securities.

Under the requirements of SFAS 128, "Earnings Per Share" our basic and diluted EPS are as follows:

	(In Millions of Dollars, Except Per Share Amounts)		
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Earnings for common stock	$ 434.2	$ 388.0	$ 458.1
Weighted average shares outstanding (000)	175,040	169,940	160,294
Add dilutive securities:			
Options	991	861	983
Performance shares	120	—	—
Total weighted average shares outstanding – assuming dilution	176,151	170,801	161,277
Basic earnings per share	$ 2.48	$ 2.28	$ 2.86
Diluted earnings per share	$ 2.46	$ 2.27	$ 2.84

N. Stock Based Compensation

From time to time, KeySpan awards stock based compensation to officers, directors, consultants and certain other management employees, primarily under the Long Term Performance Incentive Compensation Plan (the "Incentive Plan"). The Incentive Plan provides for the award of incentive stock options, non-qualified stock options, performance shares and restricted shares. The purpose of the Incentive Plan is to optimize KeySpan's performance through incentives that directly link the participant's goals to those of KeySpan's shareholders and to attract and retain participants who make significant contributions to the success of KeySpan.

Under the Incentive Plan, 19,250,000 shares were authorized for issuance of which the total shares awarded to date include 16.9 million

stock options, 222,143 shares of restricted stock, and 891,555 performance shares. At December 31, 2006, after adjusting for forfeitures, there are approximately 3.0 million shares still eligible to be granted under the Incentive Plan. In addition, under previous plans, there were an additional 1.7 million shares authorized for which approximately 1.2 million stock options were awarded.

In 2005, KeySpan continued to apply APB Opinion 25 "Accounting for Stock Issued to Employees," in accounting for grants awarded prior to January 1, 2003. No compensation cost had been recognized for these stock option awards since the exercise prices and market values were equal on the grant dates. Had compensation cost for these plans been determined based on the fair value at the grant dates for awards under the plans consistent with SFAS 123 "Accounting for Stock-Based Compensation," our net income and earnings per share for the twelve months ended December 31, 2005 and 2004 would have decreased to the pro-forma amounts indicated below:

	(In Millions of Dollars, Except Per Share Amounts)	
YEAR ENDED DECEMBER 31,	**2005**	**2004**
Earnings available for common stock:		
As reported	$388.0	$458.1
Add: recorded stock-based compensation expense, net of tax	7.0	9.1
Deduct: total stock-based compensation expense, net of tax	(8.9)	(12.4)
Pro-forma earnings	$386.1	$454.8
Earnings per share:		
Basic – as reported	$ 2.28	$ 2.86
Basic – pro-forma	$ 2.27	$ 2.84
Diluted – as reported	$ 2.27	$ 2.84
Diluted – pro-forma	$ 2.26	$ 2.82

In 2003, KeySpan adopted the prospective method of transition of accounting for stock based compensation expense in accordance with SFAS 148 "Accounting for Stock-Based Compensation – Transition and Disclosure." Accordingly, compensation expense has been recognized by employing the fair value recognition provisions of SFAS 123 for grants awarded after January 1, 2003.

In January 2006, KeySpan adopted SFAS 123 (revised 2004) "Share-Based Payment ("SFAS 123R")." The implementation of this standard required KeySpan to expense certain stock options that had previously been accounted for under the requirements of APB Opinion 25 and related Interpretations, i.e. awards issued prior to January 1, 2003. No compensation cost had been recognized for these fixed stock option plans in the Consolidated Financial Statements since the exercise prices and market values were equal on the grant dates. For the twelve months ended December 31, 2006, KeySpan recorded an expense of $1.4 million for stock option awards previously accounted for under APB 25 and which have now fully vested.

The following table presents the actual expense for all of KeySpan's stock based compensation awards recorded in the Consolidated Statement of Income for the periods indicated.

		(In Millions of Dollars)	
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Performance shares	$ 8.2	$(1.0)	$ 4.9
Restricted stock	4.1	0.9	0.7
Stock options	6.1	5.5	3.7
EDSPP discount	4.8	5.4	4.7
Total stock-based compensation included in operations and maintenance expense	23.2	10.8	14.0
Income tax benefit	(8.1)	(3.8)	(4.9)
Total stock based compensation expense, net of tax	$15.1	$ 7.0	$ 9.1

Prior to the adoption of SFAS 123R, KeySpan presented all tax benefits for deductions resulting from the exercise of stock options and disqualifying dispositions as operating cash flows in its Consolidated Statement of Cash Flows. SFAS 123R requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow. This requirement will reduce net operating cash flows and increase net financing cash flows in periods after adoption. Total cash flow will remain unchanged from what would have been reported under prior accounting rules.

During the twelve months ended December 31, 2006, 2005 and 2004 cash received from stock options exercised was $31.1 million, $43.0 million and $32.2 million, respectively. The tax benefit realized for tax deductions from stock options exercised during the twelve months ended December 31, 2006, 2005 and 2004 was less than the recognized compensation expense and accordingly there were no excess tax deductions reported in the financing section of the Consolidated Statement of Cash Flows.

The following represents a discussion of the various awards granted under our stock based compensation plans:

Performance shares

Performance shares were awarded under the Incentive Plan in 2004 and 2005 based upon the attainment of overall corporate performance goals. These performance shares are measured over a three year period by comparing KeySpan's cumulative total shareholder return to the S&P Utilities Group. For actual performance achieved at a threshold level, 50% of the award will be granted; for actual performance achieved at a targeted level, 100% of the award will be granted; and for actual performance achieved at the maximum level, 150% of the award will be granted. The 2004 and 2005 awards are being expensed ratably over their remaining performance periods.

During 2005, it became apparent to management that the 2003 performance share award would not be achieved and the 2004 performance share award would not be achieved at the level of expense being recorded. Since these awards meet the definition of a performance condition not achieved under SFAS 123, KeySpan reversed the previously

recognized expense for the 2003 award and one half of previously recognized expense for the 2004 award amounting to $3.8 million ($2.5 million after tax).

The 2006 performance share award reflects the new performance condition criteria under SFAS 123R. In 2006, 315,900 performance shares were granted. Performance shares were granted with a three-year performance period with a threshold, target and maximum performance level. The number of performance shares earned at the end of the performance period can range from 0% to 150% of the shares granted and will be linked to two performance measures: the percentage improvement in return on invested capital, or "ROIC," and KeySpan's cumulative three-year total stockholder return, or "TSR," relative to the cumulative three-year TSR for the Standard and Poor's Utilities Group, using a matrix approach that encompasses both measures. The ROIC goal will act as the primary trigger. If the ROIC goal performance is below the threshold level, all shares shall be forfeited without payment. Upon a change of control, performance shares shall be distributed based upon the greater of the number of performance shares awarded at target level or the number of shares earned based on actual performance through the change of control date. Performance share awards were priced at fair value on the date of grant. The unearned compensation as of December 31, 2006 associated with all of the performance share awards was $11.5 million.

Restricted Stock Awards

KeySpan has made certain grants of restricted stock to officers and directors under the Incentive Plan. Awards of restricted stock were made in 2002, 2005 and 2006. These awards may not be sold or otherwise transferred until certain restrictions have lapsed. The unearned stock-based compensation related to the 2002 and 2005 awards was amortized to compensation expense over the vesting period. The share-based expense for these awards was determined based on the fair value of the stock at the date of grant applied to the total number of shares that were anticipated to fully vest. The 2002 and 2005 awards expense has been fully amortized and the 2006 award was expensed in 2006. Upon a change of control, all restricted stock awards will vest immediately.

Employee Discount Stock Purchase Plan

KeySpan's Employee Discount Stock Purchase Plan ("EDSPP") allows KeySpan employees to purchase shares of KeySpan stock at a 10% discount through payroll deductions. KeySpan is currently expensing the discount. The number of shares of common stock authorized for issuance under the EDSPP is 1,750,000 shares and there are 358,731 shares remaining to be issued.

Stock Options

The stock option component of the Incentive Plan entitles the participants to purchase shares of common stock at an exercise price per share which is no less than the closing price of the common stock on the date of the grant. Stock options generally vest over a three-to-five year period and have an exercise period of ten years. Upon a change of control, all stock options granted and outstanding will vest immediately.

The value of all stock option grants are estimated on the date of the grant using the Black-Scholes option-pricing model. There were no stock options granted in 2006. The following table presents the weighted average fair value, exercise price and assumptions used for the 2005 and 2004 stock option grants:

YEAR ENDED DECEMBER 31,	2005	2004
Fair value of grants issued	$ 6.15	$ 5.47
Dividend yield	4.64%	4.74%
Expected volatility	22.63%	23.48%
Risk free rate	4.10%	3.22%
Expected lives	6.4 years	6.5 years
Exercise price	$39.25	$37.54

A summary of the status of our fixed stock option plans and changes is presented below for the periods indicated:

	2006			2005			2004		
FIXED OPTIONS	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	AGGREGATE INTRINSIC VALUE (IN MILLIONS)	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	AGGREGATE INTRINSIC VALUE (IN MILLIONS)	SHARES	WEIGHTED AVERAGE EXERCISE PRICE	AGGREGATE INTRINSIC VALUE (IN MILLIONS)
Outstanding at beginning of period	10,443,055	$33.74		10,540,946	$32.61		10,320,743	$31.39	
Granted during the year	—	—		1,451,650	$39.25		1,602,850	$37.54	
Exercised	(955,500)	$32.54		(1,400,190)	$30.65		(1,150,464)	$28.05	
Forfeited	(84,451)	$38.54		(149,351)	$36.32		(232,183)	$35.18	
Outstanding at end of period	9,403,104	$33.82	$66.4	10,443,055	$33.74	$34.8	10,540,946	$32.61	$73.2
Exercisable at end of period	6,885,572	$32.73	$56.1	5,673,084	$31.55	$29.1	5,523,259	$30.39	$50.6

The total intrinsic value of the options exercised during the 12 months ended December 31, 2006, 2005 and 2004 was approximately $6.8 million, $11.4 million and $11.3 million, respectively.

INING ACTUAL LIFE	OPTIONS OUTSTANDING AT DECEMBER 31, 2006	WEIGHTED AVERAGE EXERCISE PRICE	RANGE OF EXERCISE PRICE	OPTIONS EXERCISABLE AT DECEMBER 31, 2006	WEIGHTED AVERAGE EXERCISE PRICE	RANGE OF EXERCISE PRICE
	—	—	—	—	—	—
s	185,000	32.63	32.63	185,000	32.63	32.63
's	681,958	28.00	24.73 – 29.38	681,958	28.00	24.73 – 29.38
's	382,181	26.97	21.99 – 27.06	382,181	26.97	21.99 – 27.06
's	960,947	22.69	22.50 – 32.76	960,947	22.69	22.50 – 32.76
's	1,511,064	39.50	39.50	1,511,064	39.50	39.50
's	1,750,205	32.66	32.66	1,422,105	32.66	32.66
's	1,165,112	32.40	32.40	766,552	32.40	32.40
's	1,414,766	37.54	37.54	655,231	37.54	37.54
ars	1,351,871	39.25	39.25	320,534	39.25	39.25
	9,403,104			6,885,572		

As of December 31, 2006, there are approximately 2.5 million ›ns which have not yet vested. The unearned compensation cost ed to these stock option awards is $3.2 million which is expected to cognized over a weighted average period of 2 years.

ecent Accounting Pronouncements

bruary 2007, Financial Accounting Standards Board ("FASB") issued ment of Financial Accounting Standard ("SFAS") 159 "The Fair Value on for Financial Assets and Financial Liabilities." This statement per- entities to choose to measure many financial instruments and certain r items at fair value that are not currently required to be measured at value. The objective is to improve financial reporting by providing ies with the opportunity to mitigate volatility in reported earnings ed by measuring related assets and liabilities differently without hav- o apply complex hedge accounting provisions. This statement ires a business entity to report unrealized gains and losses on items vhich the fair value option has been elected in earnings at each sub- ent reporting date. An entity may decide whether to elect the fair e option for each eligible item on its election date, subject to certain irements described in the statement. This statement shall be effective f the beginning of each reporting entity's first fiscal year that begins November 15, 2007. KeySpan is currently reviewing the require- ts of this statement and, at this point in time, we can not determine impact, if any, that this statement may have on results of operations, ncial position or cash flows.

On September 29, 2006, the FASB issued SFAS 158 Employers' ounting for Defined Benefit Pensions and Other Postretirement Benefit s, an amendment of FASB Statements No. 87, 88, 106 and 132(R)." 158 requires employers to fully recognize all postretirement plans ed status on the balance sheet as a net liability or asset and requires ffsetting adjustment to accumulated other comprehensive income in holders' equity. Certain of KeySpan's subsidiaries are subject to ral accounting requirements pursuant to rate agreements with the C, MADTE and NHPUC. Further, KeySpan has certain contractual to reimbursement for postretirement liabilities in its agreements IPA. As such, a portion of the offsetting position to the increase in tal postretirement liabilities has been reflected as a regulatory asset ntractual asset. SFAS 158 does not change how postretirement benefits are accounted for and reported in the income statement; companies will continue to apply existing accounting guidance. KeySpan adopted the provisions of SFAS 158 in December 2006. See Note 4 "Postretirement Benefits" for further information on SFAS 158.

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. KeySpan is 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.

On July 13, 2006, the FASB issued Interpretation No. 48 "Accounting for Uncertainty In Income Taxes." The FASB, in its interpretation of SFAS 109, "Accounting for Income Taxes," seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement requirements related to accounting for income taxes. The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more-likely-than-not to be sustained upon examination by taxing authorities. The amount recognized is measured as the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. The Interpretation requires application for fiscal years beginning after December 15, 2006, for first quarter 2007 reporting. KeySpan is currently reviewing the requirements of this Interpretation and, at this point in time, we can not

determine the impact, if any, that this Interpretation may have on results of operations and financial position.

In December 2004 the FASB issued SFAS 123 (revised 2004 "SFAS 123R") "Share-Based Payment." SFAS 123R focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. SFAS 123R revises certain provisions of SFAS 123 "Accounting for Stock-Based Compensation" and supersedes APB Opinion 25 "Accounting for Stock Issued to Employees." The fair-value-based method in SFAS 123R is similar to the fair-value-based method in SFAS 123 in most respects. However, the following are key differences between the two: entities are now required to measure liabilities incurred to employees in share-based payment transactions at fair value as compared to using the intrinsic method allowed under SFAS 123; entities are now required to estimate the number of instruments for which the requisite service is expected to be rendered, as compared to accounting for forfeitures as they occur under SFAS 123; and incremental compensation cost for a modification of the terms or conditions of an award are also measured differently under SFAS 123R compared to Statement 123. SFAS 123R also clarifies and expands SFAS 123's guidance in several areas. The effective date of SFAS 123R was the beginning of the first fiscal year beginning after June 15, 2005. KeySpan adopted the prospective method of transition for stock options in accordance with SFAS 148 "Accounting for Stock-Based Compensation – Transition and Disclosure." Accordingly, compensation expense has been recognized by employing the fair value recognition provisions of SFAS 123 for grants awarded after January 1, 2003. Therefore implementation of SFAS 123R in January 2006 did not have a material impact on KeySpan's results of operations or financial position and no impact on its cash flows.

P. Impact of Cumulative Effect of Change in Accounting Principles

KeySpan implemented FASB Interpretation No. 47 ("FIN 47"), effective December 31, 2005. FIN 47 required KeySpan to record a liability and corresponding asset representing the present value of conditional asset retirement obligations associated with the retirement of tangible, long-lived assets on the date the obligations were incurred. At December 31, 2005, we recorded a $45.6 million liability and corresponding asset representing the present value of conditional asset retirement obligations associated with the retirement of tangible, long-lived assets on the date the obligations were incurred. For the $45.6 million initial asset recorded, approximately $4.3 million represents asset retirement costs that have been deferred on the Consolidated Balance Sheet and will be depreciated over the remaining life of the underlying associated assets lives. The remaining $41.3 million represented cumulative accretion and depreciation expense associated with the liability and asset from the dates the various obligations would have been recorded had this Interpretation been in effect at the time the obligations were incurred.

Of the $41.3 million recorded, $11.3 million ($6.6 million, after-tax), was recorded as a cumulative change in accounting principle on the Consolidated Statement of Income. The remaining $30.0 million was attributable to the Gas Distribution segment and was recorded as a reduction to removal cost recovered. For asset retirement costs incurred in the Gas Distribution segment, KeySpan is recovering these costs from utility customers and has been expensing a like amount through its depreciation expense. A portion of this depreciation expense represents removal costs not yet incurred. The $30.0 million recorded to removal cost recovered is for purposes of reclassifying a portion of this reserve to the asset retirement obligation. (See Note 7, "Contractual Obligations, Financial Guarantees and Contingencies – Asset Retirement Obligations" for further details.)

Under Accounting Principle Board Opinion No. 20 ("APB 20"), the pro-forma impact of the retroactive application resulting from the adoption of a change in accounting principle is to be disclosed as follows:

(In Millions of Dollars, Except Per Share Amounts)

YEAR ENDED DECEMBER 31,	2005	2004
Earnings for common stock	$388.0	$458.1
Add back: Cumulative effect of a change in accounting principle	6.6	—
Earnings for common stock before cumulative effect of a change in accounting principle	394.6	458.1
Less: FIN 47 Accretion expense, net of taxes	(0.5)	(0.4)
Add: FIN 47 Depreciation expense, net of taxes	(0.2)	(0.2)
Pro-forma earnings	$393.9	$457.5
Earnings per share before cumulative change in accounting principle:		
Basic – as reported	$2.32	$2.86
Basic – pro-forma	$2.32	$2.85
Diluted – as reported	$2.31	$2.84
Diluted – pro-forma	$2.31	$2.84
Earnings per share for common stock:		
Basic – as reported	$2.28	$2.86
Basic – pro-forma	$2.32	$2.85
Diluted – as reported	$2.27	$2.84
Diluted – pro-forma	$2.31	$2.84

In addition to the above disclosure, FIN 47 requires disclosure of the pro-forma impact of the liability for the asset retirement obligation for the beginning of the earliest year presented and at the end of all years presented as if this Interpretation had been applied during all periods effected. The disclosure is as follows:

(In Millions of Dollars)

DECEMBER 31,	2006	2005
Asset retirement obligation – January 1	$47.4	$44.9
Accretion	2.6	2.5
Cost Incurred	(2.7)	—
Asset retirement obligation – December 31	$47.3	$47.4

Q. Accumulated Other Comprehensive Income

As required by SFAS 130, "Reporting Comprehensive Income," the components of accumulated other comprehensive income are as follows:

	(In Millions of Dollars)	
DECEMBER 31,	**2006**	**2005**
Unrealized gains (losses) on marketable securities	$1.1	$(0.9)
Accrued unfunded pension obligation	(25.6)	(63.5)
SFAS 158 transition	(148.0)	—
Unrealized losses on derivative financial instruments	(2.8)	(10.4)
Accumulated other comprehensive loss	$(175.3)	$(74.8)

R. Pension and Other Postretirement Plan Assets

Consistent with past practice and as required by SFAS 158, KeySpan values its pension and other postretirement assets using the year-end market value of those assets. Benefit obligations are also measured at year-end.

Note 2. Business Segments

We have four reportable segments: Gas Distribution, Electric Services, Energy Services and Energy Investments.

The Gas Distribution segment consists of our six gas distribution subsidiaries. KEDNY provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Queens and Staten Island. KEDLI provides gas distribution services to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. The remaining gas distribution subsidiaries, collectively referred to as KEDNE, provide gas distribution service to customers in Massachusetts and New Hampshire.

The Electric Services segment consists of subsidiaries that operate the electric transmission and distribution system owned by LIPA; own and provide capacity to and produce energy for LIPA from our generating facilities located on Long Island; and manage fuel supplies for LIPA to fuel our Long Island generating facilities. These services are provided in accordance with existing long-term service contracts having remaining terms that range from one to six years and power purchase agreements having remaining terms that range from six to 20 years. On February 1, 2006, KeySpan and LIPA agreed to extend, amend and restate these contractual arrangements. (See Note 11, "2006 LIPA Settlement" for a further discussion of these agreements.) The Electric Services segment also includes subsidiaries that own or lease and operate the 2,200 MW Ravenswood Facility located in Queens, New York, and the 250 MW combined-cycle Ravenswood Expansion. Collectively the Ravenswood Facility and Ravenswood Expansion are referred to as the "Ravenswood Generating Station". All of the energy, capacity and ancillary services related to the Ravenswood Generating Station are sold to the NYISO energy markets. To finance the purchase and/or construction of the Ravenswood Generating Station, KeySpan entered into leasing arrangement for each facility. The Electric Services segment also conducts retail marketing of electricity to commercial customers. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for further details on the leasing arrangements.)

The Energy Services segment includes companies that provide energy-related services to customers located primarily within the Northeastern United States. Subsidiaries in this segment provide residential and small commercial customers with service and maintenance of energy systems and appliances, as well as operation and maintenance, design, engineering, consulting and fiber optic services to commercial, institutional and industrial customers.

In 2005, KeySpan sold its mechanical contracting subsidiaries. The operating results and financial position of these companies have been reflected as discontinued operations on the Consolidated Statement of Income and Consolidated Statement of Cash Flows for 2005. In the fourth quarter of 2004, KeySpan's investment in its mechanical contracting subsidiaries was written-down to an estimated fair value. During 2004, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) associated with its mechanical contracting operations and certain remaining operations. In addition, an impairment charge of $100.3 million ($72.1 million after-tax or $0.45 per share) was also recorded to reduce the carrying value of the remaining assets of the mechanical contracting companies. (See Note 10 "Energy Services – Discontinued Operations" for additional details regarding these charges.) During the first six months of 2005, operating losses were incurred through the dates of sale of these companies of $4.1 million after-tax, including but not limited to costs incurred for employee related benefits. Partially offsetting these losses was a gain of $2.3 million associated with the related divestitures, reflecting the difference between the fair value estimates and the financial impact of the actual sale transactions. The net income impact of the operating losses and the disposal gain was a loss of $1.8 million, or $0.01 per share for the twelve months ended December 31, 2005.

The Energy Investments segment consists of our gas production and development investments, as well as certain other domestic energy-related investments. KeySpan's gas production and development activities include its wholly-owned subsidiaries Seneca Upshur Petroleum, Inc. ("Seneca-Upshur") and KeySpan Exploration and Production, LLC ("KeySpan Exploration"). Seneca-Upshur is engaged in gas production and development activities primarily in West Virginia. KeySpan Exploration is involved in a joint venture with Merit Energy Corporation, an independent oil and gas producer that purchased its interest in the Joint Venture from Houston Exploration.

This segment is also engaged in pipeline development activities. KeySpan and Spectra Energy Corporation (formerly part of Duke Energy Corporation) each own a 50% interest in the Islander East Pipeline Company, LLC ("Islander East"). Islander East was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Shoreham, Long Island. Once in service, the pipeline is expected to transport up to 260,000 DTH daily to the Long Island and New York City energy markets. Further,

KeySpan has a 26.25% interest in the Millennium Pipeline Company LLC, the developer of the Millennium pipeline project, which is expected to have the capacity to transport up to 525,000 DTH of natural gas a day from Corning, New York to Ramapo, New York, where it will connect to an existing pipeline. Additionally, subsidiaries in this segment hold a 20% equity interest in the Iroquois Gas Transmission System LP, a pipeline that transports Canadian gas supply to markets in the northeastern United States. These investments are accounted for under the equity method. Accordingly, equity income from these investments is reflected as a component of operating income in the Consolidated Statement of Income.

Through its wholly owned subsidiary, KeySpan LNG, KeySpan owns a 600,000 barrel liquefied natural gas storage and receiving facility in Providence, Rhode Island, the operations of which are fully consolidated.

In the first quarter of 2005, KeySpan sold its 50% interest in Premier Transmission Limited ("Premier"), a gas pipeline from southwest Scotland to Northern Ireland. On February 25, 2005, KeySpan entered into a Share Sale and Purchase Agreement with BG Energy Holdings Limited and Premier Transmission Financing Public Limited Company ("PTFPL"), pursuant to which all of the outstanding shares of Premier were to be purchased by PTFPL. On March 18, 2005, the sale was completed and generated cash proceeds of approximately $48.1 million. In the fourth quarter of 2004, KeySpan recorded a pre-tax non-cash impairment charge of $26.5 million reflecting the difference between the anticipated cash proceeds from the sale of Premier compared to its carrying value. The final sale of Premier resulted in a pre-tax gain of $4.1 million reflecting the difference from earlier estimates; this gain was recorded in the first quarter of 2005.

During the first five months of 2004, our gas exploration and production investments also included a 55% equity interest in The Houston Exploration Company ("Houston Exploration"), an independent natural gas and oil exploration company located in Houston, Texas, the operations of which were fully consolidated in KeySpan's Consolidated Financial Statements. On June 2, 2004, KeySpan exchanged 10.8 million shares of common stock of Houston Exploration for 100% of the stock of Seneca-Upshur, previously a wholly owned subsidiary of Houston Exploration. This transaction reduced our interest in Houston Exploration from 55% to 23.5%. Effective June 1, 2004, Houston Exploration's earnings and our ownership interest in Houston Exploration were accounted for on the equity method of accounting. This transaction resulted in a gain to KeySpan of $150.1 million and was reflected in other income and (deductions) on the Consolidated Statement of Income. The deconsolidation of Houston Exploration required the recognition of certain deferred taxes on our remaining investment resulting in a net deferred tax expense of $44.1 million. Therefore, the net gain on the share exchange less the deferred tax provision was $106 million, or $0.66 per share.

In November 2004, KeySpan sold its remaining 23.5% interest in Houston Exploration (6.6 million shares) and received cash proceeds of approximately $369 million. KeySpan recorded a pre-tax gain of $179.6 million which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was $116.8 million or $0.73 per share.

Houston Exploration's revenues, which are reflected in KeySpan's Consolidated Statement of Income in 2004 were $268.1 million. Houston Exploration's operating income, including KeySpan's share of equity earnings, was $138.5 million in 2004.

During the first quarter of 2004, we also had an approximate 61% investment in certain midstream natural gas assets in Western Canada through KeySpan Energy Canada Partnership ("KeySpan Canada"). These assets included 14 processing plants and associated gathering systems that produced approximately 1.5 BCFe of natural gas daily and provided associated natural gas liquids fractionation. These operations were fully consolidated in KeySpan's Consolidated Financial Statements. On April 1, 2004, KeySpan and KeySpan Facilities Income Fund (the "Fund"), which previously owned a 39.09% interest in KeySpan Canada, consummated a transaction whereby the Fund sold 15.617 million units of the Fund and acquired an additional 35.91% interest in KeySpan Canada from KeySpan. As a result of this transaction, KeySpan's ownership of KeySpan Canada decreased to 25%. KeySpan recorded a gain of $22.8 million ($10.1 million after-tax, or $0.06 per share) at the time of this transaction. This gain was reflected in other income and (deductions) on the Consolidated Statement of Income. Effective April 1, 2004 KeySpan Canada's earnings and our ownership interest in KeySpan Canada were accounted for on the equity method of accounting.

In July 2004, the Fund issued an additional 10.7 million units, the proceeds of which were used to fund the acquisition of the midstream assets of Chevron Canada Midstream Inc. This transaction had the effect of further diluting KeySpan's ownership of KeySpan Canada to 17.4%. KeySpan continued to account for its investment in KeySpan Canada on the equity basis of accounting since it still exercised significant influence over this entity.

In December 2004, KeySpan sold its remaining 17.4% interest in KeySpan Canada to the Fund and received net proceeds of approximately $119 million and recorded a pre-tax gain of approximately $35.8 million, which is reflected in other income and (deductions) on the Consolidated Statement of Income. The after-tax gain was approximately $24.7 million, or $0.15 per share.

KeySpan Canada's revenues, which are reflected in KeySpan's Consolidated Statement of Income in 2004 were $25.2 million. KeySpan Canada's operating income, including KeySpan's share of equity earnings, was $16.5 million in 2004.

The accounting policies of the segments are the same as those used for the preparation of the Consolidated Financial Statements. The segments are strategic business units that are managed separately because of their different operating and regulatory environments. Operating results of our segments are evaluated by management on an operating income basis. For fiscal year 2004, the operating data of Houston

Exploration has been separately displayed. The reportable segment information is as follows:

(In Millions of Dollars)

	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	ENERGY INVESTMENTS	ELIMINATIONS	CONSOLIDATED
YEAR ENDED DECEMBER 31, 2006						
Unaffiliated revenue	5,062.6	1,880.6	203.4	35.0	—	7,181.6
Intersegment revenue	—	—	9.6	5.3	(14.9)	—
Depreciation, depletion and amortization	266.7	102.2	8.3	7.3	13.0	397.5
Gain on sales of property	—	0.5	—	0.3	0.8	1.6
Income from equity investments	—	—	—	13.1	—	13.1
Operating income	568.6	293.0	5.3	15.5	(54.9)	827.5
Interest income	1.5	0.6	0.1	0.4	10.6	13.2
Interest charges	179.6	65.0	20.9	1.5	(10.9)	256.1
Total assets	10,536.6	2,471.8	192.3	351.3	885.5	14,437.5
Equity method investments	—	—	—	124.2	—	124.2
Construction expenditures	400.5	78.9	8.0	18.7	17.9	524.0

Eliminating items include intercompany interest income and expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.
Electric Services revenues from LIPA and the NYISO of $1.8 billion for the year ended December 31, 2006 represents approximately 26% of our consolidated revenues during that period.

(In Millions of Dollars)

	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	ENERGY INVESTMENTS	ELIMINATIONS	CONSOLIDATED
YEAR ENDED DECEMBER 31, 2005						
Unaffiliated revenue	5,390.1	2,042.7	191.2	38.0	—	7,662.0
Intersegment revenue	—	4.6	10.8	5.0	(20.4)	—
Depreciation, depletion and amortization	277.0	91.7	7.6	6.8	13.4	396.5
Gain on sales of property	0.1	1.2	—	0.1	0.2	1.6
Income from equity investments	—	—	—	15.1	—	15.1
Operating income	565.7	342.3	(2.7)	20.6	(18.1)	907.8
Interest income	0.9	0.8	0.2	2.8	7.6	12.3
Interest charges	178.2	71.7	18.4	1.8	(0.8)	269.3
Total assets	10,052.5	2,348.0	199.0	341.9	871.2	13,812.6
Equity method investments	—	—	—	106.7	—	106.7
Construction expenditures	410.3	88.8	8.4	22.6	9.4	539.5

Eliminating items include intercompany interest income and expense, the elimination of certain intercompany accounts, as well as activities of our corporate and administrative subsidiaries.
Electric Services revenues from LIPA and the NYISO of $2.0 billion for the year ended December 31, 2005 represents approximately 26% of our consolidated revenues during that period.

(In Millions of Dollars)

	GAS DISTRIBUTION	ELECTRIC SERVICES	ENERGY SERVICES	HOUSTON EXPLORATION	ENERGY INVESTMENTS	ELIMINATIONS	CONSOLIDATED
YEAR ENDED DECEMBER 31, 2004							
Unaffiliated revenue	4,407.3	1,738.7	182.4	268.1	54.0	—	6,650.5
Intersegment revenue	—	—	11.5	—	4.9	(16.4)	—
Depreciation, depletion and amortization	276.5	88.2	7.5	104.6	59.7	15.3	551.8
Gain on sales of property	—	2.0	—	—	5.0	—	7.0
Income from equity investments	—	—	—	20.7	25.8	—	46.5
Operating income	579.6	289.8	(48.3)	138.5	(33.8)	9.5	935.3
Interest income	2.2	9.9	—	3.5	3.0	(9.2)	9.4
Interest charges	176.8	72.9	19.4	3.5	3.9	54.8	331.3
Total assets	8,908.8	2,144.3	246.6	—	701.3	1,363.1	13,364.1
Equity method investments	—	—	—	—	107.1	—	107.1
Construction expenditures	414.5	150.3	13.7	146.5	13.7	11.6	750.3

Eliminating items include intercompany interest income and expense and the elimination of certain intercompany accounts as well as activities of our corporate and administrative subsidiaries.
Electric Services revenues from LIPA and the NYISO of $1.7 billion for the year ended December 31, 2004 represents approximately 25% of our consolidated revenues during that period.

Note 3. Income Tax

KeySpan files a consolidated federal income tax return. A tax sharing agreement between the KeySpan's holding company and its subsidiaries provides for the allocation of a realized tax liability or asset based upon separate return contributions of each subsidiary to the consolidated taxable income or loss in the consolidated income tax return. The subsidiaries record income tax payable or receivable from KeySpan resulting from the inclusion of their taxable income or loss in the consolidated return.

Income tax expense is reflected as follows in the Consolidated Statement of Income:

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Current Income Tax			
Federal	41.3	175.7	205.1
State and Local	16.6	30.9	(3.2)
Total Current Income Tax	$ 57.9	$206.6	$201.9
Deferred Income Tax			
Federal	93.8	17.1	118.3
State and Local	23.8	15.6	5.3
Total Deferred Income Tax	$117.6	$ 32.7	$123.6
Total Income Tax	$175.5	$239.3	$325.5

At December 31, the significant components of KeySpan's deferred tax assets and liabilities calculated under the provisions of SFAS No.109 "Accounting for Income Taxes" were as follows:

		(In Millions of Dollars)
DECEMBER 31,	**2006**	**2005**
Reserves not currently deductible	$46.1	$28.4
State income tax	(49.7)	(20.6)
Property related differences	(1,179.3)	(1,080.8)
Regulatory tax asset	(29.3)	(24.5)
Employees benefits and compensation	24.6	(30.3)
Property taxes	(82.7)	(84.1)
Other items – net	93.9	54.0
Net deferred tax liability	$(1,176.4)	$(1,157.9)

The federal income tax amounts included in the Consolidated Statement of Income differ from the amounts which result from applying the statutory federal income tax rate to income before income tax.

The table below sets forth the reasons for such differences:

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Computed at the statutory rate	$213.2	$223.3	$329.1
Adjustments related to:			
State income tax, net of Federal benefit	29.4	29.0	24.8
Tax credits	(1.3)	(1.4)	(2.2)
Removal costs	(2.1)	(2.9)	(0.6)
Accrual to return adjustments	(3.8)	6.7	(10.7)
Sale of subsidiary stock	—	—	(22.5)
Minority interest in Houston Exploration	—	—	12.9
Contribution of land	—	(3.8)	—
Dividends paid to employee benefit plan	(3.7)	(3.9)	(3.6)
Impact of IRS audit settlement	(44.5)	—	—
Impact of NYC audit settlement	(7.1)	—	—
Other items – net	(4.6)	(7.7)	(1.7)
Total Income Tax	$175.5	$239.3	$325.5
Effective income tax rate (1)	29%	38%	35%

(1) Reflects both federal as well as state income taxes.

KeySpan's consolidated effective income tax rate, including city and state income taxes, was 28.8% for the twelve months ended December 31, 2006 compared to 37.5% for the corresponding period in 2005. In 2006, KeySpan resolved its dispute with the New York City Department of Taxation and Finance with respect to income taxes relating to the operations of its merchant electric generating facility. As a result of the favorable settlement of this issue, KeySpan reversed a previously recorded tax reserve of $11.9 million ($7.1 million after federal income taxes). In addition, pursuant to indemnity obligations contained in the Long Island Lighting Company ("LILCO") / KeySpan merger agreement of May 1998, KeySpan had been working with the Internal Revenue Service ("IRS") to resolve certain disputes with regard to LILCO's tax returns for the tax years ended December 31, 1996 through March 31, 1999 and KeySpan's and The Brooklyn Union Gas Company's (d/b/a KEDNY) tax returns for the years ended September 30, 1997 through December 31, 1998. A settlement of the outstanding issues was reached in 2006 and, following IRS procedure, the settlement was submitted to the Joint Committee on Taxation on October 30, 2006 for final approval, which is expected in early 2007. Accordingly, KeySpan reversed $44.5 million of previously established tax reserves. Further, a $3.4 million benefit was recorded in 2006 reflecting an accrual for prior investment tax credits that KeySpan is entitled to. KeySpan has recently filed amended tax returns to reflect its entitlement to investment tax credits for the period 2000 through 2004. The decrease in the effective tax rate for the twelve months ended December 31, 2006 compared to the same period in 2005, was primarily due to the aforementioned items.

The IRS has also recently commenced the examination of KeySpan's tax returns for the years ended December 31, 2002 and 2003. At this time, we cannot predict the result of these audits.

The American Jobs Creation Act of 2004, signed into law on October 22, 2004, provides for a special one-time tax deduction, or dividend received deduction ("DRD") of 85% of qualifying foreign earnings that were repatriated in 2004 or 2005. We currently estimate that KeySpan has repatriated dividends of approximately $9.5 million of earnings under this provision and received, as a result, a tax benefit of $2.8 million.

As of December 31, 2006 KeySpan has $412 million of state net operating losses which will expire between 2011 and 2022.

Note 4. Postretirement Benefits

Pension Plans: The following information represents the consolidated results for our noncontributory defined benefit pension plans which cover substantially all employees. Benefits are based on years of service and compensation. Funding for pensions is in accordance with requirements of federal law and regulations. KEDLI and Boston Gas Company are subject to certain deferral accounting requirements mandated by the NYPSC and MADTE, respectively for pension costs and other postretirement benefit costs. Further, KeySpan's electric subsidiaries are subject to certain "true-up" provisions in accordance with the LIPA service agreements.

The calculation of net periodic pension cost is as follows:

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2006**	**2005**	**2004**
Service cost, benefits earned during the period	$ 62.7	$ 56.5	$ 52.9
Interest cost on projected benefit obligation	155.1	148.5	144.2
Expected return on plan assets	(186.0)	(173.1)	(158.2)
Net amortization and deferral	88.7	74.1	63.3
Special termination benefits	—	2.2	—
Total pension cost	$ 120.5	$ 108.2	$ 102.2

The following table sets forth the pension plans' funded status at December 31, 2006 and December 31, 2005.

		(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	**2006**	**2005**
Change in benefit obligation:		
Benefit obligation at beginning of period	$(2,715.0)	$(2,520.1)
Service cost	(62.7)	(56.6)
Interest cost	(155.0)	(148.5)
Amendments	(11.5)	(0.1)
Actuarial loss	28.3	(117.9)
Benefits paid	133.8	130.4
Special termination benefits	—	(2.2)
Benefit obligation at end of period	$(2,782.1)	$(2,715.0)
Change in plan assets:		
Fair value of plan assets at beginning of period	2,213.5	2,028.9
Actual return on plan assets	299.6	166.7
Employer contribution	94.9	148.3
Benefits paid	(133.8)	(130.4)
Fair value of plan assets at end of period	2,474.2	2,213.5
Funded status	(307.9)	(501.5)

Amounts recognized in the statement of financial position consist of:	
Noncurrent assets	$ —
Current liabilities	(6.3)
Noncurrent liabilities	(301.6)
Total	$ (307.9)

Amounts recognized in accumulated other comprehensive income consist of:	
Net gain/(loss)	$ (451.8)
Prior service cost	(49.4)
Total	$ (501.2)*

Estimated amounts of accumulated other comprehensive income to be recognized in the next fiscal year through net periodic pension cost:	
Net gain/(loss)	$ (53.3)
Prior service cost	(10.3)
Total	$ (63.6)*

**The above amounts are before adjustments for regulatory and contractual deferrals and deferred taxes*

The table below details the end-of-year assumptions used for both the net periodic cost calculations and liability amounts.

YEAR END DECEMBER 31,	**2006**	**2005**	**2004**	**2003**
Assumptions:				
Obligation discount	6.00%	5.75%	6.00%	6.25%
Asset return, net of tax	8.50%	8.50%	8.50%	8.50%
Average annual increase in compensation	4.00%	4.00%	4.00%	4.00%

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years indicated:

	(In Millions of Dollars) PENSION BENEFITS
2007	$138.3
2008	$141.8
2009	$145.5
2010	$150.4
2011	$156.0
Years 2012- 2016	$906.4

Under Funded Pension Obligation: SFAS 158 "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans" requires full balance sheet recognition of the net overfunded or underfunded status of each pension and other postretirement plan. The funded status of pension plans is to be measured as the difference between the fair value of plan assets minus the projected benefit obligation. At December 31, 2006, KeySpan's projected benefit obligation was in excess of pension assets by $307.9 million. Amounts that are not recognized in net periodic benefit costs will be recorded through accumulated other comprehensive income. At December 31, 2006, the amount recognized in accumulated other comprehensive income was $134.7 million, net of tax and regulatory and contractual deferrals.

The following table reconciles the 2005 Consolidated Balance Sheet with the impact of SFAS 158:

	(In Millions of Dollars) PENSION	
	LIABILITY	AOCI
Prepaid Asset December 31, 2005	$ 218.9	$ —
Additional minimum liability	(257.4)	(63.5)
Balance at December 31, 2005	(38.5)	(63.5)
2006 activity	(25.6)	—
Reduction to additional minimum liability	137.0	137.0
Incremental SFAS 158 liability	(380.8)	(380.8)
Intangible asset reversal	—	(41.1)
Incremental deferrals and deferred taxes	—	213.7
Balance at December 31, 2006	$(307.9)	$(134.7)

At December 31, 2006 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in excess of plan assets were $1.4 billion, $1.3 billion and $1.2 billion, respectively.

At December 31, 2005 the accumulated benefit obligation was in excess of pension assets. As prescribed by SFAS 87 "Employers' Accounting for Pensions," KeySpan had a $257.4 million minimum liability at December 31, 2005, for this unfunded pension obligation. As permitted under accounting guidelines then applicable, these accruals were offset by a corresponding debit to a long-term asset up to the amount of accumulated unrecognized prior service costs. Any remaining amount was to be recorded in accumulated other comprehensive income on the Consolidated Balance Sheet.

Therefore, at December 31, 2005, we had a long-term asset in deferred charges other of $41.1 million, representing the amount of unrecognized prior service cost and a debit to accumulated other comprehensive income of $97.8 million, or $63.6 million after-tax. The remaining amount of $118.3 million was recorded as a contractual receivable from LIPA of $103.8 million and a regulatory asset of $14.5 million, representing the amounts that could be recovered from LIPA and the Boston Gas ratepayer in accordance with our service and rate agreements.

At December 31, 2005 the projected benefit obligation, accumulated benefit obligation and value of assets for plans with accumulated benefit obligations in excess of plan assets were $1.4 billion, $1.3 billion and $997 million, respectively.

Other Postretirement Benefits: The following information represents the consolidated results for our non-contributory defined benefit plans covering certain health care and life insurance benefits for retired employees. We have 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.

Net periodic other postretirement benefit cost included the following components:

			(In Millions of Dollars)
YEAR ENDED DECEMBER 31,	2006	2005	2004
Service cost, benefits earned during the period	$ 24.9	$ 24.4	$ 19.7
Interest cost on accumulated postretirement benefit obligation	74.9	75.7	70.2
Expected return on plan assets	(36.6)	(36.1)	(33.9)
Net amortization and deferral	57.3	59.9	41.0
Special termination benefits	—	1.7	—
Other postretirement cost	$ 120.5	$ 125.6	$ 97.0

The following table sets forth the plans' funded status at December 31, 2006 and December 31, 2005.

YEAR ENDED DECEMBER 31,	2006	2005
	(In Millions of Dollars)	
Change in benefit obligation:		
Benefit obligation at beginning of period	$(1,414.3)	$(1,336.7)
Actual Medicare Part D subsidy received	(0.9)	—
Expected less actual Medicare Part D subsidy received in 2006	(2.7)	—
Service cost	(24.9)	(24.4)
Interest cost	(74.9)	(75.7)
Plan participants' contributions	(3.5)	(3.4)
Amendments	—	3.2
Actuarial gain (loss)	132.4	(38.3)
Benefits paid	65.8	62.7
Special termination benefit	—	(1.7)
Benefit obligation at end of period	(1,323.0)	(1,414.3)
Change in plan assets:		
Fair value of plan assets at beginning of period	469.6	464.0
Actual return on plan assets	56.8	29.1
Employer contribution	36.3	35.8
Plan participants' contributions	3.5	3.4
Benefits paid	(65.8)	(62.7)
Fair value of plan assets at end of period	500.4	469.6
Funded status	(822.6)	(944.7)

Amounts recognized in the statement of financial position consist of:	
Noncurrent assets	$ 13.6
Current liabilities	(6.6)
Noncurrent liabilities	(829.6)
Total	$ (822.6)

Amounts recognized in accumulated other comprehensive income consist of:	
Net gain/(loss)	$ (337.9)
Prior service cost	85.1
Total	$ (252.8)*

Estimated amounts of accumulated other comprehensive income to be recognized in the next fiscal year through net periodic pension cost:	
Net gain/(loss)	$ (61.4)
Prior service cost	12.3
Total	$ (49.1)*

The above amounts are before adjustments for regulatory and contractual deferrals and deferred taxes

The table below details the end-of-year assumptions used for both the net periodic cost calculations and liability amounts.

YEAR END DECEMBER 31,	2006	2005	2004	2003
Assumptions:				
Obligation discount	6.00%	5.75%	6.00%	6.25%
Asset return, net of tax	8.25%	8.25%	8.25%	8.00%
Average annual increase in compensation	4.00%	4.00%	4.00%	4.00%

The measurement of plan liabilities assumes a health care cost trend rate of 9.0% grading down to 4.75% in the year 2012. A 1% increase in the health care cost trend rate would have the effect of increasing the accumulated postretirement benefit obligation as of December 31, 2006 by $157.3 million and the net periodic health care expense by $14.5 million. A 1% decrease in the health care cost trend rate would have the effect of decreasing the accumulated postretirement benefit obligation as of December 31, 2006 by $137.4 million and the net periodic health care expense by $12.3 million.

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid in the years indicated:

	GROSS BENEFIT PAYMENTS	SUBSIDIARY RECEIPTS EXPECTED**
		(In Millions of Dollars)
2007	$68.0	$3.9
2008	$72.4	$4.3
2009	$77.1	$4.6
2010	$81.6	$4.9
2011	$85.6	$5.2
Years 2012 – 2016	$472.4	$29.7

***Rebates are based on calendar year in which prescription drug costs are incurred. Actual receipt of rebates may occur in the following year.*

Under Funded Other Postretirement Obligation: As noted previously, SFAS 158 requires full balance sheet recognition of the net overfunded or underfunded status of each pension and other postretirement plan. The funded status of other postretirement plans is to be measured as the difference between the fair value of plan assets minus the accumulated benefit obligation. At December 31, 2006, KeySpan's accumulated benefit obligation was in excess of other postretirement assets by $822.6 million. Amounts that are not recognized in net periodic benefit costs will be recorded through accumulated other comprehensive income. At December 31, 2006, the amount recognized in accumulated other comprehensive income was $39.0 million, net of tax and regulatory and contractual deferrals.

The following table reconciles the 2005 Consolidated Balance Sheet with the impact of FAS 158:

	(In Millions of Dollars)	
	OPEB	
	LIABILITY	AOCI
Accrual at December 31, 2005	$(484.7)	$ —
2006 Activity	(85.1)	—
Incremental SFAS 158 liability	(252.8)	(252.8)
Incremental deferrals and deferred taxes	—	213.8
Balance at December 31, 2006	$(822.6)	$ (39.0)

At December 31, 2006, KeySpan had a contractual receivable from LIPA of $583.7 million representing pension and other postretirement benefits associated with the electric business unit employees recorded in deferred charges other on the Consolidated Balance Sheet. LIPA has been reimbursing us for costs related to the postretirement benefits of the electric business unit employees in accordance with the LIPA Agreements.

Pension/Other Postretirement Benefit Plan Assets: KeySpan's weighted average asset allocations at December 31, 2006 and 2005, by asset category, for both the pension and other postretirement benefit plans are as follows:

	PENSION		OPEB	
ASSET CATEGORY	2006	2005	2006	2005
Equity securities	67%	65%	69%	70%
Debt securities	26%	27%	24%	23%
Cash and equivalents	1%	3%	2%	2%
Venture capital	6%	5%	5%	5%
Total	100%	100%	100%	100%

The long-term rate of return on assets (pre-tax) is assumed to be 8.5%, net of expenses which management believes is an appropriate long-term expected rate of return on assets based on our investment strategy, asset allocation mix and the historical performance of equity and fixed income investments over long periods of time. The actual ten- year compound rate of return, net of expenses, for our Plans is greater than 8.5%.

Our master trust investment allocation policy target for the assets of the pension and other postretirement benefit plans is 70% equity and 30% fixed income.

KeySpan has developed a multi-year funding strategy for its plans. We believe that it is reasonable to assume assets can achieve or outperform the assumed long-term rate of return with the target allocation as a result of historical performance of equity investments over long-term periods.

Cash Contributions: In 2007, KeySpan is expected to contribute approximately $95 million to its pension plan and approximately $36 million to its other postretirement benefit plan.

Defined Contribution Plan: KeySpan also offers both its union and management employees a defined contribution plan. Both the KeySpan Energy 401(k) Plan for Management Employees and the KeySpan Energy 401(k) Plan for Union Employees are available to all eligible employees. These Plans are defined contribution plans subject to Title I of the Employee Retirement Income Security Act of 1974 ("ERISA"). Eligible employees contributing to the Plan may receive certain employer contributions including matching contributions and a 10% discount on the purchase of KeySpan common stock in the Plan. The matching contributions were in KeySpan's common stock until January 2006. The matching contributions are now determined at election of KeySpan employees. For the years ended December 31, 2006, 2005 and 2004, we recorded an expense of $14.7 million, $15.2 million, and $14.7 million, respectively.

Required disclosures on the Impact of the Adoption of SFAS No.158 on the Balance Sheet: SFAS 158 requires that in the transition year KeySpan must first calculate the minimum pension liability as of the end of the year the statute is implemented and disclose the change that would have been reflected in OCI for that year. The difference between the recorded amounts in OCI and the amounts reflected in the implementation of SFAS 158 constitute the transition adjustment amount. The following table reflects the effect of the transition.

			(In Millions of Dollars)
	DECEMBER 31, 2006 BEFORE SFAS 158	SFAS 158 TRANSITION	DECEMBER 31, 2006
Regulatory assets	$ 710.9	$ 226.6	$ 937.5
Other deferred charges	$ 695.2	$ 179.9	$ 875.1
Deferred income taxes	$1,309.0	$(132.6)	$1,176.4
Postretirement benefits and other reserves	$1,033.0	$ 634.3	$1,667.3
Accumulated other comprehensive loss	$ (27.3)	$(148.0)	$ (175.3)
Total common equity	$4,666.8	$(148.0)	$4,518.8

Note 5. Capital Stock

Common Stock: Currently KeySpan has 450,000,000 shares of authorized common stock. At December 31, 2006, KeySpan had 9.5 million shares, or $273.6 million of treasury stock outstanding. During 2006, KeySpan issued approximately 1.0 million shares out of treasury for the dividend reinvestment feature of our Investor Program, the Employee Discount Stock Purchase Plan, the 401(k) Plan and the Long-Term Incentive Compensation Plan.

On May 16, 2005, KeySpan issued 12.1 million shares of common stock, in association with the MEDS Equity Units conversion, at an issuance price of $37.93 per share pursuant to the terms of the forward purchase contract. KeySpan received proceeds of approximately $460 million from the equity conversion. The number of shares issued was dependent on the average closing price of our common stock over

the 20 day trading period ending on the third trading day prior to May 16, 2005. (See Note 6 "Long-Term Debt and Commercial Paper" for further details on the MEDS Equity Units.)

Preferred Stock: We have the authority to issue 100,000,000 shares of preferred stock with the following classifications: 16,000,000 shares of preferred stock, par value $25 per share; 1,000,000 shares of preferred stock, par value $100 per share; and 83,000,000 shares of preferred stock, par value $.01 per share. There was no outstanding preferred stock at December 31, 2006 and 2005.

Note 6. Long-Term Debt And Commercial Paper

Notes Payable: During 2006, KeySpan issued at KEDNY and KEDLI, respectively, $400 million and $100 million of Senior Unsecured Notes at 5.60% due November 29, 2016. Additionally, KEDLI has $125 million of Medium-Term Notes at 6.90% due January 15, 2008, and $400 million of 7.875% Medium-Term Notes due February 1, 2010, outstanding at December 31, 2006 each of which is guaranteed by KeySpan.

KeySpan also has $1.9 billion of medium and long term notes outstanding at December 31, 2005 of which $950 million of these notes were associated with the acquisition of Eastern and ENI. These notes were issued in two series as follows: $700 million of 7.625% Notes due 2010 and $250 million of 8.00% Notes due 2030. In addition, KeySpan has $467.2 million of notes outstanding pursuant to the MEDS Equity Units conversion in 2005. The MEDS Equity Units consisted of a three-year forward purchase contract for our common stock and a six-year note. The purchase contract required us, three years from the date of issuance of the MEDS Equity Units, May 16, 2005, to issue and the investors to purchase, a number of shares of our common stock based on a formula tied to the market price of our common stock at that time. The 8.75% coupon was composed of interest payments on the six-year note of 4.9% and premium payments on the three-year equity forward contract of 3.85%.

In 2005, KeySpan was required to remarket the note component of the Equity Units and reset the interest rate to the then current market rate of interest; however, the reset interest rate could not be set below 4.9%. In March 2005, KeySpan remarketed the note component of $394.9 million of the Equity Units at the reset interest rate of 4.9% through their maturity date of May 2008. The balance of the notes ($65.1 million) were held by the original MEDS equity holders in accordance with their terms and not remarketed. KeySpan then exchanged $300 million of the remarketed notes for $307.2 million of new 30 year notes bearing an interest rate of 5.8%. Therefore, KeySpan now has $160 million of 4.9% notes outstanding with a maturity date of May 2008 and $307.2 million of 5.8% notes outstanding with a maturity date of April 2035 that are classified as medium and long term notes.

On May 16, 2005 KeySpan issued 12.1 million shares of common stock, at an issuance price of $37.93 per share, pursuant to the terms of the financial purchase contract described above. KeySpan received proceeds of approximately $460 million from the equity conversion. The number of shares issued was dependent on the average closing price of our common stock over the 20 day trading period ending on the third trading day prior to May 16, 2005.

The remaining debt of $483.2 million had interest rates ranging from 4.65% to 9.75%.

Gas Facilities Revenue Bonds: KEDNY can issue tax-exempt bonds through the New York State Energy Research and Development Authority ("NYSERDA"). Whenever bonds are issued for new gas facilities projects, proceeds are deposited in trust and subsequently withdrawn to finance qualified expenditures. There are no sinking fund requirements on any of our Gas Facilities Revenue Bonds ("GFRBs"). At December 31, 2006, $640.5 million of GFRBs were outstanding. The interest rate on the variable rate series due through July 1, 2026 is reset weekly and ranged from 2.55% to 3.65% during the year ended December 31, 2006, at which time the rate was 3.65%.

Promissory Notes to LIPA: In connection with the KeySpan/LILCO transaction, KeySpan and certain of its subsidiaries issued promissory notes to LIPA to support certain debt obligations assumed by LIPA. At December 31, 2006, $155.4 million of these promissory notes remained outstanding. Under these promissory notes, KeySpan is required to obtain letters of credit to secure its payment obligations if its long-term debt is not rated at least in the "A" range by at least two nationally recognized statistical rating agencies. At December 31, 2006, KeySpan was in compliance with this requirement.

Industrial Development Revenue Bonds: At December 31, 2006, KeySpan had outstanding $128.3 million of tax-exempt bonds with a 5.25% coupon maturing in June 2027. Fifty-three million dollars of these Industrial Development Revenue Bonds were issued in its behalf through the Nassau County Industrial Development Authority for the construction of the Glenwood Energy Center, an electric-generation peaking plant, and the balance of $75 million was issued in its behalf by the Suffolk County Industrial Development Authority for the Port Jefferson Energy Center an electric-generation peaking plant. KeySpan has guaranteed all payment obligations of these subsidiaries with regard to these bonds.

First Mortgage Bonds: Colonial Gas Company had outstanding $95.0 million of first mortgage bonds at December 31, 2006. These bonds are secured by gas utility property. The first mortgage bond indentures include, among other provisions, limitations on: (i) the issuance of long-term debt; (ii) engaging in additional lease obligations; and (iii) the payment of dividends from retained earnings. At December 31, 2006, these bonds remain outstanding and have interest rates ranging from 6.34% to 8.80% and maturities that range from 2008 – 2028.

Authority Financing Notes: Certain of our electric generation subsidiaries can issue tax-exempt bonds through the NYSERDA. At December 31, 2006, $41.1 million of Authority Financing Notes 1999 Series A Pollution Control Revenue Bonds due October 1, 2028 were outstanding. The interest rate on these notes is reset based on an auction procedure. The interest rate during 2006 ranged from 2.70% to 3.65%, through December 31, 2006, at which time the rate was 3.65%.

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 ranged from 2.98% to 4.00% for the year ended December 31, 2006, at which time the rate was 3.95%.

Ravenswood Master Lease: We have an arrangement with an unaffiliated variable interest financing entity through which we lease a portion of the Ravenswood Facility. We acquired the Ravenswood Facility, in part, through the variable interest entity, from the Consolidated Edison Company of New York ("Consolidated Edison") on June 18, 1999 for approximately $597 million. In order to reduce the initial cash requirements, we entered into a lease agreement (the "Master Lease") with the variable interest entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to a KeySpan subsidiary. The variable interest financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity. KeySpan has guaranteed all payment and performance obligations of our subsidiary under the Master Lease. Monthly lease payments are substantially equal to the monthly interest expense on the debt securities.

We have classified the Master Lease as $412.3 million of long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary as defined in Financial Accounting Standards Board Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51." Further, we have an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date, or approximately $307.7 million. Under the terms of our credit facilities, the Master Lease is considered debt in the ratio of debt-to-total capitalization. (See Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding the leasing arrangement associated with the Master Lease Agreement.)

Commercial Paper and Revolving Credit Agreements: KeySpan has two credit facilities, which total $1.5 billion – $920 million for five years through 2010, and $580 million through 2009 – which will continue to support KeySpan's commercial paper program for ongoing working capital needs.

The fees for the facilities are based on KeySpan's current credit ratings and are increased or decreased based on a downgrading or upgrading of our ratings. The current annual facility fee is 0.07% based on our credit rating of A3 by Moody's Investor Services and A by Standard & Poor's for each facility. Both credit facilities allow for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin that is tied to our applicable credit ratings. ABR loans are based on the higher of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%. Competitive bid loans are based on bid results requested by KeySpan from the lenders. We do not anticipate borrowing against these facilities; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The facilities contain certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its utility property to any lien, as well as certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 65% at the last day of any fiscal quarter. Violation of these covenants could result in the termination of the facilities and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements. At December 31, 2006, KeySpan's consolidated indebtedness was 49.9% of its consolidated capitalization and KeySpan was in compliance with all covenants.

Subject to certain conditions set forth in the credit facility, KeySpan has the right, at any time, to increase the commitments under the $920 million facility up to an additional $300 million. In addition, KeySpan has the right to request that the termination date be extended for an additional period of 365 days prior to each anniversary of the closing date. This extension option, however, requires the approval of lenders holding more than 50% of the total commitments to such extension request. Under the agreements, KeySpan has the ability to replace non-consenting lenders with other pre-approved banks or financial institutions.

At December 31, 2006, we had cash and temporary cash investments of $210.9 million. During 2006, we repaid $572.6 million of commercial paper and, at December 31, 2006, $85.0 million of commercial paper was outstanding at a weighted average annualized interest rate of 5.43%. At December 31, 2006, KeySpan had the ability to issue up to an additional $1.4 billion, under its commercial paper program.

Capital Leases: Our subsidiaries lease certain facilities and equipment under long-term leases, which expire on various dates through 2014. The weighted average interest rate on these obligations was 6.0%.

Debt Maturity: The following table reflects the maturity schedule for our debt repayment requirements, including capitalized leases and related maturities, at December 31, 2006:

			(In Millions of Dollars)
	LONG-TERM DEBT	CAPITAL LEASES	TOTAL
Repayments:			
2007	$ —	$1.2	$ 1.2
2008	305.0	1.1	306.1
2009	412.3	1.2	413.5
2010	1,110.0	1.3	1,111.3
2011	20.0	1.3	21.3
Thereafter	2,575.6	3.7	2,579.3
	$4,422.9	$9.8	$4,432.7

Note 7. Contractual Obligations, Financial Guarantees and Contingencies

Lease Obligations: Lease costs included in operating expense were $76.2 million in 2006 including the lease of KeySpan's Brooklyn headquarters of $10.7 million. KeySpan has a leveraged lease financing arrangement associated with the Ravenswood Expansion. The yearly operating lease expense is approximately $17 million per year. (See the caption below "Sale/Leaseback Transaction" for further details of this lease.) Lease costs also include leases for other buildings, office equipment, vehicles and power operated equipment. Lease costs for the year ended December 31, 2005 and 2004 were $76.5 million and $67.7 million, respectively. As previously mentioned, the Master Lease is consolidated and, as a result, lease payments are reflected as interest expense on the Consolidated Statement of Income. The future minimum cash lease payments under various leases, excluding the Master Lease, but including the Ravenswood Expansion lease, all of which are operating leases, are $103.8 million per year over the next five years and $580.1 million, in the aggregate, for all years thereafter. (See discussion below for further information regarding the Master Lease and the Ravenswood Expansion sale/leaseback transaction.)

Variable Interest Entity: As mentioned, KeySpan has an arrangement with a variable interest entity through which it leases a portion of the Ravenswood Facility. We acquired the Ravenswood Facility, a 2,200-megawatt electric generating facility located in Queens, New York, in part, through the variable interest entity from Consolidated Edison on June 18, 1999, for approximately $597 million. In order to reduce the initial cash requirements, we entered into the Master Lease with a variable interest, unaffiliated financing entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to our subsidiary, KeySpan Ravenswood, LLC. The variable interest unaffiliated financing entity acquired the property for $425 million, financed with debt of $412.3 million (97% of capitalization) and equity of $12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity. KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, under the Master Lease. Monthly lease payments substantially equal the monthly interest expense on such debt securities. Interest expense for the year ended December 31, 2006 was $30.0 million.

The term of the Master Lease extends through June 20, 2009. On all future semi-annual payment dates, we have the right to: (i) either purchase the facility for the original acquisition cost of $425 million, plus the present value of the lease payments that would otherwise have been paid through June 2009; or (ii) terminate the Master Lease and dispose of the facility. In June 2009, when the Master Lease terminates, we may purchase the facility in an amount equal to the original acquisition cost, subject to adjustment, or surrender the facility to the lessor. If we elect not to purchase the property, the Ravenswood Facility will be sold by the lessor. We have guaranteed to the lessor, as residual value, 84% of the acquisition cost of the property.

We have classified the Master Lease as $412.3 million of long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary. Further, we have an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date, or approximately $307.7 million. If KeySpan Ravenswood, LLC, was not able to fulfill its payment obligations with respect to the Master Lease payments, then the maximum amount KeySpan would be exposed to under its current guarantees would be $425 million plus the present value of the remaining lease payments through June 20, 2009.

Sale/leaseback Transaction: KeySpan also has a leveraged lease financing arrangement associated with the Ravenswood Expansion. In May 2004, the unit was acquired by a lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to that subsidiary. All the obligations of KeySpan Ravenswood, LLC have been unconditionally guaranteed by KeySpan. This lease transaction generated cash proceeds of $385 million, before transaction costs, which approximates the fair market value of the facility, as determined by a third-party appraiser. This lease transaction qualifies as an operating lease under SFAS 98 "Accounting for Leases: Sale/Leaseback Transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; an Initial Direct Costs of Direct Financing Leases, an amendment of FASB Statements No.13, 66, 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11." The lease has an initial term of 36 years and the yearly operating lease expense is approximately $17 million per year. Lease payments will fluctuate from year to year, but are substantially paid over the first 16 years. The future minimum cash lease payments under this lease is approximately $171 million over the next five years and $378 million, in the aggregate, for all years thereafter. The sale/leaseback transaction resulted in a pre-tax gain of approximately $6 million which has been deferred and is being amortized over the life of the lease.

Asset Retirement Obligations: On December 31, 2005, KeySpan 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 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.

The following table presents our asset retirement obligation at December 31, 2006 and December 31, 2005:

		(In Millions of Dollars)	
DECEMBER 31,		**2006**	**2005**
Asset Retirement Obligations			
Asbestos removal	(i)	$ 3.5	$ 3.5
Tanks removal and cleaning	(ii)	7.3	6.9
Main – cutting, purging and capping	(iii)	29.7	30.6
Wells – plug and capping	(iv)	0.2	0.2
KeySpan LNG tank demolition	(v)	2.3	2.1
Waste water treatment pond removal	(vi)	1.5	1.4
Fiber network removal	(vii)	0.9	0.8
Exploration wells – plug and capping	(viii)	1.9	1.9
Total Asset Retirement Obligations		$47.3	$47.4

(i) Asbestos-containing materials 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 has a legal obligation to remove asbestos upon either a major renovation or demolition.

(ii) KeySpan has numerous storage tanks that contain among other things waste oil, #2 and #6 grade 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 has a legal requirement to cut (disconnect from the gas distribution system), purge (clean of natural gas and PCB contaminants) and cap gas mains within its gas distribution and transmission system when mains are retired in place. Gas mains are generally abandoned in place when retired, unless the main and other equipment needs to be removed due to sewer or water system rerouting or other roadblock work. When such a main and equipment are removed certain PCB test procedures must be employed.

(iv) KeySpan owns approximately 52% of an underground gas storage facility in western New York State. The facility includes 39 gas injection and extraction wells. There is a regulatory obligation to close and seal the wells.

(v) KeySpan owns a 600,000 gallon Liquefied Natural Gas ("LNG") tank and ancillary facilities located in Providence, RI under a 30 year contract with New England Gas Company entered into on November 1, 1999. At the end of the contract, the contract can be; (i) Extended; or (ii) New England Gas Company can require KeySpan to dismantle and remove the LNG tank and ancillary facilities or; (iii) KeySpan can elect to dismantle and remove the LNG tank and ancillary facilities. Since we may or may not be required to dismantle and remove the LNG tank and ancillary facilities, the obligation to perform was discounted to a 50% probability as premitted under FIN 47.

(vi) KeySpan 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.

(vii) KeySpan Communications has portions of its fiber optic network (underground and above ground) that are required to be removed upon termination of various agreements.

(viii) KeySpan has a regulatory obligation to close and seal the wells primarily associated with its gas production and development activities.

Financial Guarantees: KeySpan has issued financial guarantees in the normal course of business, primarily on behalf of its subsidiaries, to various third party creditors. At December 31, 2006, the following amounts would have to be paid by KeySpan in the event of non-payment by the primary obligor at the time payment is due:

		(In Millions of Dollars)	
		AMOUNT OF EXPOSURE	**EXPIRATION DATES**
Guarantees for Subsidiaries			
Medium-Term Notes – KEDLI	(i)	$ 525.0	2008 – 2010
Industrial Development Revenue Bonds	(ii)	128.3	2027
Ravenswood – Master Lease	(iii)	425.0	2009
Ravenswood – Sale/leaseback	(iv)	403.5	2019
Surety Bonds	(v)	65.2	2006 – 2010
Commodity Guarantees and Other	(vi)	64.6	2006 – 2009
Letters of Credit	(vii)	80.3	2007 – 2010
		$1,691.9	

The following is a description of KeySpan's outstanding subsidiary guarantees:

(i) KeySpan has fully and unconditionally guaranteed $525 million to holders of Medium-Term Notes issued by KEDLI. These notes are due to be repaid on January 15, 2008 and February 1, 2010. KEDLI is required to comply with certain financial covenants under the debt agreements. The face value of these notes is included in long-term debt on the Consolidated Balance Sheet.

(ii) KeySpan has fully and unconditionally guaranteed the payment obligations of its subsidiaries with regard to $128 million of Industrial Development Revenue Bonds issued through the Nassau County and Suffolk County Industrial Development Authorities for the construction of two electric-generation peaking plants on Long Island. The face value of these notes is included in long-term debt on the Consolidated Balance Sheet.

(iii) KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, the lessee under the Master Lease. The term extends through June 20, 2009. The Master Lease is classified as $412.3 million long-term debt on the Consolidated Balance Sheet.

(iv) KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, the lessee under the sale/leaseback transaction associated with the 250 MW Ravenswood Expansion, including future decommissioning costs. The initial term of the lease is for 36 years. As noted previously, this lease qualifies as an operating lease and is not reflected on the Consolidated Balance Sheet.

(v) KeySpan has agreed to indemnify the issuers of various surety and performance bonds associated with certain construction projects being performed by certain former subsidiaries. In the event that the subsidiaries fail to perform their obligations under contracts, the injured party may demand that the surety make payments or provide services under the bond. KeySpan would then be obligated to reimburse the surety for any expenses or cash outlays it incurs. Although KeySpan is not guaranteeing any new bonds for any of the former subsidiaries, KeySpan's indemnity obligation supports the contractual obligation of these former subsidiaries. KeySpan has also received from a former subsidiary an indemnity bond issued by a third party insurance company, the purpose of which is to reimburse KeySpan in an amount up to $80 million in the event it is required to perform under all other indemnity obligations previously incurred by KeySpan to support such company's bonded projects existing prior to divestiture. At December 31, 2006, the total cost to complete such remaining bonded projects is estimated to be approximately $28.5 million.

(vi) KeySpan has guaranteed commodity-related payments for subsidiaries within the Electric Services segment. These guarantees are provided to third parties to facilitate physical and financial transactions involved in the purchase of natural gas, oil and other petroleum products for electric production and marketing activities. The guarantees cover actual purchases by these subsidiaries that are still outstanding as of December 31, 2006.

(vii) KeySpan has arranged for stand-by letters of credit to be issued to third parties that have extended credit to certain subsidiaries. Certain vendors require us to post letters of credit to guarantee subsidiary performance under our contracts and to ensure payment to our subsidiary subcontractors and vendors under those contracts. Certain of our vendors also require letters of credit to ensure reimbursement for amounts they are disbursing on behalf of our subsidiaries, such as to beneficiaries under our self-funded insurance programs. Such letters of credit are generally issued by a bank or similar financial institution. The letters of credit commit the issuer to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, KeySpan would be required to reimburse the issuer of the letter of credit.

To date, KeySpan has not had a claim made against it for any of the above guarantees and we have no reason to believe that our subsidiaries or former subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact any such defaults may have on our consolidated results of operations, financial condition or cash flows.

Fixed Charges Under Firm Contracts: Our utility subsidiaries and the Ravenswood Generating Station have entered into various contracts for gas delivery, storage and supply services. Certain of these contracts require payment of annual demand charges in the aggregate amount of approximately $449 million. We are liable for these payments regardless of the level of service we require from third parties. Such charges associated with gas distribution operations are currently recovered from utility customers through the gas adjustment clause.

Legal Matters

From time to time we are subject to various legal proceedings arising out of the ordinary course of our business. Except as described below, 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, financial condition or cash flows.

On March 20, 2006, a purported class action lawsuit was filed alleging breach of fiduciary duty against KeySpan and its directors. The complaint, which was filed in the New York State Supreme Court for the County of Kings (the "Court"), related to the execution of the Merger Agreement with National Grid plc and alleged that the merger consideration which KeySpan's stockholders would receive in connection with the proposed merger transaction was inadequate and unfair because the transaction value of $42.00 for each share of KeySpan's common stock outstanding did not provide its stockholders with a meaningful premium over the market price of the common stock. On April 19, 2006, we moved to dismiss the complaint for failure to state a cause of action upon which relief could be granted. On May 26, 2006, the plaintiff served an amended complaint adding National Grid plc as a defendant. The amended complaint alleged that National Grid plc aided and abetted the alleged breach of fiduciary duties and added claims of inadequate disclosure with respect to KeySpan's preliminary proxy materials. In June 2006,

the parties agreed in principle to settle the case, the terms of which provide for, among other things, the inclusion of additional disclosures in our 2006 Annual Meeting Proxy Statement concerning the background and principle events leading to execution of the Merger Agreement, as well as the payment of plaintiff's counsel fees of up to $350,000 following closing of the transaction. In October 2006, definitive settlement documents were executed by the parties and submitted to the Court. The settlement remains subject to a number of conditions, including Court approval following notice to shareholders.

Several lawsuits have been filed which allege damages resulting from contamination associated with the historic operations of former manufactured gas plants located in Bay Shore and Staten Island, New York. KeySpan has been conducting site investigations and remediations at these locations pursuant to Orders on Consent with the DEC. With respect to Bay Shore, on July 12, 2006, a purported class action and a separate complaint were filed. Motions to dismiss these matters have been filed and are pending. On November 27, 2006 and December 28, 2006, two other lawsuits were filed by property owners in the Bay Shore area. In addition, on October 31, 2006, a lawsuit was filed alleging damages in Staten Island, New York. KeySpan intends to contest each of these proceedings vigorously. On February 8, 2007, we received a Notice of Intent to File Suit from the Office of the Attorney General for the State of New York ("AG") against KeySpan and four other companies in connection with the cleanup of historical contamination found in certain lands located in Greenpoint, Brooklyn and in an adjoining waterway. KeySpan has previously agreed to remediate portions of the properties referenced in this notice and will work cooperatively with the DEC and AG to address environmental conditions associated with the remainder of the properties. At this time, we are unable to predict what effect, if any, the outcome of these proceedings will have on our financial condition, results of operation and cash flows.

Other Contingencies: We derive a substantial portion of our revenues in our Electric Services segment from a series of agreements with LIPA pursuant to which we manage LIPA's transmission and distribution system and supply the majority of LIPA's customers' electricity needs. KeySpan and LIPA have entered into agreements to extend, amend, and restate these contractual arrangements. See Note 11 "2006 LIPA Settlement" for a further discussion of these agreements.

LIPA completed its strategic review initiative that it had undertaken in connection with, among other reasons, its option under the Generation Purchase Rights Agreement with KeySpan. As part of its review, LIPA engaged a team of advisors and consultants, held public hearings and explored its strategic options, including continuing its existing operations, municipalizing, privatizing, selling some, but not all of its assets, becoming a regulator of rates and services, or merging with one or more utilities. Upon completion of its strategic review, LIPA determined that it would continue its existing operations and entered into the renegotiated 2006 LIPA Agreements that are discussed in Note 11 "2006 LIPA Settlement." Following the announcement of the proposed acquisition of KeySpan by National Grid plc, LIPA, National Grid plc and KeySpan have engaged in discussions concerning the impact of the transaction on LIPA's operations. At this time, we are unable to determine what impact, if any, such discussions may have on the 2006 LIPA Agreements and the receipt and timing of governmental approvals relating thereto.

Environmental Matters

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 "CAIR PLUS" program. 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. KeySpan is currently developing its compliance strategy to address the anticipated requirements of CAIR and CAIR PLUS by 2009. Since detailed requirements under CAIR have not yet been fully articulated, it is not possible to definitively estimate capital expenditures that may be required to meet these regulatory mandates. At the present time, it is anticipated that NOx control equipment may be required at one or more of KeySpan's Long Island facilities at a cost between $20 to $30 million. However, 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 Ravenswood Generating Station may also require upgrades at a cost of up to $15 million. 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.

Land, Manufactured Gas Plants and Related Facilities.

New York Sites: Within the State of New York we have identified 43 historical MGP sites and related facilities, which were owned or operated by KeySpan subsidiaries or such companies' predecessors. These former sites, some of which are no longer owned by KeySpan, have been identified to the DEC for inclusion on appropriate site inventories. Administrative Orders on Consent ("ACO") or Voluntary Cleanup Agreements ("VCA") have been executed with the DEC to address the investigation and remediation activities associated with certain sites and one waterway. In

March 2005, KeySpan withdrew its previously filed applications under the DEC's Brownfield Cleanup Program ("BCP") because of the uncertainty associated with contribution suits which we may need to bring against other parties who impacted these sites for their share of remedial cost. As a result of the December 2004 Cooper Industries v. Aviall Services, Inc. decision by the United States Supreme Court and the emerging case law in New York, KeySpan has evaluated the potential for third party recovery at each of the remaining sites. KeySpan intends to enter into an ACO for fifteen of these sites and continues to evaluate how to proceed with respect to participation in the DEC's remediation programs for the other sites.

KeySpan has identified 28 of these sites as being associated with the historical operations of KEDNY. One site has been fully remediated. Subject to the issues described in the preceding paragraph, the remaining 27 sites will be investigated and, if necessary, remediated under the terms and conditions of ACOs, VCAs or Brownfield Cleanup Agreements ("BCA"). Expenditures incurred to date by us with respect to KEDNY MGP-related activities total $80.1 million.

The remaining 15 sites have been identified as being associated with the historical operations of KEDLI. One site has been fully investigated and requires no further action. The remaining sites will be investigated and, if necessary, remediated under the terms and conditions of ACOs, VCAs or BCAs. Expenditures incurred to date by us with respect to KEDLI MGP-related activities total $62.5 million.

We presently estimate the remaining cost of our KEDNY and KEDLI MGP-related environmental remediation activities will be $325.4 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. However, remediation costs for each site may be materially higher than noted, depending upon changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered.

With respect to remediation costs, KEDNY and KEDLI rate plans generally provide for the recovery from customers of investigation and remediation costs of certain sites. At December 31, 2006, we have reflected a regulatory asset of $373.2 million for KEDNY/KEDLI MGP sites. KeySpan has recently filed proposed rate plans for KEDNY and KEDLI with the NYPSC as part of its application for approval of the KeySpan / National Grid plc merger, as well as individual applications for a proposed annual increase in revenues for KEDNY and KEDLI. Among other things, these filings seek recovery of deferred expenses associated with remediation of MGP sites, as well as recovery of ongoing remediation expenses.

We are also responsible for environmental obligations associated with the Ravenswood Facility, purchased from Consolidated Edison in 1999, including remediation activities associated with its historical operations and those of the MGP facilities that formerly operated at the site. We are not responsible for liabilities arising from disposal of waste at offsite locations prior to the acquisition closing and any monetary fines arising from Consolidated Edison's preclosing conduct. We presently estimate the remaining environmental clean up activities for this site will be $1.4 million, which amount has been accrued by us. Expenditures incurred to date total $3.6 million.

New England Sites: Within the Commonwealth of Massachusetts and the State of New Hampshire, we are aware of 74 former MGP sites and related facilities within the existing or former service territories of KEDNE.

Boston Gas Company, Colonial Gas Company and Essex Gas Company may have or share responsibility under applicable environmental laws for the remediation of 64 of these sites. A subsidiary of National Grid USA ("National Grid"), formerly New England Electric System, has assumed responsibility for remediating 11 of these sites, subject to a limited contribution from Boston Gas Company, and has provided full indemnification to Boston Gas Company with respect to eight other sites. In addition, Boston Gas Company, Colonial Gas Company, and Essex Gas Company have assumed responsibility for remediating three sites each. At this time, it is uncertain as to whether Boston Gas Company, Colonial Gas Company or Essex Gas Company have or share responsibility for remediating any of the other sites. No notice of responsibility has been issued to us for any of these sites from any governmental environmental authority.

We presently estimate the remaining cost of these Massachusetts KEDNE MGP-related environmental cleanup activities will be $8.8 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites, however remediation costs for each site may be materially higher than noted, depending upon changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered. Expenditures incurred since November 8, 2000, the date KeySpan acquired Eastern Enterprises, with respect to these MGP-related activities total $34.7 million.

In 2004, Boston Gas Company reached settlements with certain insurance carriers for recovery of a portion of previously incurred environmental expenditures. Under a previously issued MADTE rate order, insurance and third-party recoveries, after deducting legal fees, are shared between Boston Gas and its firm gas customers. As a result of these settlements, in 2004 Boston Gas Company recorded a $5.0 million benefit to operations and maintenance expense.

We may have or share responsibility under applicable environmental laws for the remediation of 10 MGP sites and related facilities associated with the historical operations of EnergyNorth. At four of these sites we have entered into cost sharing agreements with other parties who share responsibility for remediation of these sites. EnergyNorth also has entered into an agreement with the EPA for the contamination from the Nashua site that was allegedly commingled with asbestos at the so-called Nashua River Asbestos Site, adjacent to the Nashua MGP site.

We presently estimate the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $25.5 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites, however remediation costs for each site may be materially higher than noted, depending upon changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered. Expenditures incurred since November 8, 2000, with respect to these MGP-related activities total $23.0 million.

By rate orders, the MADTE and the NHPUC provide for the recovery of site investigation and remediation costs and, accordingly, at December 31, 2006, we have reflected a regulatory asset of $43.4 million for the KEDNE MGP sites. As previously mentioned, Colonial Gas Company and Essex Gas Company are not subject to the provisions of SFAS 71 and therefore have recorded no regulatory asset. However, rate orders currently in effect for these subsidiaries provide for the recovery of investigation and remediation costs.

KeySpan New England LLC Sites: We are aware of three non-utility sites associated with KeySpan New England, LLC, a successor company to Eastern Enterprises, for which we may have or share environmental remediation or ongoing maintenance responsibility. These three sites, located in Philadelphia, Pennsylvania, New Haven, Connecticut and Everett, Massachusetts, were associated with historical operations involving the production of coke and related industrial processes. Honeywell International, Inc. and Beazer East, Inc. (both former owners and/or operators of certain facilities at Everett ("the Everett Facility") together with KeySpan, entered into an ACO with the Massachusetts Department of Environmental Protection for the investigation and development of a remedial response plan for a portion of that site. KeySpan, Honeywell and Beazer East entered into a cost-sharing agreement under which each company agreed to pay one-third of the costs of compliance with the consent order, while preserving any claims against the other companies for, among other things, reallocation of proportionate liability. In 2002, Beazer East commenced an action in the U.S. District Court for the Southern District of New York, which sought a judicial determination on the allocation of liability for the Everett Facility. A confidential settlement agreement has been executed on favorable terms to KeySpan and the Beazer lawsuit has been discontinued.

In 2004, KeySpan reached a settlement with insurance carriers regarding cost recovery for expenses at one of the above noted sites and recorded an $11.6 million reduction to operating expenses. We presently estimate the remaining cost of our environmental cleanup activities for the three non-utility sites will be approximately $11.4 million, which amount has been accrued by us as a reasonable estimate of probable costs for known sites, however remediation costs for each site may be materially higher than noted, depending upon changing technologies and regulatory standards, selected end use for each site, and actual environmental conditions encountered. Expenditures incurred since November 8, 2000, with respect to these sites total $21.4 million.

We believe that in the aggregate, the accrued liability for these MGP sites and related facilities identified above are reasonable estimates of the probable cost for the investigation and remediation of these sites and facilities. As circumstances warrant, we periodically re-evaluate the accrued liabilities associated with MGP sites and related facilities. We may be required to investigate and, if necessary, remediate each site previously noted, or other currently unknown former sites and related facility sites, the cost of which is not presently determinable but may be material to our financial position, results of operations or cash flows.

Insurance Reimbursement of MGP Response Costs: We have instituted lawsuits in New York, Massachusetts and New Hampshire against numerous insurance carriers for reimbursement of costs incurred for the investigation and remediation of these MGP sites.

In January 1998 and July 2001, KEDLI and KEDNY, respectively, filed complaints for the recovery of its remediation costs in the New York State Supreme Court against the various insurance companies that issued general comprehensive liability policies to KEDLI and KEDNY. The outcome of these proceedings cannot yet be determined.

In March 1999, Boston Gas Company and a subsidiary of National Grid filed a complaint for the recovery of remediation costs in the Massachusetts Superior Court against various insurance companies that issued comprehensive general liability policies to National Grid and its predecessors with respect to, among other things, the 11 sites for which Boston Gas Company has agreed to make a limited contribution. In October 2002, Boston Gas Company filed a complaint in the United States District Court – Massachusetts District against one of the insurance companies that issued comprehensive general liability policies to Boston Gas Company for its remaining sites. In November 2005, the trial commenced on the declaratory judgment action of Boston Gas against Century Indemnity for insurance coverage for the costs incurred in the investigation and remediation at the former Boston Gas Everett MGP site and in December 2005, the jury returned a verdict in favor of KeySpan. KeySpan anticipates that Century Indemnity will appeal this verdict. The outcome of these proceedings cannot yet be determined.

EnergyNorth has filed a number of lawsuits in both the New Hampshire Superior Court and the United States District Court for the District of New Hampshire for recovery of its remediation costs against the various insurance companies that issued comprehensive general liability and excess liability insurance policies to EnergyNorth and its predecessors. In October 2004, EnergyNorth's case against the London Market Insurers for the costs incurred investigating and remediating the former MGP site in Laconia went to trial and the jury returned a verdict in favor of EnergyNorth, finding that EnergyNorth was entitled to recover against London Market Insurers. In February 2005, the trial of EnergyNorth's coverage action for the Dover MGP site began against the only remaining defendant, Century Indemnity (all other carriers settled prior to trial) and at the conclusion of the trial the federal judge directed a verdict in EnergyNorth's favor on all issues. Century Indemnity filed an appeal with the First Circuit Court of Appeals and in a decision dated June 28, 2006, the First Circuit court of Appeals denied Century Indemnity's appeal in its entirety. In a jury trial in the Nashua MGP action commenced against the London Market Insurers and Century Indemnity in November 2005, the jury returned a verdict in favor of KeySpan finding that London and Century Indemnity were obligated to indemnify EnergyNorth for response

costs incurred at the site. Century Indemnity has sought reconsideration of this verdict. The outcome of this proceeding cannot yet be determined.

In 1993, KeySpan New England LLC filed a declaratory judgment action against the Hanover and Travelers insurance companies in the Superior Court for Middlesex County for the Everett Facility. The declaratory judgment action sought to have the court compel the insurers to defend KeySpan New England, LLC in connection with the Massachusetts Department of Environmental Protection's Notice of Responsibility ("NOR"). In 2004, the Court granted KeySpan New England LLC's unopposed motion for leave to file a Second Amended Complaint in this action to seek a declaratory ruling that the insurers have a duty to indemnify KeySpan New England LLC for the costs associated with the Everett NOR and certain other related private actions. The Second Amended Complaint also adds certain excess insurance carriers as defendants in the action. The outcome of this proceeding cannot yet be determined.

KeySpan has entered into confidential settlement agreements with certain of the defendant insurance carriers for recovery of costs associated with the investigation and remediation of the sites included in the above proceedings. Pursuant to these settlements, KeySpan recorded a benefit of $5.5 million in its Consolidated Statement of Income for the twelve months ended December 31, 2006, reflecting the benefit accruing to KeySpan's shareholders. Recovery of environmental costs from insurance carriers associated with utility MGP sites are refunded to KeySpan's ratepayers, subject to certain sharing provisions. During the past year, KeySpan has received approximately $22 million from insurance carriers in settlements for recovery of environmental costs associated with remediation of MGP sites.

Note 8. Hedging, Derivative Financial Instruments and Fair Values

From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas distribution operations, gas production and development activities and its electric generating facilities at the Ravenswood Generating Station. As discussed in greater detail below, certain derivative financial instruments employed by KeySpan are accounted for as cash-flow hedges under SFAS 133 "Accounting for Derivative Instruments and Hedging Activities," as amended by SFAS 149 "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," collectively SFAS 133. However, KeySpan also employs derivative financial instruments that do not qualify for hedge accounting treatment. Additionally, certain derivative financial instruments employed by our Gas Distribution operations are subject to SFAS 71 "Accounting for the Effects of Certain Types of Regulation."

Commodity Derivative Instruments – Hedge Accounting: Our Energy Investments subsidiary, Seneca-Upshur, utilizes OTC natural gas swaps to hedge the cash flow variability associated with forecasted sales of a portion of its natural gas production. At December 31, 2006, Seneca-Upshur has hedge positions in place for approximately 70% of its estimated 2006 through 2009 gas production, net of gathering costs. We use market quoted forward prices to value these swap positions. The maximum length of time over which Seneca-Upshur has hedged such cash flow variability is through December 2009. The fair value of these derivative instruments at December 31, 2006 was a liability of $3.9 million. The estimated amount of losses associated with such derivative instruments that are reported in accumulated other comprehensive income and that are expected to be reclassified into earnings over the next twelve months is $2.3 million. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial for the twelve months ended December 31, 2006.

Certain derivative instruments employed by our gas distribution operations are not subject to SFAS 71 and thus are not subject to deferral accounting treatment. KeySpan uses OTC natural gas swaps to hedge the cash-flow variability of gas purchases associated with certain large-volume gas sales customers. These gas swaps are accounted for as cash-flow hedges. KeySpan uses market quoted forward prices to value these swap positions. The maximum length of time over which we have hedged such cash flow variability is through October 2007. The fair value of these derivative instruments at December 31, 2006 was a liability of $2.0 million, all of which is reported in accumulated other comprehensive income and is expected to be reclassified into earnings within the next twelve months. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial in 2006.

The above noted derivative financial instruments are cash flow hedges that are accounted for as hedges under SFAS 133 and are not considered held for trading purposes as defined by current accounting literature. Accordingly, we carry the fair value of our derivative instruments on the Consolidated Balance Sheet as either a current or deferred asset or liability, as appropriate, and record the effective portion of unrealized gains or losses in accumulated other comprehensive income. Gains and losses are reclassified from accumulated other comprehensive income to the Consolidated Statement of Income in the period the hedged transaction affects earnings. Gains and losses on settled transactions are reflected as a component of either revenue or gas cost depending on the hedged transaction. Hedge ineffectiveness results from changes during the period in the price differentials between the index price of the derivative contract and the price of the purchase or sale for the cash flow that is being hedged, and is recorded directly to earnings.

Commodity Derivative Instruments that are not Accounted for as Hedges: The Ravenswood Generating Station financially hedges the cash flow variability associated with a portion of electric energy sales and fuel purchases. Our strategy is to financially hedge up to 50% of the on-peak capacity of the Ravenswood Generating Station. The maximum length of time over which derivative financial instruments are in-place is through

007. To accomplish our stated risk management strategy, employs financially-settled electric-power swap contracts with g financially-settled oil swap contracts, physical natural gas forntracts and OTC natural gas swaps. We use market quoted forices to value the electric-power swap contracts. The fair value of :tric power derivative instruments at December 31, 2006 was million. We use market quoted forward prices to value the oil swap cts and natural gas contracts. The fair value of these derivative nents at December 31, 2006, was a liability of $23.7 million.

)uring most of 2006 and in prior years, the derivative transactions iated with the Ravenswood Generating Station qualified for hedge unting treatment. As a result, there is a net $1.2 million balance cury in accumulated other comprehensive income which is expected to eclassified into earnings within the next twelve months. In 2006, 5pan reclassified a $1.4 million loss from accumulated other compresive income to earnings, based on management's assessment that tain future oil purchases were not probable of occurrence. ffectiveness associated with these outstanding derivative financial ,truments was immaterial in 2006.

On January 18, 2006, KeySpan entered into an International SWAP ealers Association Master Agreement for a fixed for float unforced apacity financial swap (the " Swap Agreement") with Morgan Stanley :apital Group Inc. ("Morgan Stanley"). The Swap Agreement has a three ear term that began on May 1, 2006. The notional quantity was ,800,000kW (the "Notional Quantity") of In-City Unforced Capacity and he fixed price is $7.57/kW-month ("Fixed Price"), subject to adjustment upon the occurrence of certain events. Cash settlement occurs on a nonthly basis based on the In-City Unforced Capacity price determined by the relevant New York Independent System Operator ("NYISO") Spot Demand Curve Auction Market ("Floating Price"). For each monthly settlement period, the price difference equals the Fixed Price minus the Floating Price. If such price difference is less than zero, Morgan Stanley will pay KeySpan an amount equal to the product of (a) the Notional Quantity and (b) the absolute value of such price difference. Conversely, if such price difference is greater than zero, KeySpan will pay Morgan Stanley an amount equal to the product of (a) the Notional Quantity and (b) the absolute value of such price difference. This derivative instrument does not qualify for hedge accounting treatment under SFAS 133. The recognized fair value associated with this instrument is immaterial to the consolidated financial statements at December 31, 2006. As noted, this is a financial derivative instrument and is unrelated to any physical production of electricity.

The NYPSC, Con Edison and other load serving entities ("LSEs") have proposed price mitigation measures that would apply to the Ravenswood Generating Station. These price mitigation measures, if approved as proposed, would essentially reduce the capacity bid price that the Ravenswood Generating Station could bid into the NYISO energy market. The NYISO's Management Committee and NYISO's Board of Directors approved the price mitigation measures proposed by the NYPSC, Con Edison and the other LSE's, notwithstanding KeySpan's analysis and objections. The NYISO filed the mitigation measures with the FERC for approval; such approval is pending. At this time, we are unable to predict the outcome of this proceeding and what effect it will have on the potential revenue that could be realized in connection with the fixed for floating financial Swap Agreement.

Commodity Derivative Instruments – Regulated Utilities: We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchase associated with our Gas Distribution operations. Our strategy is to minimize fluctuations in gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. The accounting for these derivative instruments is subject to SFAS 71. Therefore, the fair value of these derivatives is recorded as current or deferred assets and liabilities, with offsetting positions recorded as regulatory assets and regulatory liabilities on the Consolidated Balance Shee Gains or losses on the settlement of these contracts are initially deferre and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements. At December 31, 2006 the fair value of these derivative instruments was a liability of $192.1 million.

SFAS 133 establishes criteria that must be satisfied in order for option contracts, forward contracts with optionality features, or contrac that combine a forward contract and a purchase option contract to qua fy for the normal purchases and sales exception. Certain contracts for t physical purchase of natural gas associated with our regulated gas utilities do not qualify for normal purchases under SFAS 133. Since these contracts are for the purchase of natural gas sold to regulated firm gas sales customers, the accounting for these contracts is subject to SFAS 7 At December 31, 2006, these derivatives had a net fair value of $101. million.

KeySpan has a management contract with Merrill Lynch Trading, under which KeySpan and Merrill Lynch Trading will share the respons ities for managing KeySpan's upstream gas distribution assets associa with its Massachusetts gas distribution subsidiaries, as well as provic city-gate delivered supply. This contract, which replaces the prior arra ment with Merrill Lynch Trading, allows for both KeySpan and Merril Lynch Trading to employ derivative instruments to maximize the pro ity of KeySpan's portfolio of gas distribution assets. Profits associate with these activities are shared between KeySpan, Merrill Lynch Tra and KeySpan's Massachusetts ratepayers. The accounting for this c is subject to SFAS 71 since the contract was executed by KeySpan' regulated gas distribution utilities. At December 31, 2006, KeySpa proportionate share of the fair value associated with these deriva instruments amounted to $10.4 million, $9.5 million of which ha been deferred for future sharing among the alliance members ar Massachusetts ratepayers. The remaining amount was recorded benefit to revenues. KeySpan provides these services internally f New York and New Hampshire gas distribution subsidiaries.

Interest Rate Derivative Instruments: In the fourth quarter KeySpan issued $400 million Senior Unsecured Notes at KEDN $100 million Senior Unsecured Notes at KEDLI. KeySpan utiliz

component of the underlying notes and a $125 million treasury lock, at 4.82%, to hedge the 10-year US Treasury component of the underlying notes. These derivative instruments settled in the fourth quarter of 2006 at which time KeySpan paid $0.2 million to the counterparty to the contracts. The loss on the settlement of these contracts has been deferred for future collection from firm gas sales customers consistent with regulatory requirements.

The table below summarizes the fair value of all of the above outstanding derivative instruments at December 31, 2006 and 2005, and the related line item on the Consolidated Balance Sheet. Fair value is the amount at which derivative instruments could be exchanged in a current transaction between willing parties, other than in a forced liquidation sale.

		(In Millions of Dollars)
	DECEMBER 31, 2006	**DECEMBER 31, 2005**
Gas Contracts:		
Other current assets	$ 30.7	$ 132.1
Other deferred charges	127.1	75.2
Regulatory asset	196.3	30.9
Other current liability	(211.7)	(39.8)
Other deferred liabilities	(42.1)	(44.3)
Regulatory liability	(120.6)	(175.4)
Oil Contracts:		
Other current assets	0.3	0.5
Other current liability	(7.2)	(6.8)
Other deferred liabilities	(0.5)	—
Electric Contracts:		
Other current assets	23.2	10.2
Other deferred charges	0.3	—
Other current liability	(0.8)	(0.7)
Other deferred liabilities	(0.6)	—
	$ (5.6)	$ (18.1)

Weather Derivatives: The utility tariffs associated with KEDNE's operations do not contain weather normalization adjustments. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations.

In 2006, we entered into heating-degree day put options to mitigate the effect of fluctuations from normal weather on KEDNE's financial position and cash flows for the 2006/2007 winter heating season – November 2006 through March 2007. These put options will pay KeySpan up to $37,500 per heating degree day when the actual temperature is below 4,159 heating degree days, or approximately 5% warmer than normal, based on the most recent 20-year average for normal weather. The maximum amount KeySpan will receive on these purchased put options is $15 million. The net premium cost for these options is $1.7 million and will be amortized over the heating season. Since weather was warmer than normal during the fourth quarter of 2006, KeySpan recorded a $9.1 million benefit to earnings associated with the weather derivative. We account for these derivatives pursuant to the requirements of EITF 99-2, "Accounting for Weather Derivatives." In this regard, such instruments are accounted for using the "intrinsic value method" as set forth in such guidance.

In 2005, we entered into heating-degree day put options, which expired during the first quarter of 2006, to mitigate the effect of fluctuations from normal weather on KEDNE's financial position and cash flows for the 2005/2006 winter heating season – November 2005 through March 2006. These put options would have paid KeySpan up to $40,000 per heating degree day when the actual temperature was below 4,169 heating degree days, or approximately 5% warmer than normal, based on the most recent 20-year average for normal weather. The maximum amount KeySpan would have received on these purchased put options was $16 million. The net premium cost for these options was $1.2 million and was amortized over the heating season. Weather for the entire primary winter heating season – November 2005 through March 2006 – was slightly colder than normal. Therefore, there was no earnings impact associated with these weather derivatives, except for the amortization of the net premium cost.

Credit and Collateral: Derivative contracts are primarily used to manage exposure to market risk arising from changes in commodity prices and interest rates. In the event of non-performance by a counterparty to a derivative contract, the desired impact may not be achieved. The risk of counterparty non-performance is generally considered a credit risk and is actively managed by assessing each counterparty credit profile and negotiating appropriate levels of collateral and credit support. In instances where the counterparties' credit quality has declined, or credit exposure exceeds certain levels, we may limit our credit exposure by restricting new transactions with counterparties, requiring additional collateral or credit support and negotiating the early termination of certain agreements. At December 31, 2006, KeySpan has received $7.9 million from its counterparties as collateral associated with outstanding derivative contracts. This amount has been recorded as restricted cash, with an offsetting position in current liabilities on the Consolidated Balance Sheet. At December 31, 2006, KeySpan has $33.9 million of outstanding margin calls to its counterparties for open derivative instruments associated with its strategy to minimize fluctuations in gas sales prices to its regulated firm gas sales customers.

Long-term Debt: The following tables depict the fair values and carrying values of KeySpan's long-term debt at December 31, 2006 and 2005.

Fair Values of Long-Term Debt

		(In Millions of Dollars)
DECEMBER 31,	**2006**	**2005**
First Mortgage Bonds	$111.4	$114.1
Notes	3,078.5	2,692.1
Gas Facilities Revenue Bonds	647.3	651.3
Authority Financing Notes	66.0	66.0
Promissory Notes	156.7	156.6
Master Lease	412.0	430.5
Tax Exempt Bonds	131.0	130.8
	$4,602.9	$4,241.4

Carrying Values of Long-Term Debt

	(In Millions of Dollars)	
DECEMBER 31,	**2006**	**2005**
First Mortgage Bonds	$95.0	$95.0
Notes	2,925.4	2,437.2
Gas Facilities Revenue Bonds	640.5	640.5
Authority Financing Notes	66.0	66.0
Promissory Notes	155.4	155.4
Master Lease	412.3	412.3
Tax Exempt Bonds	128.3	128.3
	$4,422.9	$3,934.7

All other financial instruments included in the Consolidated Balance Sheet such as cash, commercial paper, accounts receivable and accounts payable, are stated at amounts that approximate fair value.

Note 9. Gas Production and Development Property – Depletion

As described in Note 2 "Business Segments," during much of 2004 KeySpan's investment in gas production and development activities consisted of its ownership interest in Houston Exploration, as well as KeySpan's wholly-owned subsidiary KeySpan Exploration and Production. Further, KeySpan's investment in these activities also includes its wholly-owned subsidiary Seneca-Upshur. These assets are accounted for under the full cost method of accounting. Under the full cost method, costs of acquisition, exploration and development of natural gas and oil reserves plus asset retirement obligations are capitalized into a "full cost pool" as incurred. Unproved properties and related costs are excluded from the depletion and amortization base until a determination as to the existence of proved reserves. Properties are depleted and charged to operations using the unit of production method.

To the extent that such capitalized costs (net of accumulated depletion) less deferred taxes exceed the present value (using a 10% discount rate) of estimated future net cash flows from proved natural gas and oil reserves and the lower of cost or fair value of unproved properties, less deferred taxes, such excess costs are charged to operations, but would not have an impact on cash flows. Once incurred, such impairment of gas properties is not reversible at a later date even if prices increase. The ceiling test is calculated using natural gas and oil prices in effect as of the balance sheet date, adjusted for outstanding derivative instruments, held flat over the life of the reserves.

As a result of the sale of Houston Exploration discussed in Note 2 "Business Segments", KeySpan accounted for its investment in Houston Exploration on the equity method from June 2004 through November 19, 2004. Therefore, we were required to calculate a ceiling test on KeySpan Exploration and Production's and Seneca-Uphsur's assets independently of Houston Exploration's assets in the second quarter of 2004. Based on a report furnished by an independent reservoir engineer at that time, it was determined that the remaining proved undeveloped oil reserves held in the joint venture required a substantial investment in order to develop. Therefore, KeySpan and Houston Exploration elected not to develop these oil reserves. As a result, in the second quarter of 2004, KeySpan recorded a $48.2 million non-cash impairment charge to write down its wholly-owned gas exploration and production subsidiaries' assets. This charge was recorded in depreciation, depletion and amortization on the Consolidated Statement of Income.

Note 10. Energy Services – Discontinued Operations

In 2004, the Energy Services segment experienced significantly lower operating profits and cash flows than originally projected. At a meeting held on November 2, 2004, KeySpan's Board of Directors authorized management to begin the process of disposing of a significant portion of its ownership interests in certain companies within the Energy Services segment – specifically those companies engaged in mechanical contracting activities. In January and February of 2005, KeySpan sold its mechanical contracting investments. The operating results and cash flows of these businesses, are reflected as discontinued operations on the Consolidated Statement of Income and Consolidated Statement of Cash Flows.

In regard to the January 2005 transactions, KeySpan received proceeds of approximately $16 million, including approximately $5 million to be paid within a three year period. In addition, KeySpan retained its previously incurred indemnity support obligations related to certain surety, performance and payment bonds issued for the benefit of KeySpan's former subsidiaries prior to closing. In June 2005, the balance to be paid over the three year period was fully collected on a present value basis and a significant portion of the performance bonds were replaced without any remaining indemnification obligation on the part of KeySpan. The buyers have completed the projects for which such indemnity obligations were incurred.

In connection with the February 2005 transaction, KeySpan paid or contributed approximately $26 million to its former subsidiary prior to closing the sale transaction in exchange for, among other things, the disposition of outstanding shares in the former subsidiary and the settlement of intercompany advances and replacement of a performance and payment bond issued for the benefit of its former subsidiary with respect to a pending project, which bond had been supported by a $150 million indemnity obligation of KeySpan. In addition, KeySpan received from its former subsidiary an indemnity bond issued by a third party insurance company, the purpose of which is to reimburse KeySpan in an amount up to $80 million in the event it is required to perform under all other indemnity obligations previously incurred by KeySpan to support the remaining bonded projects of its former subsidiary as of the closing. As of December 31, 2006, the total cost to complete such remaining bonded projects is estimated to be approximately $21.9 million. The aforementioned guarantees are reflected in Note 7 "Contractual Obligations, Financial Guarantees and Contingencies". KeySpan's former subsidiary has also agreed to complete the projects for which such indemnity obligations were incurred and to indemnify and hold KeySpan harmless with respect to its liabilities in connection with such bonds.

In anticipation of these sales and in connection with the preparation of the third quarter and fourth quarter 2004 financial statements, KeySpan conducted an evaluation of the carrying value of these investments,

including recorded goodwill. Further, we evaluated the carrying value of goodwill for the entire Energy Services segment. As noted, KeySpan records goodwill on purchased transactions, representing the excess of acquisition cost over the fair value of net assets acquired.

As a result of these evaluations, KeySpan recorded a non-cash goodwill impairment charge of $108.3 million ($80.3 million after tax, or $0.50 per share) in 2004. This charge was recorded as follows: (i) $14.4 million as an operating expense on the Consolidated Statement of Income reflecting the write-down of goodwill on Energy Services segment's continuing operations; and (ii) $93.9 million ($67.8 million after-tax) as discontinued operations reflecting the impairment on the mechanical contracting companies.

In addition, an impairment charge of $100.3 million ($72.1 million after-tax or $0.45 per share) was also recorded in 2004 to reduce the carrying value of the remaining assets of the mechanical contracting companies. This charge is reflected in discontinued operations on the Consolidated Statement of Income to reflect the estimated loss on disposal.

KeySpan employed a combination of two methodologies in determining the estimated fair value for its investment in the Energy Services segment, a market valuation approach and an income valuation approach. Under the market valuation approach, KeySpan utilized a range of near-term potential realizable values for the mechanical contracting businesses. Under the income valuation approach, the fair value was obtained by discounting the sum of (i) the expected future cash flows and (ii) the terminal value. KeySpan utilized certain significant assumptions in this valuation, specifically the weighted-average cost of capital, short and long-term growth rates and expected future cash flows. Approximately $65 million of goodwill remains in this segment.

The information below highlights the major income and expense captions of the discontinued mechanical contracting companies.

	(In Millions of Dollars)	
FOR THE YEAR ENDED DECEMBER 31,	**2005**	**2004**
Revenues	$33.8	$ 338.7
Less:		
Operating expenses	40.2	364.9
Goodwill impairment	—	108.3
	(6.4)	(134.5)
Income taxes (benefit)	(2.3)	(55.5)
Operating loss	(4.1)	(79.0)
Gain (Loss) on disposal, net of tax	2.3	(72.0)
Net Loss	$ (1.8)	$(151.0)

Note 11. 2006 LIPA Settlement

LIPA is a corporate municipal instrumentality and a political subdivision of the State of New York. On May 28, 1998, certain of LILCO's business units were merged with KeySpan and LILCO's common stock and remaining assets were acquired by LIPA. At the time of this transaction, KeySpan and LIPA entered into three major long-term service agreements that (i) provide to LIPA all operation, maintenance and construction services and significant administrative services relating to the Long Island electric transmission and distribution system ("T&D System") pursuant to a Management Services Agreement (the "1998 MSA"); (ii) supply LIPA with electric generating capacity, energy conversion and ancillary services from our Long Island generating units pursuant to a Power Supply Agreement (the "1998 PSA") and other long-term agreements through which we provide LIPA with approximately one half of its customers' energy needs; and (iii) manage all aspects of the fuel supply for our Long Island generating facilities, as well as all aspects of the capacity and energy owned by or under contract to LIPA pursuant to an Energy Management Agreement (the "1998 EMA"). We also purchase energy, capacity and ancillary services in the open market on LIPA's behalf under the 1998 EMA. The 1998 MSA, 1998 PSA and 1998 EMA all became effective on May 28, 1998 and are collectively referred to as the 1998 LIPA Agreements.

On February 1, 2006, KeySpan and LIPA entered into (i) an amended and restated Management Services Agreement (the "2006 MSA"), pursuant to which KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island; (ii) 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 acquire substantially all of the electric generating facilities owned by KeySpan on Long Island; and (iii) a Settlement Agreement (the "2006 Settlement Agreement") resolving outstanding issues between the parties regarding the 1998 LIPA Agreements. The 2006 MSA, the 2006 Option Agreement and the 2006 Settlement Agreement are collectively referred to herein as the "2006 LIPA Agreements." Each of the 2006 LIPA Agreements will become effective upon all of the 2006 LIPA Agreements receiving the required governmental approvals; otherwise none of the 2006 LIPA Agreements will become effective. These agreements will become effective following approval by the New York State Comptroller's Office and the New York State Attorney General. Following the announcement of the proposed acquisition of KeySpan by National Grid plc, LIPA, National Grid plc and KeySpan have engaged in discussions concerning the impact of the transaction on LIPA's operations. At this time, we are unable to determine what impact, if any, the results of such discussions may have on the 2006 LIPA Agreements and the receipt and timing of governmental approvals relating thereto.

2006 Settlement Agreement: Pursuant to the terms of the 2006 Settlement Agreement, KeySpan and LIPA agreed to resolve issues that have existed between the parties relating to the various 1998 LIPA Agreements. In addition to the resolution of these matters, KeySpan's entitlement to utilize LILCO's available tax credits and other tax attributes will increase from approximately $50 million to approximately $200 million. These credits and attributes may be used to satisfy KeySpan's previously incurred indemnity obligation to LIPA for any federal income tax liability that results from the recent settlement with the IRS regarding the audit of LILCO's tax returns for the years ended

December 31, 1996 through March 31, 1999. On October 30, 2006, the IRS submitted the settlement provisions of the recently concluded IRS audit to the Joint Committee on Taxation for approval. Key provisions of the settlement included the resolution of the tax basis of assets transferred to KeySpan at the time of the KeySpan/LILCO merger, the tax deductibility of certain merger related costs and the tax deductibility of certain environmental expenditures. The settlement enabled KeySpan to utilize 100% of the available tax credits. (See Note 3 to the Consolidated Financial Statements "Income Taxes" for additional information of the settlement.) In recognition of these items, as well as for the modification and extension of the 1998 MSA and the amendments to the GPRA, upon effectiveness of the Settlement Agreement KeySpan will record a contractual asset in the amount of approximately $160 million, of which approximately $110 million will be attributed to the right to utilize such additional credits and attributes and approximately $50 million will be amortized over the eight year term of the 2006 MSA. In order to compensate LIPA for the foregoing, KeySpan will pay LIPA $69 million in cash and will settle certain accounts receivable in the amount of approximately $90 million due from LIPA.

Generation Purchase Rights Agreement and 2006 Option Agreement: 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 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. The 2006 Option Agreement replaces the GPRA, the expiration of which has been stayed pending effectiveness of the 2006 LIPA Agreements. In the event such agreements do not become effective by reason of failure to secure any of the requisite governmental approvals, the GPRA will be reinstated for a period of 90 days from the date such approval is denied. 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.

Management Services Agreements: In place of the previous compensation structure (whereby KeySpan was reimbursed for budgeted costs, and earned a management fee and certain performance and cost-based incentives), KeySpan's compensation for managing the T&D System under the 2006 MSA consists of two components: a minimum compensation component of $224 million per year and a variable component based on electric sales. The $224 million component will remain unchanged for three years and then increase annually by 1.7%, plus inflation. The variable component, which will comprise no more than 20% of KeySpan's compensation, is based on electric sales on Long Island exceeding a base amount of 16,558 gigawatt hours, increasing by 1.7% in each year. Above that level, KeySpan will receive approximately 1.34 cents per kilowatt hour for the first contract year, 1.29 cents per kilowatt hour in the second contract year (plus an annual inflation adjustment), 1.24 cents per kilowatt hour in the third contract year (plus an annual inflation adjustment), with the per kilowatt hour rate thereafter adjusted annually by inflation. Subject to certain limitations, KeySpan will be able to retain all operational efficiencies realized during the term of the 2006 MSA.

LIPA will continue to reimburse KeySpan for certain expenditures incurred in connection with the operation and maintenance of the T&D System, and other payments made on behalf of LIPA, including: real property and other T&D System taxes, return postage, capital construction expenditures and storm costs.

Upon approval, the 2006 LIPA Agreements will be effective retroactive to January 1, 2006. KeySpan's reported operating income and net income for 2006 under the 2006 MSA are substantially the same as they would have been if the terms and provisions of the 1998 MSA had continued to be applied. At this point in time, KeySpan is unable to estimate what the impact would be to its results of operations, financial position and cash flows if the 2006 LIPA Agreements do not become fully effective.

Note 12. KeySpan Gas East Corporation Summary Financial Data

KEDLI is a wholly owned subsidiary of KeySpan. KEDLI was formed on May 7, 1998 and on May 28, 1998 acquired substantially all of the assets related to the gas distribution business of LILCO. KEDLI provides gas distribution services to customers in the Long Island counties of Nassau and Suffolk and the Rockaway peninsula of Queens county. KEDLI established a program for the issuance, from time to time, of up to $600 million aggregate principal amount of Medium-Term Notes, which will be fully and unconditionally guaranteed by the parent, KeySpan Corporation. On February 1, 2000, KEDLI issued $400 million of 7.875% Medium-Term Notes due 2010. In January 2001, KEDLI issued an additional $125 million of Medium- Term Notes at 6.9% due January 2008. The following condensed financial statements are required to be disclosed by SEC regulations and set forth those of KEDLI, KeySpan Corporation as guarantor of the Medium-Term Notes and our other subsidiaries on a combined basis. Additionally, in 2006, KEDLI issued $100 million of Senior Unsecured Notes at 5.60% due November 29, 2016. This debt is not guaranteed by the parent, KeySpan Corporation.

Statement of Income

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2006	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Revenues	$ 0.7	$1,319.4	$ 5,862.2	$ (0.7)	$ 7,181.6
Operating Expenses					
Purchased gas	—	864.4	2,467.1	—	3,331.5
Fuel and purchased power	—	—	548.6	—	548.6
Operations and maintenance	62.4	138.9	1,478.7	—	1,680.0
Intercompany expense	—	5.3	(4.6)	(0.7)	—
Depreciation and amortization	—	77.5	320.0	—	397.5
Operating taxes	—	65.1	346.1	—	411.2
Total Operating Expenses	62.4	1,151.2	5,155.9	(0.7)	6,368.8
Gain on sale of property	—	—	1.6	—	1.6
Income from equity investments	—	—	13.1	—	13.1
Operating Income (Loss)	(61.7)	168.2	721.0	—	827.5
Interest charges	(166.2)	(54.4)	(69.0)	33.5	(256.1)
Other income and (deductions)	575.2	2.3	(62.8)	(476.4)	38.3
Total Other Income and (Deductions)	409.0	(52.1)	(131.8)	(442.9)	(217.8)
Income Taxes (Benefit)	(86.9)	42.2	220.2	—	175.5
Net Income	$ 434.2	$ 73.9	$ 369.0	$ (442.9)	$ 434.2

Statement of Income

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2005	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Revenues	$ 0.6	$1,432.9	$ 6,229.1	$ (0.6)	$ 7,662.0
Operating Expenses					
Purchased gas	—	963.0	2,634.3	—	3,597.3
Fuel and purchased power	—	—	752.1	—	752.1
Operations and maintenance	22.0	133.5	1,462.4	—	1,617.9
Intercompany expense	—	4.8	(4.2)	(0.6)	—
Depreciation and amortization	—	76.9	319.6	—	396.5
Operating taxes	0.1	65.9	341.1	—	407.1
Total Operating Expenses	22.1	1,244.1	5,505.3	(0.6)	6,770.9
Gain on sale of property	—	—	1.6	—	1.6
Income from equity investments	—	—	15.1	—	15.1
Operating Income (Loss)	(21.5)	188.8	740.5	—	907.8
Interest charges	(144.5)	(61.9)	(83.9)	21.0	(269.3)
Other income and (deductions)	523.8	2.9	(81.3)	(446.0)	(0.6)
Total Other Income and (Deductions)	379.3	(59.0)	(165.2)	(425.0)	(269.9)
Income Taxes (Benefit)	(32.4)	48.2	223.5	—	239.3
Earnings from Continuing Operations	390.2	81.6	351.8	(425.0)	398.6
Discontinued Operations	—	—	(1.8)	—	(1.8)
Cumulative Change in Accounting Principles	—	(0.2)	(6.4)	—	(6.6)
Net Income	$ 390.2	$ 81.4	$ 343.6	$ (425.0)	$ 390.2

Statement of Income

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2004	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Revenues	$ 0.6	$1,124.4	$ 5,526.1	$ (0.6)	$ 6,650.5
Operating Expenses					
Purchased gas	—	664.9	1,999.6	—	2,664.5
Fuel and purchased power	—	—	540.3	—	540.3
Operations and maintenance	5.3	137.8	1,423.9	—	1,567.0
Intercompany expense	—	5.4	(5.4)	—	—
Depreciation and amortization	—	79.9	471.9	—	551.8
Operating taxes	—	65.7	338.4	—	404.1
Goodwill Impairment	—	—	41.0	—	41.0
Total Operating Expenses	5.3	953.7	4,809.7	—	5,768.7
Gain on sale of property	—	—	7.0	—	7.0
Income from equity investments	—	—	46.5	—	46.5
Operating Income (Loss)	(4.7)	170.7	769.9	(0.6)	935.3
Interest charges	(204.5)	(61.5)	(267.7)	202.4	(331.3)
Other income and (deductions)	635.4	0.8	423.9	(723.9)	336.2
Total Other Income and (Deductions)	430.9	(60.7)	156.2	(521.5)	4.9
Income Taxes (Benefit)	(45.5)	35.8	335.2	—	325.5
Earnings from Continuing Operations	471.7	74.2	590.9	(522.1)	614.7
Discontinued Operations	—	—	(151.0)	—	(151.0)
Net Income	$ 471.7	$ 74.2	$ 439.9	$ (522.1)	$ 463.7

Balance Sheet

(In Millions of Dollars)

DECEMBER 31, 2006	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Assets					
Current Assets					
Cash and temporary cash investments	$ 140.5	$ 34.7	$ 35.7	$ —	$ 210.9
Accounts receivable, net	0.5	175.6	710.7	—	886.8
Other current assets	1.5	314.0	1,373.8	—	1,689.3
	142.5	524.3	2,120.2	—	2,787.0
Investments and Other	5,017.8	—	144.0	(4,892.1)	269.7
Property					
Gas	—	2,164.4	5,475.0	—	7,639.4
Other	—	32.3	3,171.5	—	3,203.8
Accumulated depreciation and depletion	—	(434.7)	(2,830.2)	—	(3,264.9)
	—	1,762.0	5,816.3	—	7,578.3
Intercompany Accounts Receivable	969.1	80.8	1,682.9	(2,732.8)	—
Deferred Charges	1,942.3	502.0	1,358.2	—	3,802.5
Total Assets	$8,071.7	$2,869.1	$11,121.6	$(7,624.9)	$14,437.5
Liabilities and Capitalization					
Current Liabilities					
Accounts payable	$ 57.2	$ 118.9	$ 849.9	$ —	$ 1,026.0
Commercial paper	85.0	—	—	—	85.0
Other current liabilities	231.8	71.4	293.8	—	597.0
	374.0	190.3	1,143.7	—	1,708.0
Intercompany Accounts Payable	2.6	319.4	897.0	(1,219.0)	—
Deferred Credits and Other Liabilities					
Deferred income tax	(24.3)	407.0	793.7	—	1,176.4
Other deferred credits and liabilities	1,216.1	204.7	1,178.7	—	2,599.5
	1,191.8	611.7	1,972.4	—	3,775.9
Capitalization					
Common shareholders' equity	4,641.5	996.8	3,772.6	(4,892.1)	4,518.8
Long-term debt	1,861.8	750.9	3,320.2	(1,513.8)	4,419.1
Total Capitalization	6,503.3	1,747.7	7,092.8	(6,405.9)	8,937.9
Minority Interest in Consolidated Companies	—	—	15.7	—	15.7
Total Liabilities and Capitalization	$8,071.7	$2,869.1	$11,121.6	$(7,624.9)	$14,437.5

Balance Sheet

(In Millions of Dollars)

DECEMBER 31, 2005	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	ELIMINATIONS	CONSOLIDATED
Assets					
Current Assets					
Cash and temporary cash investments	$ 79.6	$ 3.5	$ 41.4	$ —	$ 124.5
Accounts receivable, net	0.6	149.9	822.2	—	972.7
Other current assets	4.0	368.9	1,550.0	—	1,922.9
	84.2	522.3	2,413.6	—	3,020.1
Investments and Other	4,571.0	0.7	128.2	(4,457.5)	242.4
Property					
Gas	—	—	7,275.9	—	7,275.9
Other	—	2,111.3	981.5	—	3,092.8
Accumulated depreciation and depletion	—	(400.6)	(2,631.2)	—	(3,031.8)
	—	1,710.7	5,626.2	—	7,336.9
Intercompany Accounts Receivable	2,813.6	44.6	95.6	(2,953.8)	—
Deferred Charges	482.5	316.1	2,414.6		3,213.2
Total Assets	$7,951.3	$2,594.4	$10,678.2	$(7,411.3)	$13,812.6
Liabilities and Capitalization					
Current Liabilities					
Accounts payable	$ 36.4	$ 149.7	$ 900.9	$ —	$ 1,087.0
Commercial paper	657.6	—	—	—	657.6
Other current liabilities	196.2	128.5	85.9	—	410.6
	890.2	278.2	986.8	—	2,155.2
Intercompany Accounts Payable	51.8	338.3	1,049.8	(1,439.9)	—
Deferred Credits and Other Liabilities					
Deferred income tax	27.2	330.6	800.1	—	1,157.9
Other deferred credits and liabilities	634.0	225.3	1,240.0	—	2,099.3
	661.2	555.9	2,040.1	—	3,257.2
Capitalization					
Common shareholders' equity	4,485.4	897.0	3,539.3	(4,457.6)	4,464.1
Long-term debt	1,862.7	525.0	3,046.9	(1,513.8)	3,920.8
Total Capitalization	6,348.1	1,422.0	6,586.2	(5,971.4)	8,384.9
Minority Interest in Consolidated Companies			15.3		15.3
Total Liabilities and Capitalization	$7,951.3	$2,594.4	$10,678.2	$(7,411.3)	$13,812.6

Statement of Cash Flows

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2006	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	CONSOLIDATED
Operating Activities				
Net Cash (Used in) Provided by Continuing Operating Activities	$ (68.1)	$ 112.6	$1,014.1	$1,058.6
Investing Activities				
Capital expenditures	—	(89.0)	(435.0)	(524.0)
Cost of removal	—	(7.7)	(24.9)	(32.6)
Proceeds from sale of property and investments	—	—	1.6	1.6
Derivative margin call	—	(15.2)	(18.7)	(33.9)
Net Cash (Used in) Continuing Investing Activities	—	(111.9)	(477.0)	(588.9)
Financing Activities				
Treasury stock issued	30.1	—	—	30.1
Issuance (payment) of debt, net	(572.6)	100.0	387.0	(85.6)
Common and preferred stock dividends paid	(325.3)	—	—	(325.3)
Intercompany dividend payments	8.4	—	(8.4)	—
Other	—	—	(2.5)	(2.5)
Net intercompany accounts	988.4	(69.5)	(918.9)	—
Net Cash Provided by (Used in) Continuing Financing Activities	129.0	30.5	(542.8)	(383.3)
Net Increase (Decrease) in Cash and Cash Equivalents	$60.9	$ 31.2	$ (5.7)	$ 86.4
Cash and Cash Equivalents at Beginning of Period	79.6	3.5	41.4	124.5
Cash and Cash Equivalents at End of Period	$ 140.5	$ 34.7	$ 35.7	$ 210.9

Statement of Cash Flows

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2005	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	CONSOLIDATED
Operating Activities				
Net Cash (Used in) Provided by Continuing Operating Activities	$ (327.7)	$ 168.5	$ 562.5	$ 403.3
Investing Activities				
Capital expenditures	—	(113.3)	(426.2)	(539.5)
Cost of removal	—	(2.6)	(25.2)	(27.8)
Proceeds from sale of property and investments	—	(2.1)	49.1	47.0
Derivative margin call	—	—	(8.9)	(8.9)
Net Cash (Used in) Continuing Investing Activities	—	(118.0)	(411.2)	(529.2)
Financing Activities				
Treasury stock issued	41.2	—	—	41.2
Common stock issued associated with MEDS conversion	460.0	—	—	460.0
Issuance (payment) of debt, net	(754.6)	—	(15.0)	(769.6)
Redemption of preferred stock	(75.0)	—	—	(75.0)
Common and preferred stock dividends paid	(308.4)	—	—	(308.4)
Dividend paid to parent	375.0	—	(375.0)	—
Other	(1.6)	—	(3.8)	(5.4)
Net intercompany accounts	90.0	(46.1)	(43.9)	—
Net Cash (Used in) Continuing Financing Activities	(173.4)	(46.1)	(437.7)	(657.2)
Net (Decrease) Increase in Cash and Cash Equivalents	$ (501.1)	$ 4.4	$ (286.4)	$ (783.1)
Net Cash Flow from Discontinued Operations	—	—	(14.4)	(14.4)
Cash and Cash Equivalents at Beginning of Period	580.7	(0.9)	342.2	922.0
Cash and Cash Equivalents at End of Period	$ 79.6	$ 3.5	$ 41.4	$ 124.5

Statement of Cash Flows

(In Millions of Dollars)

YEAR ENDED DECEMBER 31, 2004	GUARANTOR	KEDLI	OTHER SUBSIDIARIES	CONSOLIDATED
Operating Activities				
Net Cash (Used in) Provided by Continuing Operating Activities	$ (88.7)	$ 169.5	$ 669.3	$ 750.1
Investing Activities				
Capital expenditures	—	(108.7)	(641.6)	(750.3)
Cost of removal	—	(7.1)	(29.2)	(36.3)
Proceeds from sale of property and investments	—	—	1,021.3	1,021.3
Net Cash (Used in) Provided by Continuing Investing Activities	—	(115.8)	350.5	234.7
Financing Activities				
Treasury stock issued	33.4	—	—	33.4
Issuance (payment) of debt, net	(269.7)	—	(170.7)	(440.4)
Redemption of preferred stock	(8.5)	—	—	(8.5)
Net proceeds from sale/leaseback transaction	—	—	382.0	382.0
Common and preferred stock dividends paid	(291.1)	—	—	(291.1)
Gain on interest rate swap	12.7	—	—	12.7
Dividend paid to parent	447.6	(40.0)	(407.6)	—
Other	27.6	—	8.5	36.1
Net intercompany accounts	619.8	(16.2)	(603.6)	—
Net Cash Provided by (Used in) Continuing Financing Activities	571.8	(56.2)	(791.4)	(275.8)
Net Increase (Decrease) in Cash and Cash Equivalents	$ 483.1	$ (2.5)	$ 228.4	$ 709.0
Net Cash Flow from Discontinued Operations	—	—	9.6	9.6
Cash and Cash Equivalents at Beginning of Period	97.6	1.6	104.2	203.4
Cash and Cash Equivalents at End of Period	$ 580.7	$ (0.9)	$ 342.2	$ 922.0

Note 13. Summary of Quarterly Information (Unaudited)

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2006.

(In Millions of Dollars, Except Per Share Amounts)

QUARTER ENDED	3/31/06	6/30/06	9/30/06	12/31/06
Operating Revenue	2,661.1	1,377.7	1,218.5	1,924.3
Operating Income	389.1	107.5	135.8	195.1
Earnings for common stock	208.0	49.4 (a)	50.3	126.5 (b)
Basic earnings per common share	1.19	0.28	0.29	0.72
Diluted earnings per common share	1.18	0.28	0.29	0.71
Dividends declared	0.465	0.465	0.465	0.465

(a) and (b) Pursuant to indemnity obligations contained in the Long Island Lighting Company ("LILCO") / KeySpan merger agreement of May 1998, KeySpan had been working with the Internal Revenue Service ("IRS") to resolve certain disputes with regard to LILCO's tax returns for the tax years ended December 31, 1996 through March 31, 1999 and KeySpan's and The Brooklyn Union Gas Company's (d/b/a KEDNY) tax returns for the years ended September 30, 1997 through December 31, 1998. During the second quarter of 2006, two issues were settled. Accordingly, KeySpan reversed $9.5 million of previously established federal income tax reserves. A settlement of the remaining outstanding issues was reached in the fourth quarter and, following IRS procedure, the settlement was submitted to the Joint Committee on Taxation on October 30, 2006 for final approval, which is expected in early 2007. Accordingly, KeySpan reversed $35.0 million of previously established federal income tax reserves in the fourth quarter of 2006.

The following is a table of financial data for each quarter of KeySpan's year ended December 31, 2005

(In Millions of Dollars, Except Per Share Amounts)

QUARTER ENDED	3/31/05	6/30/05	9/30/05	12/31/05
Operating Revenue	2,480.5	1,342.5	1,303.1	2,535.9
Operating Income	438.7	103.2	102.8	263.1
Earnings from continuing operations, less preferred stock dividends	234.4	18.0	22.6	121.4
Cumulative change in accounting principles, net of tax	—	—	—	(6.6) (a)
Loss from discontinued operations	—	(1.8)	—	—
Earnings for common stock	234.4	16.2	22.6	114.8
Basic earnings per common share from continuing operations less preferred stock dividends	1.45	0.11	0.13	0.70
Basic earnings per common share from discontinued operations	—	(0.01)	—	—
Basic earnings per common share from cumulative change in accounting principles	—		—	(0.04) (a)
Basic earnings per common share	1.45	0.10	0.13	0.66
Diluted earnings per common share	1.44	0.09	0.13	0.65
Dividends declared	0.455	0.455	0.455	0.455

(a) Cumulative change in accounting principles for implementation of FASB Interpretation No. 47 ("FIN 47") "Accounting for Conditional Asset Retirement Obligations."

SELECTED FINANCIAL DATA

YEAR ENDED DECEMBER 31,	2006	2005	2004	2003	2002
				(In Millions of Dollars, Except Per Share Amounts)	
Income Summary					
Revenues					
Gas Distribution	$ 5,062.6	$ 5,390.1	$ 4,407.3	$ 4,161.3	$ 3,163.8
Electric Services	1,880.6	2,042.8	1,738.7	1,606.0	1,645.7
Energy Services	203.4	191.2	182.4	158.9	208.6
Energy Investments	35.0	37.9	322.1	609.3	447.1
Total revenues	7,181.6	7,662.0	6,650.5	6,535.5	5,465.2
Operating expenses					
Purchased gas for resale	3,331.5	3,597.3	2,664.5	2,495.1	1,653.3
Fuel and purchased power	548.6	752.1	540.3	414.6	395.9
Operations and maintenance	1,680.0	1,617.9	1,567.0	1,622.6	1,631.3
Depreciation, depletion and amortization	397.5	396.5	551.8	571.7	513.7
Operating taxes	411.2	407.1	404.2	418.2	380.5
Impairment Charges	—	—	41.0	—	—
Total operating expenses	6,368.8	6,770.9	5,768.8	5,522.2	4,574.7
Gain on sale of property	1.6	1.6	7.0	15.1	4.7
Income from equity investments	13.1	15.1	46.5	19.2	14.1
Operating income	827.5	907.8	935.3	1,047.6	909.3
Other income and (deductions)	(217.8)	(269.9)	4.9	(340.3)	(301.4)
Income taxes	175.5	239.3	325.5	281.3	229.6
Earnings from continuing operations	434.2	398.6	614.7	426.0	378.3
Discontinued Operations					
Income (loss) from operations, net of tax	—	(4.1)	(79.0)	(1.9)	15.7
Loss on disposal, net of tax	—	2.3	(72.0)	—	(16.3)
Loss from discontinued operations	—	(1.8)	(151.0)	(1.9)	(0.6)
Cumulative change in accounting principles	—	(6.6)	—	(37.4)	—
Net income	434.2	390.2	463.7	386.7	377.7
Preferred stock dividend requirements	—	2.2	5.6	5.8	5.8
Earnings for common stock	$ 434.2	$ 388.0	$ 458.1	$ 380.9	$ 371.9
Financial Summary					
Earnings per share ($)	2.48	2.28	2.86	2.41	2.63
Cash dividends declared per share ($)	1.86	1.82	1.78	1.78	1.78
Book value per share, year-end ($)	25.17	25.60	24.22	22.99	20.67
Market value per share, year-end ($)	41.18	35.69	39.45	36.80	35.24
Shareholders, year-end	65,398	68,421	72,549	75,067	78,281
Capital expenditures ($)	524.0	539.5	750.3	1,009.4	1,057.5
Total assets ($)	14,437.5	13,812.6	13,364.1	14,640.2	12,980.1
Common shareholders' equity ($)	4,518.8	4,464.1	3,894.7	3,670.7	2,944.6
Preferred stock redemption required ($)	—	—	75.0	75.0	75.0
Preferred stock no redemption required ($)	—	—	—	8.6	8.8
Long-term debt ($)	4,419.1	3,920.8	4,418.7	5,610.9	5,224.1
Total capitalization ($)	8,937.9	8,384.9	8,333.2	9,365.2	8,252.5

KEYSPAN CORPORATION DIRECTORS AND OFFICERS

BOARD OF DIRECTORS

Robert B. Catell
Chairman and
Chief Executive Officer
KeySpan Corporation

Stephen W. McKessy
Lead Director and
Retired Vice Chairman
PricewaterhouseCoopers

Andrea S. Christensen
Special Counsel
Kaye Scholer LLP

Robert J. Fani
President and
Chief Operating Officer
KeySpan Corporation

Alan H. Fishman
Sovereign Bank and
Former President and
Chief Executive Officer
Independence Community
Bank

James R. Jones
Co-Chairman and
Chief Executive Officer
Manatt Jones Global
Strategies, LLC

Dean James L. Larocca
Distinguished Professor
of Public Policy
Long Island University

Gloria C. Larson
Partner
Foley Hoag LLP

Edward D. Miller
Former President and
Chief Executive Officer
AXA Financial, Inc.

Vikki L. Pryor
President and
Chief Executive Officer
SBLI USA Mutual Life
Insurance Company, Inc.

COMMITTEES OF THE BOARD

Executive Committee

Robert B. Catell,
Chairman

Alan H. Fishman
James R. Jones
Stephen W. McKessy
Edward D. Miller

Audit Committee

Alan H. Fishman,
Chairman

Andrea S. Christensen
James L. Larocca
Stephen W. McKessy
Vikki L. Pryor

Compensation and Management Development Committee

Edward D. Miller,
Chairman

James R. Jones
James L. Larocca
Gloria C. Larson
Stephen W. McKessy

Corporate Governance and Nominating Committee

James R. Jones,
Chairman

Andrea S. Christensen
James L. Larocca
Gloria C. Larson
Edward D. Miller
Vikki L. Pryor

PRINCIPAL OFFICERS

Office of the Chairman

Robert B. Catell
Chairman and
Chief Executive Officer

Robert J. Fani
President and
Chief Operating Officer

Wallace P. Parker Jr.
President
Energy Delivery and
Customer Relationship
Group

Steven L. Zelkowitz
President
Energy Assets
and Supply Group

Executive Vice Presidents

John J. Bishar, Jr.
Executive Vice President,
General Counsel and
Chief Governance Officer

John A. Caroselli
Executive Vice President
and Chief Strategy Officer

Gerald Luterman
Executive Vice President
and Chief Financial Officer

David J. Manning
Executive Vice President
Corporate Affairs and
Chief Environmental
Officer

Anthony Nozzolillo
Executive Vice President
Electric Operations

Nickolas Stavropoulos
Executive Vice President
and President
KeySpan Energy Delivery

Senior Vice Presidents

Joseph F. Bodanza, Jr.
Senior Vice President
Regulatory Affairs and
Asset Optimization

Coleen A. Ceriello
Senior Vice President
Shared Services

John F. Haran
Senior Vice President
and Chief Engineer
KeySpan Energy Delivery

Michael J. Taunton
Senior Vice President,
Treasurer and
Chief Risk Officer

Anthony J. Sartor
President and
Chief Operating Officer
KeySpan Services

Elaine Weinstein
Senior Vice President
Human Resources and
Chief Diversity Officer

Other Officers

Theresa A. Balog
Vice President and
Chief Accounting Officer

Lawrence S. Dryer
Vice President and
General Auditor

Joseph E. Hajjar
Vice President and
Controller

Michael A. Walker
Vice President and
Deputy General Counsel

General Office

KeySpan Corporation
One MetroTech Center
Brooklyn, NY 11201-3850

Stock Listings

KeySpan common stock is traded primarily on the New York Stock Exchange (NYSE) under the trading symbol 'KSE.' Daily stock quotes are listed in most major newspapers under the heading 'KeySpan'.

KeySpan Investor Program ('Dividend Reinvestment Plan')

The KeySpan Investor Program is an Open Enrollment/Dividend Reinvestment Plan. The Plan offers individuals a convenient and cost effective way of purchasing KeySpan common stock. This Plan is open to everyone (NOT just existing shareholders). There is no enrollment fee for joining the Plan. We welcome your participation in the KeySpan Investor Program. If you are interested in receiving Program material, please contact KeySpan's Stock Transfer Agent, Computershare (electronic request line) at 1-866-238-5345 (1-866-2FULFIL).

To enroll in the Plan, individuals must complete an application and mail in an initial investment of at least $250, or authorize electronic deductions of at least $25. Individuals may also enroll in the Plan via our web site http://investor.keyspanenergy.com.

Parameters

Eligibility: Open Enrollment

Investment Fee: None

Initial Investment	**Ongoing Investment**
Minimum: $250	Minimum: $25
Maximum: $150,000	Maximum: $150,000

Investment Frequency: Weekly on Thursday
Source of Shares: Open Market (as of January 2004)
Sales Frequency: Daily
Sales Fee: $5.00 + 5 cents per share
Full or Partial Reinvestment: Yes
Electronic Debits/Credits: Yes
Safekeeping of Shares: Yes

Dividends

KeySpan paid an annual dividend of $1.86 in 2006. All of the dividends paid during the calendar year 2006 are considered to be ordinary dividend income and are therefore taxable (subject to review by the IRS). Tax Forms 1099Div were mailed in November 2006.

KeySpan's annual dividend for 2007 is $1.90 per share, payable quarterly at a rate of $0.475 per share.
Annual: $1.90 Per Share Payable Quarterly: At $0.475/Share

Declaration Date	Record Date	Payment Date
December 13, 2006	January 10, 2007	February 1, 2007
April 4, 2007	April 18, 2007	May 1, 2007
June 27, 2007	July 11, 2007	August 1, 2007
October 3, 2007	October 17, 2007	November 1, 2007
December 12, 2007	January 9, 2008	February 1, 2008

Stock Plans Group

Please direct inquiries to:
KeySpan Corporation Stock Plans Group
One MetroTech Center
22nd Floor
Brooklyn, NY 11201-3850
Call: 1-718-403-3131 Email: financial@keyspanenergy.com

Investor Relations

Inquiries from security analysts, stockbrokers, investment managers and other members of the financial community should be addressed to George Laskaris, Director of Investor Relations, at 1-718-403-2526, or by email, glaskaris@keyspanenergy.com. Company information, including financial reports, is available at **http://investor.keyspanenergy.com.**

Stock Transfer Agent and Registrar

Computershare Trust, N.A.
Investment Plan Services
P.O. Box 43069
Providence, RI 02940-3069
Call: 1-800-482-3638

Annual Report – Form 10K

The New York Stock Exchange (NYSE) Section 303A.12(a) Chief Executive Officer Certification was filed with the NYSE on September 7, 2006. KeySpan files reports with the Securities and Exchange Commission (SEC), including annual reports on Form 10K, quarterly reports on Form 10Q and any other filings required by the SEC. The most recent certifications by KeySpan's Chief Executive Officer and Chief Financial Officer pursuant to Sections 302 and 906 of the SarbanesOxley Act of 2002, were filed as exhibits to KeySpan's 2006 Form 10K.

Independent Registered Public Accountants

Deloitte & Touche LLP
2 World Financial Center
New York, NY 10281
1-212-436-2000

Web Address

For more information on KeySpan, or for copies of our press releases and quarterly reports, please visit our web site at **http://investor.keyspanenergy.com.**

Design: MGT Design, Inc. Printing: Georgian Press, NYC

This Annual Report is Printed on Recycled Paper

One MetroTech Center
Brooklyn, New York 11201
www.keyspanenergy.com

ENERGYNORTH NATURAL GAS, INC d/b/a NATIONAL GRID NH
Federal Income Tax Reconciliation
Puc 1604.01(a)(3)

	Test Year 12 Months Ending June 30, 2007
OPERATING INCOME BEFORE INCOME TAXES& INTEREST CHARGES	7,476,921
INTEREST CHARGES and OTHER CHARGES	3,000,384
OPERATING INCOME BEFORE INCOME TAXES	**4,476,537**
State Income Taxes	382,272
Permanent Differences	
Lobbying Expenses	(6,812)
Meals & Entertainmemt	(96)
Penalties & Fines	6,750
Medicare Income	20,938
Total Perm M's	**20,780**
Income Subject To Tax	**4,115,045**
Income Tax @35%	1,440,266
Accural To Return Adjustment	
Current	(294,618)
Deferred	303,807
Total	9,189
Federal Income Tax Expense	**1,449,455**
Timing Differences	
Deferred Gas Costs	3,487,990
Gain/<Loss> on Sale of Assets	95,276
AFUDC Debt	(127,738)
Pension Cost	1,077,059
Unbilled Revenue	4,589,307
Unamortized Debt Expense	28,898
Bad Debts	(4,066,237)
Gas Research Institute	(137,379)
Incentive Plan	(83,619)
OPEB/FASB 106	6,610
Performance Shares	(24,996)
Vacation Accrual	15,035
Environmental Clean Up Costs	(2,355,301)
Cathodic Protection	(39,640)
CIAC -- Deferral	660,376
Depreciation Expense -- Tax	(5,494,690)
Depreciation Expense -- Books	5,075,925
Removal Cost -- Deferral	230,495
Property Tax Deferral	2,100,000
Uniform Capitalization -- Section 263	(2,557,837)
UNICAP -- Self-Constructed Assets	(841,404)
Deferred State Income Taxes	(139,241)
Total Timing M's	**1,498,889**
Taxable Income	**5,613,934**
Current Income Tax @ 35%	1,964,877
Current Accural To Return Adjustment	(294,618)
Current Income Tax Expense	**1,670,259**
Deferred Income Tax Expense	(524,611)
Deferred Accural To Return Adjustment	303,807
Deferred Income Tax Expense	**(220,804)**
Total Income Tax Expense Deferred & Current	**1,449,455**

ENERGYNORTH NATURAL GAS, INC d/b/a NATIONAL GRID NH
Computation of NH and Federal Income Tax Factors
Puc 1604.01(a)(4)

The following formula calculates the required increment of revenue needed to produce a given increment of net operating income:

$$R = \frac{1}{(1-(STR+(FTR x(1-.STR))))}$$

Where:

STR = New Hampshire State Tax Rate = 8.5%
FTR = Federal Tax Rate = 35%

Therefore: $$R = \frac{1}{(1-(.085+(.35x(1-.085))))}$$

Or $$R = \frac{1}{(1-(.085+(.32025))}$$

Or $$R = \frac{1}{(1-.40525)}$$

Or $$R = \frac{1}{0.59475}$$

Or $$R = 1.6814$$

ENERGYNORTH NATURAL GAS, INC d/b/a NATIONAL GRID NH
Donations
Test Year Expenditures in Excess of $5,000
PUC 1604.01(a)(5)

Project	Proj Description	Activity	Activity Description	Account	Account Description	Cost Type	CT Description	Provider Cost Center	Provider Company *	Amount
K02158	Community Affairs NE	002467	SPONSORSHIP	9210K	Office Supplies and Expenses	777	SPONSORSHIPS	345 CORPORATE AFFAIRS	KEYSPAN CORPORATE SERVICES (31)	22,575.77
K02158	Community Affairs NE	002493	CONTRIBUTIONS	4261K	Donations	777	SPONSORSHIPS	345 CORPORATE AFFAIRS	KEYSPAN CORPORATE SERVICES (31)	13,950.00
K02158	Community Affairs NE	002493	CONTRIBUTIONS	4261K	Donations	778	CONTRIBUTIONS	345 CORPORATE AFFAIRS	KEYSPAN CORPORATE SERVICES (31)	6,077.56

* Note: These charges all represent Service Company allocations of EnergyNorth's share of Donations. Specific details are maintained in the Service Company and will be furnished upon request.

ENERGYNORTH NATURAL GAS, INC d/b/a NATIONAL GRID NH
Advertising
Test Year Expenditures in Excess of $5,000
PUC 1604.1 (a)(6)

Project	Proj Description	Activity	Activity Description	Account	Account Description	Cost Type	Cost Type Description	Provider Cost Center	Provider Company *	Test Year
K00572	CONS COMM N.E.	004657	CONS COMM&ADV-ENERGY NORTH	9100K	Customer Assistance Expenses	375	ADVERTISING - OTHER	153 PUBLIC AFFAIRS	KEYSPAN CORPORATE SERVICES (31)	**15,124.82**
K02093	Program Management NE	003762	RESIDENTIAL SALES COLLATERAL	91200	SALES-DEMONST & SELL EXP	375	ADVERTISING - OTHER	207 Program Management NE	KEYSPAN CORPORATE SERVICES (31)	**5,443.43**
K02272	Program Mgmt - Advertising NE	003277	ADVERTISING CHARGES	91300	SALES-ADVERTISING EXP	375	ADVERTISING - OTHER	207 Program Management NE	KEYSPAN CORPORATE SERVICES (31)	**20,565.99**
K02272	Program Mgmt - Advertising NE	003277	ADVERTISING CHARGES	91300	SALES-ADVERTISING EXP	378	ADVERTISING - DIRECT MAIL	207 Program Management NE	KEYSPAN CORPORATE SERVICES (31)	**44,699.82**
K02272	Program Mgmt - Advertising NE	003283	PROPERTY TAX ALLOCATION STUDY	91300	SALES-ADVERTISING EXP	375	ADVERTISING - OTHER	207 Program Management NE	KEYSPAN CORPORATE SERVICES (31)	**15,054.05**
K02272	Program Mgmt - Advertising NE	003758	COMM & INDUST OUTBOUND TELEMKT	91200	SALES-DEMONST & SELL EXP	378	ADVERTISING - DIRECT MAIL	207 Program Management NE	KEYSPAN CORPORATE SERVICES (31)	**9,533.66**
K03664	MARKETING MEDIA	004870	KEDNE - OTHER	9170K	Promotional Advertising Expenses	376	ADVERTISING - TELEVISION & RADIO	051 STRATEGIC MARKETING	KEYSPAN CORPORATE SERVICES (31)	**61,321.92**
										171,743.69

* Note: These charges all represent Service Company allocations of EnergyNorth's share of common Advertising costs. Specific details are maintained in the Service Company and will be furnished upon request.

Cost of Service Study
(1604.01(a)(7))

See Attachment GLG-RD-3 to
Testimony of Gary Goble on Rate Design

Most Recent Construction Budget
(1604.01(a)(8))

See #22

Chart of Accounts
(1604.01(a)(9))

Conversion from FERC Chart of Accounts to PUC Chart of Accounts