**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

# FORM 10-K

**[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2005

**Commission file number 1-14161**

## KEYSPAN CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **NEW YORK** | **11-3431358** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **One MetroTech Center, Brooklyn, New York** | **11201** |
| **175 East Old Country Road, Hicksville, New York** | **11801** |
| (Address of principal executive offices) | (Zip code) |

**(718) 403-1000 (Brooklyn)**
**(516) 755-6650 (Hicksville)**

(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Stock, $.01 par value | New York Stock Exchange |
| | Pacific Stock Exchange |

**SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:**
None
(Title of class)

Indicate by check mark if the registrant is a well known seasoned issuer, as defined in Rule 405 of the Securities Act.

_X_ Yes ___ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

__ Yes _X_ No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

_X_ Yes ___ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. __ Yes _X_ No

Indicate by check mark whether the registrant is a large accelerated filer, or a non-accelerated filler.

Large accelerated filer _X_ Accelerated filer ___ Non-accelerated filer ___

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). __ Yes _X_ No

The aggregate market value of the voting and non-voting common equity held by non-affiliates (174,014,400 shares) of the registrant was $7,150,251,696 based on the closing price of the New York Stock Exchange on February 23, 2006, of $41.09 per share.

As of February 23, 2006, there were 174,573,840 shares of common stock, $.01 par value, outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

The Proxy Statement dated on or about March 31, 2006 is incorporated by reference into Part III, Items 10, 11, 12 and 13 hereof.

**KEYSPAN CORPORATION**
**INDEX TO FORM 10-K**

Page

**PART I**



**PART II**



**PART III**

# PART I

## ITEM 1. BUSINESS

## CORPORATE OVERVIEW

KeySpan Corporation (“KeySpan”) is a member of the Standard and Poor’s 500 Index. KeySpan is a New York corporation and a holding company under the Public Utility Holding Company Act of 2005 (“PUHCA 2005”). KeySpan 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, we acquired Eastern Enterprises (“Eastern”), now known as KeySpan New England, LLC (“KNE”), a Massachusetts limited liability company, which primarily owns Boston Gas Company (“Boston Gas”), Colonial Gas Company (“Colonial Gas”) and Essex Gas Company (“Essex Gas”), gas utilities operating in Massachusetts, as well as EnergyNorth Natural Gas, Inc. (“EnergyNorth”), a gas utility operating principally in central New Hampshire. 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 (“LNG”) 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.

### 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 $.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 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 Federal Energy Regulatory Commission ("FERC") pursuant to PUHCA 2005. See "Regulation and Rate Matters" for additional information on the Energy Act and PUHCA 2005. As used herein, "KeySpan," "we," "us" and "our" refers to KeySpan, its six principal gas distribution subsidiaries, and its other regulated and unregulated subsidiaries, individually and in the aggregate.

Under our holding company structure, we have no independent operations and conduct substantially all of our operations through our subsidiaries. Our subsidiaries operate in the following four business segments: Gas Distribution, Electric Services, Energy Services and Energy Investments.

The Gas Distribution segment consists of our six regulated gas distribution subsidiaries, which operate in New York, Massachusetts and New Hampshire and serve approximately 2.6 million customers.

The Electric Services segment consists of subsidiaries that manage the electric transmission and distribution system ("T&D System") owned by LIPA; provide generating capacity and, to the extent required, energy conversion services for LIPA from our approximately 4,200 megawatts ("MW") of generating facilities located on Long Island; and manage fuel supplies for LIPA to fuel our Long Island generating facilities. The Electric Services segment also includes subsidiaries that own, lease and operate the 2,200 MW Ravenswood electric generation facility (the "Ravenswood Facility"), located in Queens County in New York City, and the 250 MW combined cycle generating unit (the "Ravenswood Expansion") which began full commercial operation in May 2004 (collectively, the Ravenswood Facility and the Ravenswood Expansion are referred to herein as the "Ravenswood Generating Station" and have a total electric capacity of 2,450 MW). Moreover, subsidiaries in this segment also provide retail marketing of electricity to commercial customers.

The Energy Services segment provides energy-related services to customers primarily located within the Northeastern United States, with concentrations in the New York City and Boston metropolitan areas. During January and February 2005, we disposed of our ownership interests in companies engaged in mechanical contracting activities under this segment.

The Energy Investments segment includes our gas exploration and production activities, domestic pipelines, gas storage facilities and LNG facilities and operations.

KeySpan's strategic vision is to be the premier energy company in the Northeastern United States. KeySpan is the largest gas distribution company in the Northeast and the fifth largest in the United States. KeySpan's size and scope enables it to provide enhanced cost-effective customer service; to offer our existing customers other services and products by building upon our existing customer relationships; and to capitalize on growth opportunities for natural gas expansion in the Northeast by expanding our infrastructure, primarily on Long Island and in New England.

KeySpan's principal executive offices are located at One MetroTech Center, Brooklyn, New York 11201 and 175 East Old Country Road, Hicksville, New York 11801, and its telephone numbers are (718) 403-1000 (Brooklyn) and (516) 755-6650 (Hicksville).

KeySpan makes available free of charge on or through its website, http://www.keyspanenergy.com (Investor Relations section), its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. You may also read and copy any of these documents at the SEC's public reference room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public on the SEC's web site at www.sec.gov.

## GAS DISTRIBUTION OVERVIEW

Our gas distribution activities are conducted by our six regulated gas distribution subsidiaries, which operate in three states in the Northeast: New York, Massachusetts and New Hampshire. We are the fifth largest gas distribution company in the United States and the largest in the Northeast, with approximately 2.6 million customers served within an aggregate service area covering 4,273 square miles. In New York, The Brooklyn Union Gas Company, doing business as KeySpan Energy Delivery New York ("KEDNY") provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Queens and Staten Island; and KeySpan Gas East Corporation doing business as KeySpan Energy Delivery Long Island ("KEDLI") provides gas distribution services to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. In Massachusetts, Boston Gas provides gas distribution services in eastern and central Massachusetts; Colonial Gas provides gas distribution services on Cape Cod and in eastern Massachusetts; and Essex Gas provides gas distribution services in eastern Massachusetts. In New Hampshire, EnergyNorth provides gas distribution services to customers principally located in central New Hampshire. Our New England gas companies all do business as KeySpan Energy Delivery New England ("KEDNE").

In New York, there are two separate, but contiguous service territories served by KEDNY and KEDLI, comprising approximately 1,417 square miles and 1.68 million customers. In Massachusetts, Boston Gas, Colonial Gas and Essex Gas serve three service territories consisting of 1,934 square miles and approximately 792,000 customers. In New Hampshire, EnergyNorth has a service territory that is contiguous to Colonial Gas' and ranges from within 30 to 85 miles of the greater Boston area. EnergyNorth provides service to approximately 80,000 customers over a service area of approximately 922 square miles. Collectively, KeySpan owns and operates gas distribution, transmission and storage systems that consist of approximately 23,336 miles of gas mains and distribution pipelines.

Natural gas is offered for sale to residential and small commercial customers on a "firm" basis, and to most large commercial and industrial customers on either a "firm" or "interruptible" basis. "Firm" service is offered to customers under tariffed schedules or contracts that anticipate no interruptions, whereas "interruptible" service is offered to customers under tariffed schedules or contracts that anticipate and permit interruption on short notice, generally in peak-load seasons or for system reliability reasons. We maintain a diverse portfolio of firm gas supply, storage and pipeline transportation capacity contracts to adequately serve the requirements of our gas sales customers, to maintain system reliability and system operations, and to meet our obligation to serve. We also engage in the use of derivative financial instruments from time to time to reduce the cash flow volatility associated with the purchase price for a portion of future natural gas purchases.

KeySpan actively promotes a competitive retail gas market by offering tariff firm transportation services to firm gas customers who elect to purchase their gas supplies from natural gas marketers rather than from the utility. In New York, KeySpan further facilitates competition by releasing its pipeline transportation capacity and offering bundled gas supply to natural gas marketers that would otherwise not be able to obtain their own capacity. In Massachusetts and New Hampshire, there are mandatory capacity assignment programs in place whereby capacity is released to natural gas marketers on behalf of customers they serve. However, net gas revenues are not significantly 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.

KeySpan also participates in interstate markets by releasing pipeline capacity and by selling bundled gas services to customers located outside of our service territory ("off-system" customers).

KeySpan purchases natural gas for firm gas customers under both long and short-term supply contracts, as well as on the spot market, and utilizes its firm pipeline transportation contracts to transport the gas from the point of purchase to the market. KeySpan also contracts for firm capacity in natural gas underground storage facilities to store gas during the summer for later withdrawal during the winter heating season when gas customer demand is higher. KeySpan also contracts for firm winter peaking supplies to meet firm gas customer demand on the coldest days of the year.

KeySpan sells gas to firm gas customers at its cost for such gas, plus a charge designed to recover the costs of distribution (including a return of and a return on capital invested in our distribution facilities). We share with our firm gas customers net revenues (operating revenues less the cost of gas and associated revenue taxes) from off-system sales and capacity release transactions. Further, net revenues from tariff gas balancing services and certain interruptible on-system sales are refunded, for most of our subsidiaries, to firm customers subject to certain sharing provisions.

Our gas operations can be significantly affected by seasonal weather conditions. Annual revenues are substantially realized during the heating season as a result of higher sales of gas due to cold weather. Accordingly, operating results historically are most favorable in the first and fourth calendar quarters. 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 tariffs for our four KEDNE gas distribution companies do not contain such a weather normalization adjustment and, therefore, fluctuations in seasonal weather conditions between years may have a significant effect on results of operations and cash flows for these four subsidiaries. We utilize weather derivatives for KEDNE to mitigate variations in firm net revenues due to fluctuations in weather.

**New York Gas Distribution Systems – KEDNY and KEDLY Supply and Storage**

KEDNY and KEDLI have firm long-term contracts for the purchase of transportation and underground storage services. Gas supplies are purchased under long and short-term firm contracts, as well as on the spot market. Gas supplies are transported by interstate pipelines from domestic and Canadian supply basins. Peaking supplies are available to meet system requirements on the coldest days of the winter season.

***Peak-Day Capability.*** The design criteria for the New York gas system assumes an average temperature of 0ºF for peak-day demand. Under such criteria, we estimate that the requirements to supply our firm gas customers would amount to approximately 2,093 MDTH (one MDTH equals 1,000 DTH or 1 billion British Thermal Units) of gas for a peak-day during the 2005/06 winter season and that the gas available to us on such a peak-day amounts to approximately 2,177 MDTH.

The highest daily throughput most recently experienced occurred on January 15, 2006 in which the demand of the firm New York customers was 1,654 MDTH, and the average temperature was 20°F. KEDNY and KEDLI have sufficient gas supply available to meet the requirements of their firm gas customers for the 2005/06 winter season.

Our New York firm gas peak-day capability is summarized in the following table:

| Source | MDTH per day | % of Total |
|---|---|---|
| Pipeline | 842 | 39% |
| Underground Storage | 800 | 37% |
| Peaking Supplies | 535 | 24% |
| Total | 2,177 | 100% |

***Pipelines.*** Our New York based gas distribution utilities purchase natural gas for sale under contracts with suppliers of natural gas located in domestic and Canadian supply basins and arrange for its transportation to our facilities under firm long-term contracts with interstate pipeline companies. For the 2005/06 gas year, approximately 73% of our New York natural gas supply was available from domestic sources and 27% from Canadian sources. We have available under firm contract 842 MDTH per day of year-round and seasonal pipeline transportation capacity. Our major providers of interstate pipeline capacity and related services include: Transcontinental Gas Pipe Line Corporation ("Transco"), Texas Eastern Transmission Corporation ("Tetco"), Iroquois Gas Transmission System, L.P. ("Iroquois"), Tennessee Gas Pipeline Company ("Tennessee"), Dominion Transmission Incorporated ("Dominion"), and Texas Gas Transmission Company.

***Underground Storage.*** In order to meet winter demand in our New York service territories, we also have long-term contracts with Transco, Tetco, Tennessee, Dominion, Equitrans, Inc., National Fuel Gas Supply Corporation ("National Fuel") and Honeoye Storage Corporation ("Honeoye") for underground storage capacity of 60,766 MDTH and 800 MDTH per day of maximum deliverability.

***Peaking Supplies.*** In addition to the pipeline and underground storage supply, we supplement our winter supply portfolio with peaking supplies that are available on the coldest days of the year to economically meet the increased requirements of our heating customers. Our peaking supplies include: (i) two LNG plants; (ii) peaking supply contracts with dual-fuel power producers located in our franchise areas; and (iii) peaking supply contracts with suppliers located outside our franchise area. For the 2005/06 winter season, we have the capability to provide maximum peaking supplies of 535 MDTH on extremely cold days. The LNG plants provide us with peak-day capacity of 394 MDTH and winter season availability of 2,053 MDTH. The peaking supply contracts with the dual fuel power producers provide us with peak-day capacity of 140 MDTH and winter season availability of 3,446 MDTH.

***Gas Supply Management.*** We currently perform our New York-based gas supply management services internally.

***Gas Costs.*** The current gas rate structure of each of these companies includes a gas adjustment clause pursuant to which variations between actual gas costs incurred and gas costs billed are deferred and subsequently refunded to or collected from firm customers.

***Combined Gas Supply Portfolios.*** Effective November 1, 2005 the New York Department of Public Service authorized KEDNY and KEDLI to combine the planning, management and utilization of their respective gas supply portfolios to enable each company to serve its customers more reliably and cost effectively. Specifically, these companies plan the acquisition of incremental pipeline capacity, underground storage, gas supply and peaking supply contracts to meet projected growth in firm customer demand on a combined portfolio basis. This approach enables these companies to realize synergies that would otherwise not be attainable if they were to plan independently for the development of their respective portfolios. These two companies, by virtue of their geographic proximity, complementary customer demand profiles and similar gas contracts are able to add incremental capacity more effectively to meet expected customer demand growth by planning the portfolios on a combined basis.

***Deregulation.*** Regulatory actions, economic factors and changes in customers and their preferences continue to reshape our gas operations. A number of customers currently purchase their gas supplies from natural gas marketers and then contract with us for local transportation, balancing and other unbundled services. In addition, our New York gas distribution companies release firm capacity on our interstate pipeline transportation contracts to natural gas marketers to ensure the marketers' gas supply is delivered on a firm basis and in a reliable manner. As of January 1, 2006, approximately 105,334 gas customers on the New York gas distribution system are purchasing their gas from marketers. However, net gas revenues are not significantly 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.

**New England Gas Distribution Systems – KEDNE Supply and Storage**

KEDNE has firm long-term contracts for the purchase of transportation and underground storage services. Gas supplies are purchased under long and short-term firm contracts, as well as on the spot market. Gas supplies are transported by interstate pipelines from domestic and Canadian supply basins. Peaking supplies are available to meet system requirements on the coldest days of the winter season.

***Peak-Day Capability.*** The design criteria for the New England gas systems assumes an average temperature of -6ºF in Massachusetts and -8ºF in New Hampshire for peak-day demand. Under such criteria, we estimate that the requirements to supply our firm gas customers would amount to approximately 1,361 MDTH of gas for a peak-day during the 2005/06 winter season and that the gas available to us on such a peak-day amounts to approximately 1,420 MDTH.

The highest daily throughput most recently experienced occurred on January 15, 2006 in which the demand of the firm New England customers (which includes both firm sales and firm transportation) was 1,015 MDTH, and the average temperature was 15ºF. KEDNE has sufficient gas supply available to meet the requirements of their firm gas customers for the 2005/06 winter season.

Our New England firm gas peak-day capability is summarized in the following table:

| Source | MDTH per day | % of Total |
|---|---|---|
| Pipeline | 500 | 35% |
| Underground Storage | 248 | 18% |
| Peaking Supplies | 672 | 47% |
| Total | 1,420 | 100% |

***Pipelines.*** Our New England based gas distribution utilities purchase natural gas for sale under contracts with suppliers of natural gas located in domestic and Canadian supply basins and arrange for transportation to our facilities under firm long-term contracts with interstate pipeline companies. We have available under firm contract 500 MDTH per day of year-round and seasonal pipeline transportation capacity. Our major providers of interstate pipeline capacity and related services include: Algonquin Gas Transmission Company, Iroquois, Maritimes and Northeast Pipelines, Portland Natural Gas Transmission System, Tennessee and TETCO.

***Underground Storage.*** In order to meet winter demand in our New England service territories, we also have long-term contracts with Tetco, Tennessee, Dominion, National Fuel and Honeoye for underground storage capacity of 23,280 MDTH and 248 MDTH per day of maximum deliverability.

***Peaking Supplies.*** In addition to the pipeline and underground storage supply, we supplement our winter supply portfolio with peaking supplies that are available on the coldest days of the year to economically meet the increased requirements of our heating customers. Our peaking supplies include (i) local production plants that store LNG and liquid propane until vaporized, which are located strategically across the service territory; (ii) contracts for LNG storage and delivery with our LNG subsidiary, KeySpan LNG LP, located in Providence, Rhode Island; and (iii) Distrigas of Massachusetts located in Everett, Massachusetts. For the 2005/06 winter season, we have the capability to provide maximum peaking supplies of 672 MDTH on extremely cold days.

***Gas Supply Management.*** 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. This agreement has a three year term expiring on March 31, 2006. A new three year agreement has been negotiated between Merrill Lynch and the Massachusetts KEDNE utilities, whereby Merrill Lynch will assist in the origination, structuring, valuation and execution of energy related transactions for the Massachusetts portfolio. This agreement is pending approval by the Massachusetts Department of Telecommunications and Energy ("MADTE"). In New Hampshire, these services will be provided by KeySpan employees.

***Gas Costs.*** The current gas rate structure of each of these companies includes a gas adjustment clause pursuant to which variations between actual gas costs incurred and gas costs billed are deferred and subsequently refunded to or collected from firm customers.

For additional information and for financial information concerning the gas distribution segment, see the discussion in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – "Gas Distribution" and Note 2 to the Consolidated Financial Statements, "Business Segments".

## ELECTRIC SERVICES OVERVIEW

We are the largest electric generator in New York State. Our subsidiaries own and operate 5 large generating plants and 10 smaller facilities which are comprised of 57 generating units in Nassau and Suffolk Counties on Long Island and the Rockaway Peninsula in Queens. In addition, we own, lease and operate the Ravenswood Generating Station located in Queens County, which is the largest generating facility in New York City. The Ravenswood Generating Station is comprised of 3 large steam-generating units, a recently completed 250 MW combined cycle generating unit and 17 gas turbine generators. We also operate and maintain a 55 MW gas turbine unit in Greenport, Long Island under an agreement with a third party.

As more fully described below, we: (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 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 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; (ii) a new Option and Purchase and Sale Agreement (the “2006 Option Agreement”), which allows LIPA to purchase either or both of KeySpan’s Barrett and Far Rockaway generating stations and which replaces 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”. In the event LIPA exercises its rights under the 2006 Option Agreement, KeySpan and LIPA will enter into an operation and maintenance agreement, pursuant to which KeySpan would continue to operate the subject generating units, as well as related amendments to the 1998 PSA and 1998 EMA. The 2006 LIPA Agreements will become effective as of January 1, 2006, following receipt of all necessary governmental approvals, which are pending. The effectiveness of each of the 2006 LIPA Agreements is conditioned upon all of the 2006 LIPA Agreements becoming effective.

Portions of our Electric Services business can be affected by seasonal weather conditions and market conditions. The majority of the capacity revenue associated with the Ravenswood Generating Station is realized during the six months between May and October of each year. Energy and ancillary service sales from our Ravenswood Generating Station are directly correlated to the demand for electricity and competition from other resources. Typically, the demand and price for electricity increases during extreme temperature conditions. However, depending on the availability of alternative competitive supply, extreme temperature conditions may not result in increased revenue. As a result, fluctuations in weather and competitive supply between years may have a significant effect on our results of operations for our Electric Services business.

### Generating Facility Operations

In June 1999, we acquired the 2,200 MW Ravenswood Facility located in New York City from Consolidated Edison Company of New York, Inc. (“Consolidated Edison”) for approximately \$597 million. In order to reduce our initial cash requirements to finance this acquisition, we entered into an arrangement with an unaffiliated variable interest entity through which we lease a portion of the Ravenswood Facility. Under the arrangement, the variable interest entity acquired a portion of the facility directly from Consolidated Edison and leased it to our wholly owned subsidiary, KeySpan-Ravenswood, LLC (“KSR”). For more information concerning this lease arrangement, see Note 7 to the Consolidated Financial Statements, “Contractual Obligations, Financial Guarantees and Contingencies.”

In 2004, we completed construction of the Ravenswood Expansion, a 250 MW combined cycle generating unit at the Ravenswood Facility, thereby increasing the total electric capacity of the Ravenswood Facility to 2,450 MW. In mid-May 2004, the Ravenswood Expansion began full commercial operations. To finance the Ravenswood Expansion, we entered into a leveraged lease financing arrangement pursuant to which the Ravenswood Expansion was acquired by an unaffiliated lessor from KSR and simultaneously leased back to it. This lease transaction qualifies as an operating lease under SFAS 98. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation – "Electric Services Revenue Mechanisms" for a further discussion of these matters.

The Ravenswood Generating Station sells capacity, energy and ancillary services into the New York Independent System Operator ("NYISO") electricity market at market-based rates, subject to mitigation. The Ravenswood Generating Station Facility has the ability to provide approximately 25% of New York City's capacity requirements and is a strategic asset that is available to serve residents and businesses in New York City.

**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 9, 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 9th 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 cannot, 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.

KeySpan continues to believe that New York City represents a strong capacity market and has entered into an International Swap Dealers Association ("ISDA") Master Agreement for a fixed for float unforced capacity financial swap (the "Swap Agreement") with Morgan Stanley Capital Group Inc. ("Morgan Stanley") dated as of January 18, 2006. The Swap 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. Settlement would 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.

The New York State competitive wholesale market for capacity, energy and ancillary services administered by the NYISO is still evolving and FERC has adopted several price mitigation measures which are subject to rehearing and possible judicial review. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation – "Regulatory Issues and Competitive Environment" for a further discussion of these matters.

Forty-six of our seventy-eight generating units are dual fuel units. In recent years, we have reconfigured several of our facilities to enable them to burn either natural gas or oil, thus enabling us to switch periodically between fuel alternatives based upon cost and seasonal environmental requirements. Through other innovative technological approaches, we instituted a program to reduce nitrogen oxides for improved environmental performance while recovering 80 MW of energy output.

The following table indicates the 2005 summer capacity of all of our steam generation facilities and gas turbine ("GT") units as reported to the NYISO:

| Location of Units | Description | Fuel | Units | MW |
|---|---|---|---|---|
| Long Island City | Steam Turbine | Dual* | 3 | 1737 |
| Long Island City | Combined Cycle | Dual* | 1 | 226 |
| Northport, L.I. | Steam Turbine | Dual* | 4 | 1550 |
| Port Jefferson, L.I. | Steam Turbine | Dual* | 2 | 388 |
| Glenwood, L.I. | Steam Turbine | Gas | 2 | 240 |
| Island Park, L.I. | Steam Turbine | Dual* | 2 | 396 |
| Far Rockaway, L.I. | Steam Turbine | Dual* | 1 | 110 |
| Long Island City | GT Units | Dual* | 17 | 438 |
| Glenwood and Port Jefferson Energy Center, L.I. | GT Units | Dual | 4 | 154 |
| Throughout L.I. | GT Units | Dual* | 12 | 301 |
| Throughout L.I. | GT Units | Oil | 30 | 1060 |
| TOTAL | | | 78 | 6600 |

*Dual - Oil (#2 oil or #6 residual oil) or kerosene, and natural gas.

For additional information and for financial information concerning the Electric Services segment, see the discussion in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – "Electric Services" and Note 2 to the Consolidated Financial Statements, "Business Segments".

## Agreements with LIPA

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, the 1998 MSA, 1998 PSA and 1998 EMA. Under these agreements, as well as through additional power purchase agreements, KeySpan provides: 4,214 MW of power generation capacity and energy conversion services; operation, maintenance and capital improvement services for LIPA's transmission and distribution system; and energy management services.

On February 1, 2006, KeySpan and LIPA entered into the 2006 LIPA Agreements which will become effective as of January 1, 2006, following receipt of all necessary governmental approvals, which are pending. The effectiveness of each of the 2006 LIPA Agreements is conditioned upon all of the 2006 LIPA Agreements becoming 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 agreements effective in May 1998. 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 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 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 KeySpan's interest in KeySpan Generation LLC, which includes 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. LIPA was initially required to exercise its option by May 2005, but KeySpan and LIPA agreed to extend the date by which LIPA was to make this determination to December 15, 2005. Pursuant to the December 2005 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 which are pending governmental approvals. In the event such agreements do not become effective by reason of failure to secure 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 would 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.

It is also contemplated that to the extent any emission credits attributable to the acquired facilities are not needed to satisfy the operating requirements of such plants, such excess emissions credits will be pooled and applied pro rata to satisfy the operating requirements of KeySpan's generating facilities subject to the amended PSA. Thereafter, any remaining credits attributable to the acquired plants may be sold by LIPA, who shall retain 100% of the net proceeds.

***Management Services Agreement.*** Pursuant to the 1998 MSA, we perform day-to-day operation and maintenance services and capital improvements for LIPA's transmission and distribution system, including, among other functions, transmission and distribution facility operations, customer service, billing and collection, meter reading, planning, engineering, and construction, all in accordance with policies and procedures adopted by LIPA. KeySpan furnishes such services as an independent contractor and does not have any ownership or leasehold interest in the transmission and distribution system.

In exchange for providing these services, we are reimbursed for our budgeted costs and entitled to earn an annual management fee of $10 million and may also earn certain cost-based incentives, or be responsible for certain cost-based penalties. The incentives provided us the ability to retain 100% of the first $5 million of budget underruns and 50% of any additional budget underruns up to 15% of the total cost budget. Thereafter, all savings accrued to LIPA. The penalties required us to absorb any total cost budget overruns up to a maximum of $15 million in any contract year.

In addition to the foregoing cost-based incentives and penalties, the agreement provided for performance-based incentives for performance above certain threshold target levels and subject to disincentives for performance below certain other threshold levels, with an intermediate band of performance in which neither incentives nor disincentives apply, for system reliability, worker safety, and customer satisfaction. In 2005, we earned $7.4 million in non-cost performance incentives.

The 1998 MSA was originally set to expire on May 28, 2006, but in 2005 it was extended through December 31, 2008, in connection with the extension of the option period under the GPRA as was more fully described in the discussion on "Generation Purchase Rights Agreement and 2006 Option Agreement" above.

As a result of the recent negotiations and settlement between KeySpan and LIPA discussed above, the parties entered into a 2006 MSA. Under the 2006 MSA, KeySpan will continue to perform the day-to-day operation and maintenance services and capital improvements on LIPA's

T&D System, including among other functions, T&D facility operations, customer service, meter reading, planning, engineering, and construction, all in accordance with prudent utility practice and policies and procedures adopted by LIPA. The 2006 MSA will not become effective unless and until all governmental approvals are received and, only if all of the 2006 LIPA Agreements are approved. If all governmental approvals are received, then the 2006 MSA will be implemented with an effective date of January 1, 2006 and will operate through December 31, 2013.

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.

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.

Should LIPA sell 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.

***Power Supply Agreement.*** A KeySpan subsidiary sells to LIPA all of the capacity and, to the extent requested, energy conversion services from our 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 terms of the PSA. Since October 1, 2004, pursuant to a FERC approved settlement, the rates reflect a cost of equity of 9.5% with no revenue increase in the first year of the new rate period. 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 basis and is dependent on the number of megawatt hours ("MWh") 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. In 2005, we earned $4 million in incentives under the PSA.

The 1998 PSA runs for an original term of 15 years, expiring in 2013. The 1998 PSA has a renewal provision for an additional 15 years on similar terms at LIPA's option. However, the 1998 PSA provides LIPA the option of electing to reduce or "ramp-down" the capacity it purchases from us in accordance with agreed-upon schedules. In years 7 through 10 of the 1998 PSA, if LIPA elects to ramp-down, we are entitled to receive payment for 100% of the present value of the capacity charges otherwise payable over the remaining term of the 1998 PSA. If LIPA ramps-down the generation capacity in years 11 through 15 of the 1998 PSA, the capacity charges otherwise payable by LIPA will be reduced in accordance with a formula established in the 1998 PSA. If LIPA exercises its ramp-down option, KeySpan may use any capacity released by LIPA to bid on new LIPA capacity requirements or to replace other ramped-down capacity. If we continue to operate the ramped-down capacity, the 1998 PSA requires us to use reasonable efforts to market the capacity and energy from the ramped-down capacity and to share any profits with LIPA. The 1998 PSA will be terminated in the event that LIPA purchases, at fair market value, all of KeySpan's interest in KeySpan Generation LLC pursuant to the GPRA discussed in greater detail above.

***Energy Management Agreement.*** Pursuant to the 1998 EMA, KeySpan (i) procures and manages fuel supplies for LIPA to fuel our Long Island generating facilities acquired from LILCO in 1998; (ii) performs off-system capacity and energy purchases on a least-cost basis to meet LIPA's needs; and (iii) makes off-system sales of output from the Long Island 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 electricity sales arranged by us. The original term for the fuel supply service described in (i) above is fifteen years, expiring May 28, 2013, and the original term for the off-system purchases and sales services described in (ii) and (iii) above is eight years, expiring May 28, 2006. In 2005, the EMA was amended to extend the term for the services described in (ii) and (iii) through December 31, 2006.

In exchange for these services, we earn an annual fee of $1.5 million, plus an allowance for certain costs incurred in performing services under the EMA. The EMA further provides incentives and disincentives up to $5 million annually for control of the cost of fuel purchased on behalf of LIPA. In 2005, we earned EMA incentives in an aggregate of $5 million.

We also have an inventory of sulfur dioxide (“$SO_2$”) and nitrogen oxide (“$NO_x$”) emission allowances that may be sold to third party purchasers. The amount of allowances varies from year to year relative to the level of emissions from the Long Island generating facilities, which is greatly dependent on the mix of natural gas and fuel oil used for generation and the amount of purchased power that is imported onto Long Island. In accordance with the 1998 PSA, 33% of emission allowance sales revenues attributable to the Long Island generating facilities is retained by KeySpan and the other 67% is credited to LIPA. LIPA also has a right of first refusal on any potential emission allowance sales of the Long Island generating facilities. Additionally, KeySpan voluntarily entered into a memorandum of understanding with the New York State Department of Environmental Conservation (“NYSDEC”), which memorandum prohibits the sale of $SO_2$ allowances into certain states and requires the purchaser to be bound by the same restriction, which may marginally affect the market value of the allowances.

In March 2005, LIPA issued a Request for Proposal (“RFP”) to provide system power supply management services beginning May 29, 2006 and fuel management services for certain of its peaking generating units beginning January 1, 2006. A KeySpan subsidiary is currently performing these services. KeySpan submitted a bid in response to the new RFP in April 2005. LIPA was scheduled to select a service provider in June 2005, but has deferred such decision at this time. We cannot predict the outcome or the timing of any decisions by LIPA on this matter at this time. Pending LIPA’s determination on the RFP, the EMA was extended through December 31, 2006.

***Power Purchase Agreements with KeySpan Glenwood and KeySpan Port Jefferson.*** KeySpan Glenwood Energy Center, LLC and KeySpan Port Jefferson Energy Center LLC each have 25 year power purchase agreements with LIPA expiring in 2027 (the “2002 LIPA PPAs”). Under the terms of the 2002 LIPA PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Each plant is designed to produce 79.9 MW. Pursuant to the 2002 LIPA 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.

***Other Contingencies.*** In 2005, LIPA completed the strategic organizational review initiative it commenced in 2004. As part of its strategic 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. The strategic review team also considered whether LIPA should exercise its option under the GPRA. Upon completion of its strategic review, LIPA determined that it would continue its existing organizational structure and engage KeySpan in the renegotiation of the 1998 MSA, GPRA and related agreements. As stated above, these negotiations culminated in the parties entering into the 2006 LIPA Agreements. As previously noted, the 2006 LIPA Agreements are subject to receipt of governmental approvals. Also, the LIPA Agreements do not preclude LIPA from continuing to explore privatization, municipalization or other strategic alternatives.

***Other Rights.*** Pursuant to other agreements between LIPA and KeySpan, certain future rights have been granted to LIPA. Subject to certain conditions, these rights include the right for 99 years (from May 1998) to lease or purchase, at fair market value, parcels of land and to acquire unlimited access to, as well as appropriate easements at, the Long Island generating facilities for the purpose of constructing new electric generating facilities to be owned by LIPA or its designee. Subject to this right granted to LIPA, KeySpan has the right to sell or lease property on or adjoining the Long Island generating facilities to third parties.

We own common plant assets (such as administrative office buildings and computer systems) formerly owned by LILCO and recover an allocable share of the carrying costs of such plant assets through the MSA. KeySpan has agreed to provide LIPA, for a period of 99 years (from May 1998), the right to enter into leases at fair market value for common plant assets or sub-contract for common services which it may assign to a subsequent manager of the transmission and distribution system. We have also agreed: (i) for a period of 99 years (from May 1998) not to compete with LIPA as a provider of transmission or distribution service on Long Island; (ii) that LIPA will share in synergy (*i.e.*, efficiency) savings over a 10-year period attributed to the May 28, 1998 transaction which resulted in the formation of KeySpan (estimated to be approximately $1 billion), which savings are incorporated into the cost structure under the LIPA Agreements; and (iii) generally not to commence any tax certiorari case (during the pendency of the 1998 PSA) challenging certain property tax assessments relating to the former LILCO Long Island generating facilities.

***Guarantees and Indemnities.*** We have entered into agreements with LIPA to provide for the guarantee of certain obligations, indemnification against certain liabilities and allocation of responsibility and liability for certain pre-existing obligations and liabilities. In general, liabilities associated with the LILCO assets transferred to KeySpan, have been assumed by KeySpan; and liabilities associated with the assets acquired by LIPA, are borne by LIPA, subject to certain specified exceptions. We have assumed all liabilities arising from all manufactured gas plant ("MGP") operations of LILCO and its predecessors, and LIPA has assumed certain liabilities relating to the former LILCO Long Island generating facilities and all liabilities traceable to the business and operations conducted by LIPA after completion of the 1998 KeySpan/LILCO transaction. An agreement also provides for an allocation of liabilities which relates to the assets that were common to the operations of LILCO and/or shared services or liabilities which are not traceable directly to either the business or operations conducted by LIPA or KeySpan. In addition, 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.

## ENERGY SERVICES OVERVIEW

The Energy Services segment includes companies that provide energy-related services to customers located primarily within the Northeastern United States, with concentrations in the New York City and Boston metropolitan areas. 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. Our subsidiaries in this segment have over 200,000 service contracts in place to provide home energy services, completed over 250,000 service calls during 2005 and completed more than 16,000 installations during 2005.

In January and February of 2005, KeySpan sold its mechanical contracting subsidiaries in this segment and exited such businesses. These subsidiaries were engaged in the design, building, installing and servicing of heating ventilation and air conditioning ("HVAC") systems and plumbing systems for industrial and commercial customers. In the fourth quarter of 2004, KeySpan's investment in its discontinued mechanical contracting subsidiaries was written-down to an estimated fair value.

For additional information and financial information concerning the Energy Services segment, see the discussion in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – "Energy Services", Item 8. "Financial Statements and Supplementary Data", Note 2 to the Consolidated Financial Statements, "Business Segments", and Note 10, "Energy Services – Discontinued Operations".

## ENERGY INVESTMENTS OVERVIEW

We are also engaged in Energy Investments which includes gas exploration and production activities, domestic pipelines, gas storage facilities and LNG facilities and operations.

### Gas Exploration and Production

KeySpan is engaged in the exploration for and production of domestic natural gas and oil through wholly-owned subsidiaries Seneca-Upshur Petroleum, Inc., d/b/a KeySpan Production & Development Company ("Seneca-Upshur") and KeySpan Exploration and Production, LLC ("KeySpan Exploration and Production"). KeySpan Exploration and Production is involved in a joint venture with The Houston Exploration Company ("Houston Exploration"), a former subsidiary of KeySpan, to explore for and produce natural gas and oil. KeySpan Exploration and Production's remaining venture assets are primarily proved undeveloped oil reserves located off the Gulf of Mexico in the South Timbalier and Mustang Island areas.

In June 2004, KeySpan reduced its ownership in Houston Exploration from 55% to 23.5%, through an exchange of 10.8 million shares of its Houston Exploration common stock for 100% of the stock of Seneca-Upshur, previously a wholly owned subsidiary of Houston Exploration. Seneca-Upshur's assets consist of 50 billion cubic feet of low risk, mature, onshore gas producing properties located predominantly in West Virginia and Pennsylvania. In November 2004, KeySpan decided to sell its remaining ownership interest (approximately 6.6 million shares of common stock) in Houston Exploration. See Item 7. Management's Discussion and Analysis of Financial Conditions and Results of Operations – "Energy Investments" for a further discussion of these matters.

As indicated above, as a result of the transactions with Houston Exploration, Seneca-Upshur, headquartered in Buckhannon, West Virginia, owns and operates onshore gas producing properties, and operates approximately 1,300 wells in north central West Virginia and southern Pennsylvania. To manage the inherent volatility in commodity prices, Seneca-Upshur entered into a three-year hedge for a majority of its production.

## Domestic Pipelines and Gas Storage Facilities

We own a 20.4% interest in Iroquois Gas Transmission System LP, a partnership of affiliates of six U.S. and Canadian energy companies, which is the owner of a 411-mile interstate natural gas pipeline extending from the U.S.-Canadian border at Waddington, NY through western Connecticut to its terminus in Commack, NY, and from Huntington to the Bronx. Its wholly owned subsidiary, the Iroquois Pipeline Operating Company, headquartered in Shelton, Connecticut, is the agent for and operator of the pipeline. The Iroquois pipeline can transport up to 1,124,500 DTH per day of Canadian gas supply from the New York-Canadian border to markets in the Northeastern United States. KeySpan is also a shipper on Iroquois and currently transports up to 304,950 DTH of gas per day.

We also have a 50% interest in Islander East Pipeline Company, LLC ("Islander East"), which 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. In addition, we own a 21% ownership interest in the Millennium Pipeline project which 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.

We are also the owner and operator of a 600,000 barrel LNG storage and receiving facility located in Providence, Rhode Island, known as KeySpan LNG. We acquired the KeySpan LNG facility from Algonquin LNG, a subsidiary of Duke Energy on December 12, 2002. Our subsidiary, Boston Gas is the facility's largest customer and contracts for more than half of the LNG facility's storage. KeySpan LNG is regulated by FERC.

For additional information concerning these energy related investments in pipelines and gas storage facilities, see the discussion on "Energy Investments" in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations contained herein.

We also have equity investments in two gas storage facilities in the State of New York: Honeoye Storage Corporation and Steuben Gas Storage Company. We own a 52% interest in Honeoye, an underground gas storage facility which provides up to 4.3 billion cubic feet of storage service to New York and New England. Additionally, we own 34% of a partnership that has a 50% interest in the Steuben facility that provides up to 6.2 billion cubic feet of storage service to New Jersey and Massachusetts.

## Former Energy Investments

KeySpan had previously been involved in natural gas distribution and pipeline activities in the United Kingdom. However, on March 18, 2005, KeySpan sold its 50% interest in Premier Transmission Limited ("Premier"), a gas pipeline from southwest Scotland to Northern Ireland pursuant to an agreement among KeySpan, its 50% partner, BG Energy Holdings Limited and Premier Transmission Financing Public Limited Company ("PTFPL"), pursuant to which all of the outstanding shares of PTL were purchased by PTFPL. In two transactions in April and December 2004, KeySpan sold its ownership in KeySpan Energy Canada Partnership ("KeySpan Canada") a company that owned certain midstream natural gas assets in Western Canada.

For additional information and financial information concerning the Energy Investments segment, see the discussion in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – "Energy Investments" and Note 2 to the Consolidated Financial Statements, "Business Segments".

## ENVIRONMENTAL MATTERS OVERVIEW

KeySpan's ordinary business operations subject it to regulation in accordance with various federal, state and local laws, rules and regulations dealing with the environment, including air, water, and hazardous substances. These requirements govern both our normal, ongoing operations and the remediation of impacted properties historically used in utility operations. Potential liability associated with our historical operations may be imposed without regard to fault, even if the activities were lawful at the time they occurred.

Except as set forth below, or in Note 7 to the Consolidated Financial Statements "Contractual Obligations and Contingencies - Environmental Matters," no material proceedings relating to environmental matters have been commenced or, to our knowledge, are contemplated by any federal, state or local agency against KeySpan, and we are not a defendant in any material litigation with respect to any matter relating to the protection of the environment. We believe that our operations are in substantial compliance with environmental laws and that requirements imposed by existing environmental laws are not likely to have a material adverse impact upon us. We are also pursuing claims against insurance carriers and potentially responsible parties which seek the recovery of certain environmental costs associated with the investigation and remediation of contaminated properties. We believe that investigation and remediation costs prudently incurred at facilities associated with utility operations, not recoverable through insurance or some other means, will be recoverable from our customers in accordance with the terms of our rate recovery agreements for each regulated subsidiary.

***Air.*** The Federal Clean Air Act ("CAA") provides for the regulation of a variety of air emissions from new and existing electric generating plants. Final permits in accordance with the requirements of Title V of the 1990 amendments to the CAA have been issued for all of our electric generating facilities, with the exception of two 79 MW simple cycle gas turbine facilities which were constructed in 2002. These units currently are permitted under New York State Facility permits and Title V permits have been timely applied for and are pending issuance by the NYSDEC. Renewal applications were submitted in a timely manner for 13 existing facilities whose initial permits were to expire in 2004. To date, all of the permits except one were renewed and the remaining renewal application has been deemed complete by NYSDEC and is undergoing final review by the United States Environmental Protection Agency ("EPA"). During 2005, a timely renewal application was submitted for a facility whose permit expires in 2006. The permits and timely renewal applications allow our electric generating plants to continue to operate without any additional significant expenditures, except as described below.

Our generating facilities are located within a CAA ozone non-attainment and PM 2.5 (fine particulate matter) non-attainment area, and are subject to Phase I, II and III $NO_X$ reduction requirements established under the Ozone Transport Commission ("OTC") 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 $NO_X$ 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 in a cost-effective manner. KeySpan is developing its compliance strategy in response to the implementation of CAIR, which is expected in 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. Although it is anticipated that NOx control equipment may be required at one or more of KeySpan's Long Island facilities at a cost of between $25 to $35 million. However, such amounts are recoverable from LIPA pursuant to the 1998 PSA, or if applicable, the 2006 PSA.

In 2003, New York State promulgated regulations which establish separate $NO_X$ and $SO_2$ emission reduction requirements on electric generating facilities in New York State, which commenced in late 2004 for $NO_X$ emissions and in 2005 for $SO_2$ emissions. KeySpan's facilities have been able to comply with the $NO_X$ requirements without material additional capital expenditures because of previously installed emissions control equipment and gas combustion capability. $SO_2$ compliance was achieved through a reduction in the sulfur content of the fuel oil used in our Northport and Port Jefferson facilities and a further reduction is expected to be required in 2008.

In 2004, the EPA issued regulations that require reductions, on a national basis, of mercury emissions from electric generating facilities on a national basis. The mercury regulations have no impact on KeySpan facilities since their application is limited to coal-fired plants. EPA determined that nickel emissions from oil fired plants do not pose health risks that require regulation. This determination has been challenged and litigation is pending. Until a final outcome is obtained, the nature and extent of the financial impact on KeySpan from nickel regulation, if any, cannot be determined.

In 2003, the Governor of New York initiated a Regional Greenhouse Gas Initiative that seeks to establish a coordinated multi-state plan to reduce greenhouse gas emissions (primarily carbon dioxide ("$CO_2$") from electric generating emission sources in the Northeast. In December of 2005, seven northeast states, including New York, issued a memorandum of understanding capping CO2 emissions from electric generating facilities in 2009 and, beginning in 2015, gradually requiring a 10 percent reduction in regional emissions by 2018. Each of the seven states will be promulgating individual state rules to implement the MOU. Several congressional initiatives are also under consideration that may also require greenhouse gas reductions from electric generating facilities nationwide. At the present time it is not possible to predict the nature of the requirements which ultimately will be imposed on KeySpan, nor what, if any, financial impact such requirements would have on KeySpan facilities. However, our investments in additional natural gas firing capability have resulted in approximately a 15% reduction in carbon dioxide emissions since 1990, while the electric generation industry as a whole increased carbon dioxide emissions by more than 25%. The addition of the efficient, combined cycle unit which began operation at the Ravenswood Generating Station in 2004 has further reduced average KeySpan $CO_2$ emission rates.

***Water.*** The Federal Clean Water Act provides for effluent limitations, to be implemented by a permit system, to regulate the discharge of pollutants into United States waters. We possess permits for our generating units which authorize discharges from cooling water circulating systems and chemical treatment systems. These permits are renewed from time to time, as required by regulation. Additional capital expenditures associated with the renewal of the surface water discharge permits for our power plants will likely be required by the NYSDEC. We are currently conducting studies as directed by the NYSDEC to determine the impacts of our discharges on aquatic resources and are engaged in discussions with the NYSDEC regarding the nature of capital upgrades or other mitigation measures necessary to satisfy these evolving regulatory requirements. It is difficult to predict with any certainty the costs 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 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 NYSDEC 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.*** The Federal Comprehensive Environmental Response, Compensation and Liability Act of 1980 and certain similar state laws (collectively "Superfund") impose liability, regardless of fault, upon generators of hazardous substances even before Superfund was enacted for costs associated with investigating and remediating contaminated property. In the course of our business operations, we generate materials which, after disposal, may become subject to Superfund. From time to time, we have received notices under Superfund concerning possible claims with respect to sites where hazardous substances generated by KeySpan or its predecessors and other potentially responsible parties were allegedly disposed. Normally, the costs associated with such claims are allocated among the potentially responsible parties on a pro rata basis. Superfund does, however, provide for joint and several liability against a single potentially responsible party. In the unlikely event that Superfund claims were pursued against us on that basis, the costs may be material to our financial condition, results of operations or cash flows.

KeySpan has identified certain MGP sites which were historically owned or operated by its subsidiaries (or such companies' predecessors). Operations at these sites between the mid-1800s to mid-1900s may have resulted in the release of hazardous substances. For a discussion on our MGP sites and further information concerning environmental matters, see Note 7 to the Consolidated Financial Statements, "Contractual Obligations and Contingencies - Environmental Matters."

## COMPETITION, REGULATION AND RATE MATTERS

***Competition.*** Over the last several years, the natural gas and electric industries have undergone significant change as market forces moved towards replacing or supplementing rate regulation through the introduction of competition. A significant number of natural gas and electric utilities reacted to the changing structure of the energy industry by entering into business combinations, with the goal of reducing common costs, gaining size to better withstand competitive pressures and business cycles, and attaining synergies from the combination of operations. We engaged in two such combinations, the KeySpan/LILCO transaction in 1998 and our November 2000 acquisition of Eastern and EnergyNorth.

The Ravenswood Generating Station, the merchant plant in our Electric Services segment, is subject to competitive and other risks that could adversely impact the market price for the plant's output. Such risks include, but are not limited to, the construction of new generation or transmission capacity serving the New York City market.

***Regulation.*** Public utility holding companies, like KeySpan, are now regulated by the FERC pursuant to PUHCA 2005 and to some extent by state utility commissions through the regulation of certain affiliate transaction regulations. Our utility subsidiaries are subject to extensive federal and state regulation by FERC and state utility commissions. Our gas and electric public utility companies are subject to either or both state and federal regulation. In general, state public utility commissions, such as the New York Public Service Commission ("NYPSC"), the MADTE and the New Hampshire Public Utilities Commission ("NHPUC") regulate the provision of retail services, including the distribution and sale of natural gas and electricity to consumers. Each of the federal and state regulators also regulates certain transactions among our affiliates. FERC also regulates interstate natural gas transportation and electric transmission, and has jurisdiction over certain wholesale natural gas sales and wholesale electric sales.

In addition, our non-utility subsidiaries are subject to a wide variety of federal, state and local laws, rules and regulations with respect to their business activities, including but not limited to those affecting public sector projects, environmental and labor laws and regulations, state licensing requirements, as well as state laws and regulations concerning the competitive retail commodity supply.

***State Utility Commissions.*** As noted above, our regulated gas distribution utility subsidiaries are subject to regulation by the NYPSC, MADTE and NHPUC. The NYPSC regulates KEDNY and KEDLI. Although KeySpan is not regulated by the NYPSC, it is impacted by conditions that were included in the NYPSC order authorizing the 1998 KeySpan/LILCO transaction. Those conditions address, among other things, the manner in which KeySpan, its service company subsidiaries and its unregulated subsidiaries may interact with KEDNY and KEDLI. The NYPSC also regulates the safety, reliability and certain financial transactions of our Long Island generating facilities and our Ravenswood Generating Station under a lightened regulatory standard. Our KEDNE subsidiaries and to some extent our service companies are also subject to regulation by the MADTE and NHPUC.

***Securities and Exchange Commission.*** As a result of the acquisition of Eastern and EnergyNorth, we became a holding company under PUHCA 1935. The Energy Act repealed PUHCA 1935 and replaced it with PUHCA 2005 effective February 8, 2006. Whereas our corporate and financial activities and those of our subsidiaries had been subject to regulation by the SEC, FERC now has jurisdiction over certain of our holding company activities. However, the SEC continues to have jurisdiction over the registration and issuance of our securities under the federal securities laws.

Under our holding company structure, we have no independent operations or source of income of our own and conduct substantially 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 and to pay dividends to our shareholders. 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.

In addition, in November 2000, KeySpan received authorization from the SEC to operate three mutual service companies. Under this order, the SEC determined that, in accordance with PUHCA 1935, KeySpan Corporate Services LLC ("KCS"), KeySpan Utility Services LLC ("KUS") and KeySpan Engineering & Survey, Inc. ("KENG") may operate to provide various services to KeySpan subsidiaries, including regulated utility companies and LIPA, at cost fairly and equitably allocated among them. The regulation of our three service companies has also been transferred to FERC under PUHCA 2005.

***Federal Energy Regulatory Commission.*** FERC 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. In addition to its new authority pursuant to PUHCA 2005, FERC also regulates the sale of electricity at wholesale and the transmission of electricity in interstate commerce as well as certain corporate and financial activities of companies that are engaged in such activities. The Long Island generating facilities and the Ravenswood Generating Station are subject to FERC regulation based on their wholesale energy transactions.

Our Ravenswood Generating Station's rates are based on a market-based rate application approved by FERC. The rates that our Ravenswood Generating Station may charge are subject to FERC mandated mitigation measures due to market power issues. The mitigation measures are administered by the NYISO. FERC retains the ability in future proceedings, either on its own motion or upon a complaint filed with FERC, to modify the Ravenswood Generating Station's rates, as well as the mitigation measures, if FERC concludes that it is in the public interest to do so.

KeySpan currently offers and sells the energy, capacity and ancillary services from the Ravenswood Generating Station through the energy market operated by the NYISO. For information concerning the NYISO, see Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation – "Regulatory Issues and Competitive Environment."

FERC also has jurisdiction to regulate certain natural gas sales for resale in interstate commerce, the transportation of natural gas in interstate commerce and, unless an exemption applies, companies engaged in such activities. The natural gas distribution activities of KEDNY, KEDLI, KEDNE and certain related intrastate gas transportation functions are not subject to FERC jurisdiction. However, to the extent that KEDNY, KEDLI or KEDNE purchase or sell gas for resale in interstate commerce, such transactions are subject to FERC jurisdiction and have been authorized by FERC. Our interests in Iroquois, Honeoye, Steuben and KeySpan LNG are also fully regulated by FERC as natural gas companies.

## EXECUTIVE OFFICERS OF KEYSPAN

Certain information regarding executive officers of KeySpan and certain of its subsidiaries is set forth below:

### *Robert B. Catell*

Mr. Catell, age 69, has been a Director of KeySpan since its creation in May 1998. He was elected Chairman of the Board and Chief Executive Officer in July 1998. He served as its President and Chief Operating Officer from May 1998 through July 1998. Mr. Catell joined KEDNY in 1958 and became an officer in 1974. He was elected Vice President in 1977, Senior Vice President in 1981 and Executive Vice President in 1984. He was elected Chief Operating Officer in 1986 and President in 1990. Mr. Catell continued to serve as President and Chief Executive Officer of KEDNY from 1991 through 1996, when he was elected Chairman and Chief Executive Officer. In 1997, Mr. Catell was elected Chairman, President and Chief Executive Officer of KEDNY and its parent KeySpan Energy Corporation. Mr. Catell also serves on the Board of Directors for Houston Exploration (NYSE:THX), Independence Community Bank (NASDAQ:ICBC) and Keyera Energy Management Ltd. (TSX:KEY.UN).

### *Robert J. Fani*

Mr. Fani, age 52, was elected to serve on the Board of Directors of KeySpan in January 2005 and was elected its President and Chief Operating Officer in October 2003. Mr. Fani joined KEDNY in 1976, and held a variety of management positions in distribution, engineering, planning, marketing and business development. After being elected Vice President in 1992, he was promoted to Senior Vice President of Marketing and Sales for KEDNY in 1997. In 1998, he assumed the position of Senior Vice President of Marketing and Sales for KeySpan. In September 1999, he became Senior Vice President for Gas Operations and was promoted to Executive Vice President for Strategic Services in February 2000 and then to President of the KeySpan Energy Services and Supply Group in 2001. In January 2003, he was named President of KeySpan's Energy Assets and Supply Group until assuming his current position in October 2003.

### *Wallace P. Parker Jr.*

Mr. Parker, age 56, was elected President of the KeySpan Energy Delivery and Customer Relations Group in January 2003. He also serves as Vice Chairman and Chief Executive Officer of KeySpan Services, Inc. since January 2003. He had previously served as President, KeySpan Energy Delivery, since June 2001, and from February 2000 served as Executive Vice President of Gas Operations. He joined KEDNY in 1971 and served in a wide variety of management positions. In 1987, he was named Assistant Vice President for marketing and advertising and was elected Vice President in 1990. In 1994, Mr. Parker was promoted to Senior Vice President of Human Resources for KEDNY and in August 1998 was promoted to Senior Vice President of Human Resources of KeySpan.

***Steven L. Zelkowitz***

Mr. Zelkowitz, age 56, was elected President of KeySpan's Energy Assets and Supply Group in October 2003. Prior to that, he served as Executive Vice President and Chief Administrative Officer since January 2003. He joined KeySpan as Senior Vice President and Deputy General Counsel in October 1998, and was elected Senior Vice President and General Counsel in February 2000. In July 2001, Mr. Zelkowitz was promoted to Executive Vice President and General Counsel, and in November 2002, he was named Executive Vice President, Administration and Compliance, with responsibility for the offices of General Counsel, Human Resources, Regulatory Affairs, Enterprise Risk Management and administratively for Internal Auditing. Before joining KeySpan, Mr. Zelkowitz practiced law with Cullen and Dykman LLP in Brooklyn, New York, specializing in energy and utility law and had been a partner since 1984. He served on the firm's Executive Committee and was head of its Corporate/Energy Department.

***John J. Bishar, Jr.***

Mr. Bishar, age 56, was elected Executive Vice President, General Counsel, Chief Governance Officer and Secretary effective March 1, 2005. He became Senior Vice President, General Counsel and Secretary in May 2003, with responsibility for KeySpan's Legal Department and the Corporate Secretary's Office. Prior to that, he joined KeySpan as Senior Vice President and General Counsel in November 2002. Before joining KeySpan, Mr. Bishar practiced law with Cullen and Dykman LLP since 1987. He was the Managing Partner from 1993 through 2002 and was a member of the firm's Executive Committee. From 1980 to 1987, Mr. Bishar was Vice President, General Counsel and Corporate Secretary of LITCO Bancorporation of New York, Inc.

***John A. Caroselli***

Mr. Caroselli, age 51, was elected Executive Vice President and Chief Strategy Officer in January 2003. Mr. Caroselli is responsible for Brand Management, Strategic Marketing, Strategic Planning, Strategic Performance, Customer Relations and Information Technology Strategy and Governance. Mr. Caroselli came to KeySpan in 2001 and at that time served as Executive Vice President of Strategic Development. Before joining KeySpan, Mr. Caroselli held the position of Executive Vice President of Corporate Development at AXA Financial. Prior to that, he held senior officer positions with Chase Manhattan, Chemical Bank and Manufacturers Hanover Trust. He has extensive experience in strategic planning, brand management, marketing, communications, human resources, facilities management, e-business, change management and strategic execution.

***Gerald Luterman***

Mr. Luterman, age 62, was elected Executive Vice President and Chief Financial Officer in February 2002. He previously served as Senior Vice President and Chief Financial Officer since joining KeySpan in July 1999. He formerly served as Chief Financial Officer of barnesandnoble.com and Senior Vice President and Chief Financial Officer of Arrow Electronics, Inc. Prior to that, from 1985 through 1996, he held executive positions with American Express. Mr. Luterman also serves on the Board of Directors for IKON Office Solutions Inc. (NYSE:IKN) and Technology Solutions Company (NASDAQ:TSCC).

***David J. Manning***

Mr. Manning, age 55, was elected Executive Vice President Corporate Affairs and Chief Environmental Officer effective March 1, 2005. He became Senior Vice President for Corporate Affairs in April 1999. Before joining KeySpan, Mr. Manning had been President of the Canadian Association of Petroleum Producers since 1995. From 1993 to 1995, he was Deputy Minister of Energy for the Province of Alberta, Canada. From 1988 to 1993, he was Senior International Trade Counsel for the Government of Alberta, based in New York City. Previously, he was in the private practice of law in Canada as Queen's Counsel.

***Anthony Nozzolillo***

Mr. Nozzolillo, age 57, was elected Executive Vice President of Electric Operations in February 2000. He previously served as Senior Vice President of KeySpan's Electric Business Unit from December 1998 to January 2000. He joined LILCO in 1972 and held various positions, including Manager of Financial Planning and Manager of Systems Planning. Mr. Nozzolillo served as LILCO's Treasurer from 1992 to 1994 and as Senior Vice President of Finance and Chief Financial Officer from 1994 to 1998.

***Lenore F. Puleo***

Ms. Puleo, age 52, was elected Executive Vice President of Shared Services in March 2004. She previously served as Executive Vice President of Client Services since February 2000. Prior to that, she served as Senior Vice President of Customer Relations for KEDNY from May 1994 to May 1998, and for KeySpan from May 1998 to January 2000. She joined KEDNY in 1974 and worked in management positions in KEDNY's Accounting, Treasury, Corporate Planning and Human Resources areas. She was given responsibility for the Human Resources Department in 1987 and was named a Vice President in 1990. Ms. Puleo was promoted to Senior Vice President of KEDNY's Customer Relations in 1994.

***Nickolas Stavropoulos***

Mr. Stavropoulos, age 47, was elected President, KeySpan Energy Delivery, in June, 2004 and Executive Vice President in April 2002. He previously served as President of KeySpan Energy New England since April 2002, and Senior Vice President of sales and marketing in New England since 2000. Prior to joining KeySpan, Mr. Stavropoulos was Senior Vice President of marketing and gas resources for Boston Gas Company. Before joining Boston Gas, he was Executive Vice President and Chief Financial Officer for Colonial Gas Company. In 1995, Mr. Stavropoulos was elected Executive Vice President – Finance, Marketing and CFO, and assumed responsibility for all of Colonial's financial, marketing, information technology and customer service functions. Mr. Stavropoulos was a director of Colonial Gas Company and currently serves on the Board of Directors for Enterprise Bank and Trust Company (NASDAQ:EBTC) and Dynamics Research Corporation (NASDAQ:DRCO).

*Joseph F. Bodanza*

Mr. Bodanza, age 58, was elected Senior Vice President Regulatory Affairs and Asset Optimization effective March 1, 2005. He became Senior Vice President, Regulatory Affairs and Chief Accounting Officer in April 2003. Prior to that, he served as Senior Vice President of Finance Operations and Regulatory Affairs since August 2001 and was Senior Vice President and Chief Financial Officer of KEDNE. Mr. Bodanza previously served as Senior Vice President of Finance and Management Information Systems and Treasurer of Eastern Enterprise's Gas Distribution Operations. Mr. Bodanza joined Boston Gas Company in 1972, and held a variety of positions in the financial and regulatory areas before becoming Treasurer in 1984. He was elected Vice President and Treasurer in 1988.

*Coleen A. Ceriello*

Ms. Ceriello, age 47, was named Senior Vice President of Shared Services of KeySpan Corporate Services, LLC, effective March 1, 2005. She had been KeySpan's Vice President – Property, Security and Employee Related Services since January 2005. Prior to that time, she served as Vice President of Property and Security since June 2004 and Vice President of Strategic Planning since August 1999. She joined KEDNY in 1980 and over the years held a succession of positions in Corporate Planning, Regulatory Relations, Information Technology and Strategic Planning and Performance.

*John F. Haran*

Mr. Haran, age 55, was elected Senior Vice President of KeySpan Energy Delivery and Chief Gas Engineer in March 2004. He had been Senior Vice President of gas operations for KEDNY and KEDLI in April 2002. Mr. Haran joined KEDNY in 1972, and has held management positions in operations, engineering and marketing and sales. He was named Vice President of KEDNY gas operations in 1996 and in 2000 moved to the position of Vice President of KEDLI gas operations.

*Michael J. Taunton*

Mr. Taunton, age 50, was elected Senior Vice President, Treasurer and Chief Risk Officer effective March 1, 2005. He became Senior Vice President and Treasurer in March 2004, and had been KeySpan's Vice President and Treasurer since June 2000. Prior to that time, he served as Vice President of Investor Relations since September 1998. He joined KEDNY in 1975 and held a succession of positions in Accounting, Customer Service, Corporate Planning, Budgeting and Forecasting, Marketing and Sales, and Business Process Improvement. During the KeySpan/LILCO merger, Mr. Taunton co-managed the day-to-day transition process of the merger and then served on the Transition Team during the acquisition of Eastern Enterprises.

***Elaine Weinstein***

Ms. Weinstein, age 59, was named Senior Vice President for Human Resources and Chief Diversity Officer in March 2004. She previously served as Senior Vice President of KeySpan's Human Resources division since November 2000, and as Vice President of Staffing and Organizational Development from September 1998, to her election as Senior Vice President. Prior to that time, Ms. Weinstein was General Manager of Employee Development since joining KEDNY in June of 1995. Prior to 1995, Ms. Weinstein was Vice President of Training and Organizational Development at Merrill Lynch.

***Lawrence S. Dryer***

Mr. Dryer, age 46, was elected Vice President and General Auditor in June 2003. He previously served in this position from September 1998 to August 2001. In August 2001, he was named Senior Vice President and Chief Financial Officer of KeySpan Services, Inc. Prior to such positions, Mr. Dryer had been with LILCO from 1992 to 1998 as Director of Internal Audit. Prior to joining LILCO, Mr. Dryer was an Audit Manager with Coopers & Lybrand.

***Theresa A. Balog***

Ms. Balog, age 44, was elected Vice President and Chief Accounting Officer effective March 1, 2005. She became Vice President and Controller of KeySpan in April 2003. She joined KeySpan in 2002 as Assistant Controller. Prior to joining KeySpan, Ms. Balog was Chief Accounting Officer for NiSource and held a variety of positions with the Columbia Energy Group.

***Joseph E. Hajjar***

Mr. Hajjar, age 53, was named Vice President and Controller effective March 1, 2005. He had been Senior Vice President and Chief Financial Officer of KeySpan Services, Inc. since June 2003 and Senior Vice President and Chief Financial Officer of KeySpan Business Solutions, LLC, since November 2001. Before joining KeySpan from 1998 to 2001, Mr. Hajjar was Executive Vice President and Chief Operating Officer of Opportunity America. He also was previously an officer of the Bovis group and served for over 12 years with Price Waterhouse.

***Michael A. Walker***

Mr. Walker, age 49, was named Vice President and Deputy General Counsel of KeySpan Corporation, effective March 1, 2005. He had been Senior Vice President of KeySpan Services, Inc. since June 2004 and Senior Vice President and COO of KeySpan Business Solutions, LLC, since June 2003. Prior to that time he was Senior Vice President and General Counsel of KeySpan Services, Inc. from January 2001 to December 2003. Before joining KeySpan, Mr. Walker was a shareholder in the Corporate Finance Section in the law firm of Buchanan Ingersoll. Prior to joining Buchanan Ingersoll he worked for several law firms in the north east representing both private and public sector clients on a wide variety of energy, utility, regulatory, corporate and structured finance matters.

## EMPLOYEE MATTERS

As of December 31, 2005, KeySpan and its wholly-owned subsidiaries had approximately 9,700 employees. Of that total, approximately 6,154 employees are covered under collective bargaining agreements. KeySpan has not experienced any work stoppage during the past five years and considers its relationship with employees, including those covered by collective bargaining agreements, to be good.

## ITEM 1A. RISK FACTORS

Certain statements contained in this Annual Report on Form 10-K concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are other than statements of historical facts, are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Without limiting the foregoing, all statements under the captions "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk" relating to our future outlook, anticipated capital expenditures, future cash flows and borrowings, pursuit of potential acquisition opportunities and sources of funding, are forward-looking statements. Such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties, and actual results may differ materially from those discussed in such statements.
The risks, uncertainties and factors that could cause actual results to differ materially include but are not limited to the following:

### We are a Holding Company, and Our Subsidiaries are Subject to State Regulation Which Limits Their Ability to Pay Dividends and Make Distributions to Us

We are a holding company with no business operations or sources of income of our own. We conduct all of our operations through our subsidiaries and 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 and to pay dividends on our common stock.

In addition, a substantial portion of our consolidated assets, earnings and cash flow is derived from the operation of our regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation by the utility regulatory commissions of New York, Massachusetts and New Hampshire. Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to us is conditioned upon their 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 a customer service performance program. At the end of KEDNY's and KEDLI's rate years (September 30, 2005 and November 30, 2005, respectively), their ratios of debt to total utility capitalization were well in compliance with the ratios set forth above and we have incurred no penalties under the outstanding customer service performance program.

### Our Gas Distribution and Electric Services Businesses May Be Adversely Affected by Changes in Federal and State Regulation

The regulatory environment applicable to our gas distribution and our electric services businesses has undergone substantial changes in recent years, on both the federal and state levels. These changes have significantly affected the nature of the gas and electric utility and power industries and the manner in which their participants conduct their businesses. Moreover, existing statutes and regulations may be revised or reinterpreted, new laws and regulations may be adopted or become applicable to us or our facilities and future changes in laws and regulations may affect our gas distribution and our electric services businesses in ways that we cannot predict.

In addition, our operations are subject to extensive government regulation and require numerous permits, approvals and certificates from various federal, state and local governmental agencies. A significant portion of our revenues in our Gas Distribution and Electric Services segments are directly dependent on rates established by federal or state regulatory authorities, and any change in these rates and regulatory structure could significantly impact our financial results. Increases in utility costs other than gas, not otherwise offset by increases in revenues or reductions in other expenses, could have an adverse effect on earnings due to the time lag associated with obtaining regulatory approval to recover such increased costs and expenses in rates.

Various rulemaking proposals and market design revisions related to the wholesale power market are being reviewed at the federal level. These proposals, as well as legislative and other attention to the electric power industry could have a material adverse effect on our strategies and results of operations for our electric services business and our financial condition. In particular, we sell capacity, energy and ancillary services from our Ravenswood Generating Station facility into the New York Independent System Operator, or NYISO, energy market at market-based rates, subject to mitigation measures approved by the FERC. The pricing for capacity, energy sales and ancillary services in to the NYISO market is still evolving. and some of the FERC's price mitigation measures are subject to rehearing and possible judicial review, as well as revision in response to market participant complaints or NYISO requests.

### Our Risk Mitigation Techniques Such as Hedging and Purchase of Insurance May Not Adequately Provide Protection

To mitigate our financial exposure related to commodity price fluctuations, KeySpan routinely enters into contracts to hedge a portion of our purchase and sale commitments, weather fluctuations, electricity sales, natural gas supply and other commodities. However, we do not always cover the entire exposure of our assets or our positions to market price volatility and the coverage will vary over time. To the extent we have unhedged positions or our hedging procedures do not work as planned, fluctuating commodity prices could cause our sales and net income to be volatile.

In addition, our business is subject to many hazards from which our insurance may not adequately provide coverage. An unexpected outage at our Ravenswood Generating Station, especially in the significant summer period, could materially impact our financial results. Damage to pipelines, equipment, properties and people caused by natural disasters, accidents, terrorism or other damage by third parties could exceed our insurance coverage. Although we do have insurance to protect against many of these contingent liabilities, this insurance is capped at certain levels, has self-insured retentions and does not provide coverage for all liabilities.

**SEC Rules for Exploration and Production Companies May Require Us to Recognize a Non-Cash Impairment Charge at the End of Our Reporting Periods**

Our investments in natural gas and oil consist of our ownership of KeySpan Exploration and Production and Seneca-Upshur. We use the full cost method for KeySpan Exploration and Production and Seneca-Upshur. Under the full cost method, all costs of acquisition, exploration and development of natural gas and oil reserves are capitalized into a full cost pool as incurred, and properties in the pool are depleted and charged to operations using the unit-of-production method based on production and proved reserve quantities. To the extent that these 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, those excess costs are charged to operations. If a write-down is required, it would result in a charge to earnings but would not have an impact on cash flows. Once incurred, an impairment of gas properties is not reversible at a later date, even if gas prices increase.

**Our Operating Results May Fluctuate on a Seasonal and Quarterly Basis**

Our gas distribution business is a seasonal business and is subject to weather conditions. We receive most of our gas distribution revenues in the first and fourth quarters, when demand for natural gas increases due to colder weather conditions. As a result, we are subject to seasonal variations in working capital because we purchase natural gas supplies for storage in the second and third quarters and must finance these purchases. Accordingly, our results of operations fluctuate substantially on a seasonal basis. In addition, our New England-based gas distribution subsidiaries do not have weather normalization tariffs, as we do in New York. In addition, portions of our Electric Service business are seasonal and subject to weather and market conditions. The majority of the capacity revenue associated with the Ravenswood Generating Station facility is realized during the six months between May and October of each year. Energy and ancillary service sales from our Ravenswood Generating Station facility are directly correlated to the demand for electricity and competition from other resources. Typically, the demand and price for electricity increases during extreme temperature conditions. However, depending on the availability of alternative competitive supply, extreme temperature conditions may not result in increased revenue. As a result, fluctuations in weather and competitive supply between years may have a significant effect on our results of operations for these subsidiaries; both gas and electric.

**A Substantial Portion Of Our Revenues Are Derived From Our Agreements With LIPA And No Assurances Can Be Made That These Arrangements Will Not Be Discontinued At Some Point In The Future Or That The New Agreements Will Become Effective.**

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. On February 1, 2006, KeySpan and LIPA entered into amended and restated agreements whereby KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island. As part of the amended agreements, 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 is replaced with the 2006 Option Agreement where LIPA only has the right to acquire two of our facilities, our Far Rockaway and/or E.F. Barrett Generating Stations during the period January 1, 2006 to December 31, 2006. Additionally, the new agreements resolve many outstanding issues between the parties regarding the current LIPA Agreements and provide new pricing and extensions of the Agreements. There is a risk that these agreements will not receive the necessary governmental approvals, which are pending, and the effectiveness of each of the 2006 LIPA Agreements is conditioned upon all of the 2006 LIPA Agreements becoming effective. If the 2006 LIPA Agreements do not become effective, there is uncertainty as to whether LIPA will exercise their option under the GPRA and the status of the resolution of the various disputes between KeySpan and LIPA.

**A Decline or an Otherwise Negative Change in the Ratings or Outlook on Our Securities Could Have a Materially Adverse Impact on Our Ability to Secure Additional Financing on Favorable Terms**

The credit rating agencies that rate our debt securities regularly review our financial condition and results of operations. We can provide no assurances that the ratings or outlook on our debt securities will not be reduced or otherwise negatively changed. A negative change in the ratings or outlook on our debt securities could have a materially adverse impact on our ability to secure additional financing on favorable terms.

**Our Costs of Compliance with Environmental Laws are Significant, and the Cost of Compliance with Future Environmental Laws Could Adversely Affect Us**

Our operations are subject to extensive federal, state and local environmental laws and regulations relating to air quality, water quality, waste management, natural resources and the health and safety of our employees. These environmental laws and regulations expose us to costs and liabilities relating to our operations and our current and formerly owned properties. Compliance with these legal requirements requires us to commit significant capital toward environmental monitoring, installation of pollution control equipment and permits at our facilities. Costs of compliance with environmental regulations, and in particular emission regulations, could have a material impact on our Electric Services segment and our results of operations and financial position, especially if emission limits are tightened, more extensive permitting requirements are imposed, additional substances become regulated or the number and type of electric generating plants we operate increase.

In addition, we are responsible for the clean-up of contamination at certain MGP sites and at other sites and are aware of additional MGP sites where we may have responsibility for clean-up costs. While our gas utility subsidiaries' rate plans generally allow for the full recovery of the costs of investigation and remediation of most of our MGP sites, these rate recovery mechanisms may change in the future. To the extent rate recovery mechanisms change in the future, or if additional environmental matters arise in the future at our currently or historically owned facilities, at sites we may acquire in the future or at third-party waste disposal sites, costs associated with investigating and remediating these sites could have a material adverse effect on our results of operations and financial condition.

**Our Businesses are Subject to Competition and General Economic Conditions Impacting Demand for Services**

We recently expanded the Ravenswood Facility, our merchant generation plant, in our Electric Services segment with the Ravenswood Expansion, a 250 MW combined cycle generating unit. However, the Ravenswood Facility and Ravenswood Expansion continue to be subject to competition that could adversely impact the market price for the capacity, energy and ancillary services they sell. In addition, if new generation and/or transmission facilities are constructed, and/or the availability of our Ravenswood Generating Station deteriorates, then the quantities of capacity and energy sales could be adversely affected. In December 2005, NYPA completed construction of a nominal 500 MW generating facility in New York City, and it began selling its capacity and energy into the NYISO markets. In addition, another nominal 500 MW facility is expected to come on-line in 2006. We cannot predict, however, when or if new power plants or transmission facilities in addition to the above-noted resources will be built or the nature of the future New York City capacity and energy requirements.

Competition facing our unregulated Energy Services businesses, including but not limited to competition from other 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, could adversely impact our financial results and the value of those businesses, resulting in decreased earnings as well as write-downs of the carrying value of those businesses.

Our Gas Distribution segment faces competition with distributors of alternative fuels and forms of energy, including fuel oil and propane. Our ability to continue to add new gas distribution customers may significantly impact financial results. The gas distribution industry has experienced a decrease in consumption per customer over time, partially due to increased efficiency of customers' appliances, economic factors and price elasticity. In addition, our Gas Distribution segment's future growth is dependent upon the ability to add new customers to our system in a cost-effective manner. While our Long Island and New England utilities have significant growth potential, we cannot be sure new customers will continue to offset the decrease in consumption of our existing customer base. There are a number of factors outside of our control that impact customer conversions from an alternative fuel to gas, including general economic factors impacting customers' willingness to invest in new gas equipment.

**Risk Associated with our Financial Swap Agreement for In-City Unforced Capacity**

KeySpan believes that the New York City market represents a strong capacity market due to, among other things, its local reliability rules (which recently increased to 83% from 80%), increasing demand and the time required for new resources to be constructed.

KeySpan anticipates that demand will increase and that the high cost to construct capacity in New York City will result in favorable In-City Unforced Capacity prices. Therefore, KeySpan entered into an ISDA Master Agreement for a fixed for floating unforced capacity financial swap for a notional quantity of 1,800,000kW at the Fixed Price is $7.57/kW-month. If the demand is less than KeySpan's estimates, additional resources enter the market, or costs are less than forecast, In-City Unforced Capacity prices could be on average less than the Fixed Price resulting in a loss to KeySpan, which under certain circumstances could be material.

**Labor Disruptions at Our Facilities Could Adversely Affect Our Results of Operations and Cash Flow**

Approximately 6,154 employees, or 63% of our employees, are represented by unions through various collective bargaining agreements that expire between 2006 and 2009. The bargaining agreements expiring in 2006 affect approximately 1,300 employees who primarily work for KEDNE and at our Ravenswood Generating Station. KeySpan is currently engaging in discussions with these unions for new collective bargaining agreements. It is possible that our employees may seek an increase in wages and benefits at the expiration of these agreements, and that we may be unable to negotiate new agreements without labor disruption.

**Counterparties to Our Transactions May Fail to Perform their Obligations, Which Could Harm Our Results of Operations**

Our operations are exposed to the risk that counterparties to our transactions that owe us money or supplies will not perform their obligations. Should the counterparties to arrangements with us fail to perform, we might be forced to enter into alternative hedging arrangements or honor our underlying commitment at then-current market prices that may exceed our contractual prices. In such event, we might incur additional losses to the extent of amounts, if any, already paid to counterparties. This risk is most significant where we have concentrations of receivables from natural gas and electric utilities and their affiliates, as well as industrial customers and marketers throughout the Northeastern United States.

**We Are Exposed to Risks That Are Beyond Our Control**

The cost of repairing damage to our operating subsidiaries' facilities and the potential disruption of their operations or supplier operations due to storms, natural disasters, wars, terrorist acts and other catastrophic events could be substantial. The occurrence or risk of occurrence of future terrorist attacks or related acts of war may lead to increased political, economic and financial market instability and volatility in prices for natural gas which could materially adversely affect us in ways we cannot predict at this time. A lower level of economic activity for these or other reasons could result in a decline in energy consumption, which could adversely affect our net revenues.

**The Long-Term Financial Condition of Our Gas Distribution Business Depends on the Continued Availability of Natural Gas Reserves**

The development of additional natural gas reserves requires significant capital expenditures by others for exploring, drilling and installing production, gathering, storage, transportation and other facilities that permit natural gas to be produced and delivered to our distribution systems. Low prices for natural gas, regulatory restrictions, or the lack of available capital for these projects could adversely affect the development of additional natural gas reserves. Additional natural gas reserves may not be developed in sufficient amounts to fill the capacities of our distribution systems, thus limiting our prospects for long-term growth.

**Gathering, Processing and Transporting Activities Involve Numerous Risks that May Result in Accidents and Other Operating Risks and Costs**

Our gas distribution facilities pose a variety of hazards and operating risks, such as leaks, explosions and mechanical problems caused by natural disasters, accidents, terrorism or other damage by third parties, which could cause substantial financial losses. In addition to impairing our operations, these risks could also result in loss of human life and environmental pollution. In accordance with standard industry practice, we maintain insurance against some, but not all, of these potential risks and losses. The occurrence of any of these events not fully covered by insurance could have a material adverse effect on our financial position and results of operations.

**Additional risks, uncertainties and factors that could cause actual results to differ materially include, but are not limited to, the following:**

S volatility of fuel prices used to generate electricity;

S fluctuations in weather and in gas and electric prices;

S our ability to successfully manage our cost structure and operate efficiently;

S our ability to successfully contract for natural gas supplies required to meet the needs of our customers;

S implementation of new accounting standards or changes in accounting standards or GAAP which may require adjustment to financial statements;

S inflationary trends and interest rates;

S the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of such acquisitions;

S retention of key personnel;

S federal, state and local regulatory initiatives that threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses and conduct operations;

- the impact of federal, state and local utility regulatory policies and orders on our regulated and unregulated businesses;
- 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;
- a change in the fair market value of our investments that could cause a significant change in the carrying value of such investments or the carrying value of related goodwill;
- timely receipts of payments from LIPA and the NYISO, our two largest customers; and
- other risks detailed from time to time in other reports and other documents filed by KeySpan with the SEC.

For any of these statements, KeySpan claims the protection of the safe harbor for forward-looking information contained in the Private Securities Litigation Reform Act of 1995, as amended. For additional discussion on these risks, uncertainties and assumptions, see Item 1. "Description of the Business," Item 2. "Properties," Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 7A. "Quantitative and Qualitative Disclosures About Market Risk" contained herein.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

Information with respect to KeySpan's material properties used in the conduct of its business is set forth in, or incorporated by reference in, Item 1 hereof. Except where otherwise specified, all such properties are owned or, in the case of certain rights-of-way, used in the conduct of its gas distribution business, held pursuant to municipal consents, easements or long-term leases, and in the case of gas and oil properties, held under long-term mineral leases. In addition to the information set forth therein with respect to properties utilized by each business segment, KeySpan leases the executive headquarters located in Brooklyn, New York. In addition, we lease other office and building space, office equipment, vehicles and power operated equipment. Our properties are adequate and suitable to meet our current and expected business requirements. Moreover, their productive capacity and utilization meet our needs for the foreseeable future. KeySpan continually examines its real property and other property for its contribution and relevance to our businesses and when such properties are no longer productive or suitable, they are disposed of as promptly as possible. In the case of leased office space, we anticipate no significant difficulty in leasing alternative space at reasonable rates in the event of the expiration, cancellation or termination of a lease.

## ITEM 3. LEGAL PROCEEDINGS

See Note 7 to the Consolidated Financial Statements, "Contractual Obligations and Contingencies - Legal Matters."

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of the security holders during the last quarter of the 12 months ended December 31, 2005.

# PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

KeySpan's common stock is listed and traded on the New York Stock Exchange and the Pacific Stock Exchange under the symbol "KSE." As of February 15, 2006, there were approximately 68,318 registered record holders of KeySpan's common stock. 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 approximately at the $1.86 level to be paid on a quarterly basis at a rate of approximately $0.465. KeySpan's scheduled dividend payment dates are February 1, May 1, August 1 and November 1, or the next business day, if such date is not a business day.

The following table sets forth, for the quarters indicated, the high and low sales prices and dividends declared per share for the periods indicated:

| 2005 | High | Low | Dividends Per Share |
|---|---|---|---|
| First Quarter | $40.90 | $38.04 | $0.455 |
| Second Quarter | $40.88 | $36.83 | $0.455 |
| Third Quarter | $41.03 | $36.35 | $0.455 |
| Fourth Quarter | $37.10 | $32.66 | $0.455 |

| 2004 | High | Low | Dividends Per Share |
|---|---|---|---|
| First Quarter | $38.60 | $35.72 | $0.445 |
| Second Quarter | $38.99 | $33.87 | $0.445 |
| Third Quarter | $39.50 | $35.19 | $0.445 |
| Fourth Quarter | $41.53 | $37.57 | $0.445 |

## EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth securities authorized for issuance under equity compensation plans for the year ended December 31, 2005:

| Plan category | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|---|---|---|---|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders | | | |
| **KeySpan Long Term Incentive Compensation Plan** | | | |
| Stock Options | 10,443,055 | $33.74 | - |
| Restricted Stock | 90,599 | N/A | - |
| Performance Shares | 555,927 | N/A | - |
| Equity compensation plans not approved by security holders | N/A | N/A | N/A |
| Total | 11,089,581(1) | $33.74 | 3,736,121(2) |

(1) Includes grants of options, restricted stock, and performance shares pursuant to KeySpan's Long-Term Incentive Compensation Plan, as amended, and options granted pursuant to the Brooklyn Union Long-Term Incentive Compensation Plan and options granted pursuant to the Eastern Enterprises 1995 Stock Option Plan and the Eastern Enterprises 1996 Non-Employee Trustee's Stock Option Plan.

(2) This total amount reflects the aggregate number of stock options, restricted stock and performance shares available for issuance pursuant to KeySpan's Long Term Incentive Compensation Plan.

## ITEM 6. SELECTED FINANCIAL DATA

| (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 |

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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.

Consumption 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) |
| Cummulative 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 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, 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.

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | 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.

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 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, Energy North.

**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.

## Executive Summary

## Operating Income 2004 vs 2003

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 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 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.

## 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 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 2003 in our New England service territory.

Net revenues from firm gas customers (residential, commercial and industrial customers) increased $40.8 million for the twelve months ended December 31, 2004 compared to the same period of 2003. As previously mentioned, the MADTE approved a $27 million base rate increase for Boston Gas, which became effective on 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.) Customer additions and oil-to-gas conversions, net of attrition and conservation, added $8.0 million to net gas revenues. Further, we realized a $5.7 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.

Also included in net gas revenues is the recovery of property taxes that were $1.0 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 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.

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 weather patterns on KEDNE's results of operations and cash flows, weather derivatives were in place for the 2003/2004 and 2004/2005 winter heating seasons. These financial derivatives afforded KeySpan some protection against warmer than normal weather. As a result of weather fluctuations year-to-year, offset by the benefits of the financial weather derivatives, weather had a $2.9 million unfavorable impact on comparative net gas revenues.

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 KEDLI and KEDNE are returned to firm customers as an offset to gas costs.

## Firm Sales, Transportation and Other Sales Quantities

Firm gas sales and transportation quantities for the year-ended December 31, 2004, were approximately 1% lower compared to such quantities for the same period in 2003 reflecting the warmer weather. Weather normalized sales quantities increased 2% in our service territories during 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 these services are not material.

## 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.

## Operating Expenses

Total operating expenses for the year ended December 31, 2004 increased $22.6 million, or 2%, compared to 2003, 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 $3 million, net of amounts subject to regulatory deferral treatment, associated with the implementation of the Medicare Act and implementation of Financial Accounting Standards Board Staff Position ("FSP") 106-2. In addition, in 2004, Boston Gas reached a settlement 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 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.

Higher depreciation and amortization expense in 2004 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.

## Sale of Property

During 2003 we recorded $15.1 million in gains from property sales, primarily the sale of 550 acres of real property located on Long Island.

## Gas Supply and Pricing

KeySpan has adequate gas supply available to meet its gas load demand in its service territories for the 2005/2006 winter heating season as KeySpan's gas storage was 100% full at the start of the winter heating season. The current gas rate structure of each of our gas distribution utilities includes 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, management is concerned with the rising natural gas prices and the related impact on customers' gas bills and recovery of customer accounts receivable. As noted, KeySpan has already experienced an increase in bad debt expense and an increase in collection lag. Also, it is likely that the high gas prices will lead to an increase in price elasticity possibly resulting in an increase in customer conservation measures and attrition. The recent MADTE order permitting Boston Gas regulatory recovery of the gas cost component of net bad debt write-offs should help to mitigate the increase in bad debt expense.

With our strategy of having KeySpan's storage facilities 100% full at the start of the heating season and our use of financial derivatives, KeySpan has effectively hedged the price of approximately two-thirds of the gas supply needed to serve its customers during the upcoming 2005/2006 winter. This helps mitigate the impact from rising 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, which we supported the expansion of through the Energy Act. Management believes that these measures will help mitigate the impact of rising 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 rising 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 our market segments, through the expansion of our gas distribution system for new 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 where natural gas is already in the home for other uses 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 Duke Energy Corporation formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Once in service, the pipeline is expected to transport up to 260,000 DTH of natural gas to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. In addition, during 2004 KeySpan acquired a 21% interest 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 150,000 DTH of natural gas per day of transportation capacity from the Millennium Pipeline system, increasing to 200,000 DTH in the third 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 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 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 (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; (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". (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.

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 2005 | 2004 | 2003 |
| Revenues | $ 2,047.3 | $ 1,738.7 | $ 1,606.1 |
| Purchased fuel | 751.4 | 539.6 | 464.8 |
| Net Revenues | 1,295.9 | 1,199.1 | 1,141.3 |
| Operating Expenses | | | |
| Operations and maintenance | 684.5 | 653.3 | 658.6 |
| Depreciation | 91.7 | 88.3 | 67.2 |
| Operating taxes | 178.6 | 169.7 | 145.6 |
| Total Operating Expenses | 954.8 | 911.3 | 871.4 |
| Gain on the sale of property | 1.2 | 2.0 | - |
| Operating Income | $ 342.3 | $ 289.8 | $ 269.9 |
| Electric sales (MWH)* | 6,364,279 | 6,232,190 | 4,738,331 |
| Capacity(MW)* | 2,450 | 2,450 | 2,200 |
| Summer cooling degree days | 1,472 | 1,045 | 988 |

*Reflects the operations of the Ravenswood Generating Station only.

## Executive Summary

### Operating Income 2005 vs 2004

For the twelve months ended December 31, 2005, operating income increased $52.5 million, or 18%, compared to last year, primarily due to an increase in net revenues from the Ravenswood Generating Station of $78.7 million mainly as a result of improved pricing, partially offset by an increase in operating expenses associated with the Ravenswood Generating Station of $11.8 million, as well as lower net revenues associated with KeySpan's retail electric marketing activities of $7.6 million.

### Net Revenues

Total electric net revenues realized during the twelve months ended December 31, 2005, were $96.8 million, or 8% higher than such revenues realized during the corresponding period last year.

For the year ended December 31, 2005, net revenues from the Ravenswood Generating Station increased $78.7 million, or 22%, compared to the same period last year reflecting higher energy margins of $66.0 million, as well as increased capacity revenues of $12.7 million. The increase in capacity revenues reflects the operation of the Ravenswood Expansion which went into full commercial operation in May 2004, as well as load growth in New York City.

The increase in energy margins for 2005 reflects an increase of 45% in realized "spark-spreads" (the selling price of electricity less the cost of fuel, plus hedging gains or losses), as well as from an increase of 2% in the level of megawatt hours ("MWh") sold into the New York Independent System Operator ("NYISO") energy market. These favorable energy results were primarily driven by the pricing differential between number 6-grade fuel oil and natural gas used in the Ravenswood Generating Station in 2005. Due to the dual-fuel nature of the Ravenswood Generating Station, KeySpan was able to take advantage of their ability to switch to cheaper fuel as the gap between number 6 grade fuel oil and gas prices spread during the latter part of the 2005 summer. The two hurricanes which occurred this past summer in the Gulf Coast of the United States contributed to the gap between number 6-grade fuel oil and natural gas prices. Further, in 2005 KeySpan received $9.2 million from the NYISO to settle billing issues regarding the sale of energy provided by the Ravenswood Generating Station to the NYISO in May 2000. Weather for 2005, as measured in cooling degree days, was 40% warmer than last year and 28% warmer than normal.

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 Generating Station. 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 Generating Station. These derivative instruments resulted in hedging losses, which are reflected in net electric margins, of $16.0 million in 2005 compared to hedging gains of $23.0 million in 2004. The results derived from KeySpan's hedging strategy are reflected in the calculation of realized spark-spreads. (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 FERC. See the discussion under the caption "Market and Credit Risk Management Activities" for further details on these matters.

Net revenues for the twelve months ended December 31, 2005, from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $25.7 million compared to the corresponding period of 2004. The increase is due, in part, to recovery of operating expenses billed to LIPA of approximately $14 million and the recovery of depreciation charges and property taxes of approximately $8 million. These recoveries had no impact on operating income since actual expenses increased by a like amount. The remaining increase primarily reflects an increase in emission credits earned and variable revenues, which are a function of electric generation output. In 2005 and 2004 we earned $16.4 million associated with non-cost performance incentives provided for under these agreements. (For a description of the LIPA Agreements and power purchase agreements, see the discussion under the caption "Electric Services – LIPA Agreements.")

Net revenues associated with KeySpan's retail electric marketing activities decreased $7.6 million in 2005 compared to 2004, due to a significant curtailment in these activities. KeySpan has terminated all indexed price contracts and has elected to maintain only its fixed priced contracts. As a result, the retail electric marketing business has approximately 40 MW under contract.

### Operating Expenses

For the twelve months ended December 31, 2005, operating expenses increased $43.5 million, or 5%, compared to the same period last year. Operations and maintenance expense increased $31.2 million, or 5% over last year reflecting an increase of $7.5 million in operating lease costs associated with our financing arrangement for the Ravenswood Expansion, as well as an increase in overhaul work and plant retirement costs associated with the Ravenswood Generating Station amounting to approximately $8 million. The remaining increase reflects operating costs billed to LIPA of approximately $14 million.

Depreciation expense and operating taxes increased $12.3 million in 2005 compared to 2004. Of this amount, approximately $8 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.

### Executive Summary

### Operating Income 2004 vs 2003

Operating income increased $19.9 million for the twelve months ended December 31, 2004 compared to the same period in 2003, due primarily to an increase in net revenues from the Ravenswood Generating Station of $53.8 million, partially offset by higher depreciation expense and operating taxes. In addition, in 2004, KeySpan recognized a gain of $2.0 million on the sale of a parcel of land in Far Rockaway, Queens, to LIPA.

### 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 Generating Station 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 in 2004, compared to 2003 primarily reflects the operation 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 MWh's sold into the NYISO energy market, as well as an increase of 9% in realized spark-spreads. 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 2003, 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.

As noted, 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

Generating Station. 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 Generating Station. 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.

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.

In addition to the above, net revenues from our electric marketing activities were slightly lower in 2004 compared to 2003.

**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 classification 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 Generating Station, as well as higher postretirement costs, which, for the most part, offset the beneficial impact of FIN 46. (See Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for an explanation of the Ravenswood Master Lease.)

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.

**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 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 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. We have begun discussions with LIPA regarding this proposal. At December 31, 2005, total capitalized costs associated with the siting, permitting and procurement of equipment for the Melville facility were $61.2 million.

In March 2005, LIPA issued a RFP to provide system power supply management services beginning May 29, 2006 and fuel management services for certain of its peaking generating units beginning January 1, 2006. A KeySpan subsidiary is currently performing these services. KeySpan submitted a bid in response to the new RFP in April 2005. LIPA was scheduled to select a service provider in June 2005, but has deferred such decision at this time. Pending LIPA's determination on the RFP, the service agreements between KeySpan and LIPA which provide for these services have been extended to December 31, 2006. We cannot predict the outcome or the timing of any decisions by LIPA on this matter at this time.

Also, in March 2005, the New York Power Authority ("NYPA") issued a RFP for long-term New York City capacity and energy to meet the needs of its customers at prices that are economical, stable and predictable over the long run. In June 2005, KeySpan submitted a nonbinding bid in response to NYPA's RFP in which we proposed to construct a 500 MW, combined cycle, natural gas fired power plant to be located in New York City, which could provide energy and capacity to NYPA. The proposed facility could be in commercial operation by June 2009. We cannot predict the outcome or the timing of any decisions by NYPA on this matter at this time.

As part of our growth strategy, we continually evaluate the possible acquisition and development of additional generating facilities in the Northeast, as well as other assets to complement our core operations. 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.

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.

KeySpan continues to believe that New York City represents a strong capacity market and has entered into an International Swap Dealers Association ("ISDA") Master Agreement for a fixed for float unforced capacity financial swap (the "Swap Agreement") with Morgan Stanley Capital Group Inc. ("Morgan Stanley") dated as of January 18, 2006. The Swap 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. Settlement would 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.

## 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.

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. In 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 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 in 2005. (See Note 2 to the Consolidated Financial Statements "Business Segments" for additional details on the sale of the mechanical companies.) The table below highlights selected financial information for the Energy Services segment.

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 2005 | 2004 | 2003 |
| Revenues | $ 202.0 | $ 193.9 | $ 166.4 |
| Less: Operating expenses | 204.7 | 227.8 | 199.4 |
| Goodwill impairment | | 14.4 | - |
| Operating (Loss) | $ (2.7) | $ (48.3) | $ (33.0) |

### Operating Income 2005 vs 2004

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 is 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 last year, excluding the goodwill impairment charge, primarily reflects 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.

## Operating Income 2004 vs 2003

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, in 2004 KeySpan recorded a non-cash goodwill impairment charge in continuing operations of $14.4 million. Excluding the goodwill impairment charge, operating income for the twelve months ended December 31, 2004, was essentially the same as 2003, as higher revenues were offset by higher operating expenses.

## ENERGY INVESTMENTS

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 its 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 primarily engaged in a joint venture with Houston Exploration.

This segment is also engaged in pipeline development activities. KeySpan and 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 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 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. KeySpan LNG is re-evaluating its plans to upgrade its LNG facility in Providence, Rhode Island in light of the FERC decision that denied KeySpan LNG's application for FERC authorization to expand the facility to accept marine deliveries and triple vaporization capacity.

During the first quarter of 2004, we also 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.)

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. Additionally, we sold our 20% interest in Taylor NGL LP that owned and operated 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.

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.

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 and operating statistics for these energy-related investments are set forth in the following table for the periods indicated. These results exclude the results of Houston Exploration.

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 2005 | 2004 | 2003 |
| 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, | |
|---|---|---|
| *(In Millions of Dollars)* | 2004 | 2003 |
| 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 the KeySpan LNG's liquefied 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 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 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:

| | Year Ended December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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)*<br>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 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's 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'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 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.

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, the 2005 gas cost component of bad debt write-offs from Boston Gas ratepayers beginning November 1, 2006.

**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% 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. (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**

At December 31, 2005, KeySpan and certain of its subsidiaries were subject to the jurisdiction of the SEC under PUHCA 1935. The rules and regulations under PUHCA 1935, generally limited the operations of a holding company to a single integrated public utility system, plus additional energy-related businesses. In addition, the principal regulatory provisions of PUHCA 1935: (i) regulated certain transactions among affiliates within a holding company system, including the payment of dividends by such subsidiaries to a holding company; (ii) governed the issuance, acquisition and disposition of securities and assets by a holding company and its subsidiaries; (iii) limited the entry by registered holding companies and their subsidiaries into businesses other than electric and/or gas utility businesses; and (iv) required SEC approval for certain utility mergers and acquisitions.

In August 2005, the Energy Act was enacted by Congress and signed into law by the President. 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.

***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.

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.

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.

Should LIPA sell 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.

***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% with no revenue increase. 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 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 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 2005, we earned $4 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. 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 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 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 1998 EMA reflecting that the facilities that LIPA acquires pursuant to the Option Agreement are no longer covered under the 1998 EMA and as noted above, an operation and maintenance agreement, whereby KeySpan will continue to operate the newly acquired facilities for a fixed management fee plus reimbursement for certain costs. It is anticipated that the fees received pursuant to the operation and maintenance agreement will offset the reduction in any fees earned by KeySpan pursuant to the 1998 EMA.

Under the 1998 LIPA Agreements and the 2006 LIPA 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.

***Power Purchase Agreements.*** KeySpan-Glenwood Energy Center, LLC and KeySpan-Port Jefferson Energy Center LLC each have 25 year power purchase agreements with LIPA expiring in 2027 (the "2002 LIPA PPAs"). Under the terms of the 2002 LIPA PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Each plant is designed to produce 79.9 MW. Pursuant to the 2002 LIPA 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.

**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 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. 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.

## ITEM 7A. 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 | Year of Maturity | Volumes (mmcf) | Fixed Price ($) | Current Price ($) | Fair Value ($Millions) |
|---|---|---|---|---|---|
| **Gas** | | | | | |
| 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 | Year of Maturity | Volumes (Barrels) | Fixed Price ($) | Current Price ($) | Fair Value ($Millions) |
|---|---|---|---|---|---|
| **Oil** | | | | | |
| Swaps - Long Heating Oil | 2006 | 2,056,794 | 39.65 - 67.75 | 56.00 - 57.80 | (6.3) |
| | | 2,056,794 | | | (6.3) |

| Type of Contract | Year of Maturity | MWh | Fixed Price ($) | Current Price ($) | Fair Value ($Millions) |
|---|---|---|---|---|---|
| **Electricity** | | | | | |
| 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:

| *(In Millions of Dollars)* **Change in Fair Value of Derivative Hedging Instruments** | | **2005 ($Millions)** |
|---|---|---|
| Fair value of contracts at January 1, 2005 | $ | (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 in 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 ($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.

## ITEM 8. Financial Statements and Supplementary Data

# CONSOLIDATED BALANCE SHEET

| *(In Millions of Dollars)* | December 31, 2005 | 2004 |
|---|---|---|
| **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

| *(In Millions of Dollars)* | December 31, 2005 | 2004 |
|---|---|---|
| **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 & 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.

# CONSOLIDATED STATEMENT OF INCOME

| (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

| *(In Millions of Dollars)* | **Year Ended December 31, 2005** | 2004 | 2003 |
|---|---|---|---|
| ***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/leasback 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.

## CONSOLIDATED STATEMENT OF RETAINED EARNINGS

| (In Millions of Dollars) | Year Ended December 31, 2005 | 2004 | 2003 |
|---|---|---|---|
| **Balance at Beginning of Period** | $ 792.2 | $ 621.4 | $ 522.8 |
| Net Income for Period | 390.2 | 463.7 | 386.7 |
| | 1,182.4 | 1,085.1 | 909.5 |
| Deductions: | | | |
| Cash dividends declared on common stock | 313.3 | 287.3 | 282.3 |
| Cash dividends declared on preferred stock | 2.2 | 5.6 | 5.8 |
| **Balance 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.

# CONSOLIDATED STATEMENT OF CAPITALIZATION

| (In Millions of Dollars) | December 31, 2005 | December 31, 2004 | December 31, 2005 | December 31, 2004 |
|---|---|---|---|---|
| **Common Shareholders' Equity** | **Shares Issued** | | | |
| 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.

## 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.

Consumption 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 ("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, 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 discounted 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.

| | December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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 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").

***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.

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. 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-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.

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:

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | 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 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 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.

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)* | Gas Distribution | Electric Services | Energy Services | Other 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 | 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)* | Gas Distribution | Electric Services | Energy Services | Houston Exploration | Other 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, 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) | Gas Distribution | Electric Services | Energy Services | Houston Exploration | Other Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|---|
| **Year Ended December 31, 2003** | | | | | | | |
| 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:

| | Year Ended December 31, | | |
|---|---|---|---|
| (In Millions of Dollars) | 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) |
| Employess 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:

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 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 pension and 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 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 re-set 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 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, 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 $14.1million. 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 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 $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, 2005 the following asset retirement obligations were 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 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 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 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. 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 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 continues to evaluate how to proceed with respect to participation in the BCP or alternative DEC remediation programs.

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 $60.9 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 $51.8 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 $355.3 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 to date by us with respect to these MGP-related activities total $112.7 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, 2005, we have reflected a regulatory asset of $388.0 million for our KEDNY/KEDLI MGP sites. 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 $1.7 million, which amount has been accrued by us. Expenditures incurred 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 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.

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 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 $17.0 million.

By rate orders, the MADTE and the NHPUC provide for the recovery of site investigation and remediation costs and, accordingly, at December 31, 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 Issuers 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 | December 31, 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

| | December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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

| | December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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-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 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 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 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.

Consumption 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 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.

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**

| | Year Ended December 31, 2005 | | | | |
|---|---|---|---|---|---|
| *(In Millions of Dollars)* | 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) |
| **Culmulative 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) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Year Ended December 31, 2004 | | | | |
| **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) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Year Ended December 31, 2003 | | | | |
| **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) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | | | December 31, 2005 | | |
| **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) | Guarantor | KEDLI | December 31, 2004<br>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 | | | | |
|---|---|---|---|---|
| | Year Ended December 31, 2003 | | | |
| (In Millions of Dollars) | 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 receiveable | (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***

| | | |
|---|---|---|
| | | *(In Millions of Dollars)* |
| At December 31, | | 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 | | |
|---|---|---|
| | | *(In Millions of Dollars)* |
| At December 31, | | 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**

| | *(In Millions of Dollars)* |
|---|---|
| At December 31, | 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**

| Year Ended 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* 03/31/2004 | 06/30/2004 | | 09/30/2004 | | 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.

## 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. Our audits also included the financial statement schedules listed in the Index at Item 15. These financial statements and financial statement schedules are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedules 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. Also, in our opinion, such financial statement schedules, when considered in relation to the basic consolidated financial statements taken as a whole, present fairly, in all material respects, the information set forth therein.

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.

/s/DELOITTE & TOUCHE LLP
New York, New York
February 28, 2006

## ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## ITEM 9A. 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 and financial statement schedules 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 financial statement schedules 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.

/s/DELOITTE & TOUCHE LLP
New York, New York
February 28, 2006

## ITEM 9B. OTHER INFORMATION

The following disclosures would otherwise have been filed on Form 8-K under the heading "Item 1.01 - Entry into a Material Definitive Agreement".

On February 23, 2006, following the recommendation of the Compensation and Management Development Committee (the "Compensation Committee"), KeySpan's Board of Directors set the 2006 annual base salaries for Robert B. Catell, Robert J. Fani, Wallace P. Parker Jr., Steven L. Zelkowitz and Gerald Luterman, each of whom is a KeySpan named executive officer. Such 2006 base salaries are as follows: Mr. Catell - $1,140,000, Mr. Fani - $782,000, Mr. Parker - $625,000, Mr. Zelkowitz - $625,000, and Mr. Luterman - $488,000. All 2006 base salary increases are effective January 1, 2006, with the exception of Mr. Luterman. Mr. Luterman's base salary increase is effective February 1, 2006.

Also on February 23, 2006, following the recommendation of the Compensation Committee, the Board approved the performance-based incentive awards to be paid to our executive officers for the year ending December 31, 2005 ("FY 2005") under the KeySpan Corporate Annual Incentive Compensation Plan (the "Corporate Plan"). The Corporate Plans provides for performance-based incentive awards as a percentage of cumulative base salary paid during the calendar year. The Compensation Committee had approved the target performance award levels applicable to the Corporate Plan for FY 2005 in December 2004. In January 2005, the Compensation Committee approved the performance goals relating to the FY 2005 Corporate Plan for the named executive officers based on financial and performance measures, including goals relating to earnings per share, cash flow, business unit operating income, diversity initiatives, customer satisfaction, work place safety and other individual strategic goals and initiatives. Based upon actual FY 2005 performance, an award payout for each of the named executive officers was approved as follows: Mr. Catell - $1,400,000, Mr. Fani - $741,175, Mr. Parker - $550,090, Mr. Zelkowitz - $513,129, and Mr. Luterman - $388,282.

In December 2005, the Board approved the compensation formulas for incentive awards that may be paid to our executive officers for the year ending December 31, 2006 ("FY 2006") under the Corporate Plan. For FY 2006, the performance-based target award levels for each of the named executive officers will remain the same as last year. The target performance award levels are as follows: Mr. Catell – 100%, Mr. Fani – 75%, Mr. Parker – 70%, Mr. Zelkowitz – 70% and Mr. Luterman – 65%.

Also in December 2005, the Compensation Committee approved the target award levels for performance-based equity awards that may be granted to our executive officers for FY 2006 under the KeySpan Long-Term Performance Incentive Compensation Plan (the "Long-Term Incentive Plan"). The target award levels have been modified from last year. The target award levels are designed to align with industry benchmarks at 50th percentile levels. The FY 2006 target performance award levels for the named executive officers are as follows: Mr. Catell – 240%, Mr. Fani – 160%, Mr. Parker – 125%, Mr. Zelkowitz – 125% and Mr. Luterman – 110%.

On February 23, 2006, the Compensation Committee also approved the FY 2006 grants pursuant to the Long Term Incentive Plan. The Compensation Committee awarded the following grants to the named executive officers based on actual 2005 performance as follows: Mr. Catell – 85,520 shares of restricted stock; Mr. Fani – 38,930 performance shares; Mr. Parker – 24,320 performance shares; Mr. Zelkowitz – 27,490 performance shares; and Mr. Luterman – 18,360 performance shares.

Mr. Catell's restricted stock has a two year restriction period which shall lapse on February 23, 2008 or the Compensation Committee has the ability to accelerate vesting after one year based on certain goals being achieved. The performance shares for the remaining four named executives will be measured over the three year period beginning on January 1, 2006 through December 31, 2008, with performance results linked to the percentage of improvement in Return on Invested Capital ("ROIC") and Total Shareholder Return ("TSR"). The actual number of shares to be awarded at the end of the performance period will be determined using a sliding scale which encompasses both the ROIC and TSR measures. The ROIC goal will act as the primary trigger. If the ROIC goal is below threshold, all shares will be forfeited without payment regardless of the performance of TSR.

# PART III

## ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

A definitive proxy statement will be filed with the SEC on or about March 31, 2006 (the "Proxy Statement"). The information required by this item is set forth under the caption "Executive Officers of KeySpan" in Part I hereof and under the captions "Proposal 1. Election of Directors", "Certain Relationships and Related Transactions," "Committees of the Board," "Code of Ethics" and "Compliance with Section 16(a) Beneficial Ownership Reporting Compliance" contained in the Proxy Statement, which information is incorporated herein by reference thereto.

## ITEM 11. EXECUTIVE COMPENSATION

The information required by this item is set forth under the captions "Director Compensation" and "Executive Compensation" in the Proxy Statement, which information is incorporated herein by reference thereto.

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is set forth under the captions "Security Ownership of Management" and "Security Ownership of Certain Beneficial Owners" in the Proxy Statement, and in Item 5 of this report, which information is incorporated herein by reference thereto.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information required by this item is set forth under the caption "Agreements with Executives" and "Certain Relationships and Related Transactions" in the Proxy Statement, which information is incorporated herein by reference thereto.

## ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is set forth under the caption "Proposal 2. Ratification of Deloitte & Touche LLP as Independent Registered Public Accounting Firm," "Fiscal Year 2006 Audit Firm Fee Summary" and "Report of the Audit Committee" in the Proxy Statement, which information is incorporated herein by reference thereto.

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Required Documents

1. Financial Statements

The following consolidated financial statements of KeySpan and its subsidiaries and Reports of the Independent Registered Public Accounting Firm are included in Item 8 and are filed as part of this Report:

- Consolidated Statement of Income for the year ended December 31, 2005, the year ended December 31, 2004, and the year ended December 31, 2003
- Consolidated Statement of Retained Earnings for the year ended December 31, 2005, the year ended December 31, 2004, and the year ended December 31, 2003
- Consolidated Balance Sheet at December 31, 2005 and December 31, 2004
- Consolidated Statement of Capitalization at December 31, 2005 and December 31, 2004
- Consolidated Statement of Cash Flows for the year ended December 31, 2005, the year ended December 31, 2004, and the year ended December 31, 2003
- Consolidated Statement of Comprehensive Income for the Year ended December 31, 2005, the year ended December 31, 2004 and the year ended December 31, 2003
- Notes to Consolidated Financial Statements
- Report of the Independent Registered Public Accounting Firm

2. Financial Statement Schedules

Consolidated Schedule of Valuation and Qualifying Accounts for the year ended December 31, 2005, the year ended December 31, 2004, and the year ended December 31, 2003.

**Schedule of Valuation and Qualifying Accounts**

| Descriptions | Balance at Beginning of Period | Charged to costs and expenses | Net Deductions | | Balance at End of Period |
|---|---|---|---|---|---|
| **Twelve Months Ended December 31, 2005** | | | | | |
| Deducted from asset accounts: | | | | | |
| Allowance for doubtful accounts | $ 67,796 | $ 137,190 | $ 142,159 | | $ 62,827 |
| Additions to liability accounts: | | | | | |
| Reserve for injury and damages | $ 9,370 | $ 500 | $ 570 | | $ 9,300 |
| Reserve for environmental expenditures | $ 256,789 | $ 211,178 | $ 43,719 | | $ 424,248 |
| **Twelve Months Ended December 31, 2004** | | | | | |
| Deducted from asset accounts: | | | | | |
| Allowance for doubtful accounts | $ 75,671 | $ 74,089 | $ 81,964 | | $ 67,796 |
| Additions to liability accounts: | | | | | |
| Reserve for injury and damages | $ 9,370 | $ - | $ - | | $ 9,370 |
| Reserve for environmental expenditures | $ 294,691 | $ - | $ 37,902 | | $ 256,789 |
| **Twelve Months Ended December 31, 2003** | | | | | |
| Deducted from asset accounts: | | | | | |
| Allowance for doubtful accounts | $ 63,029 | $ 82,120 | $ 69,478 | * | $ 75,671 |
| Additions to liability accounts: | | | | | |
| Reserve for injury and damages | $ 25,780 | $ 3,928 | $ 20,338 | | $ 9,370 |
| Reserve for environmental expenditures | $ 232,146 | $ 106,270 | $ 43,725 | | $ 294,691 |

* Reflects adjustment for discontinued operations.

All other schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

(b) Exhibits

Exhibits listed below which have been filed with the SEC pursuant to the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, and which were filed as noted below, are hereby incorporated by reference and made a part of this report with the same effect as if filed herewith.

3.1 Certificate of Incorporation of KeySpan effective April 16, 1998, Amendment to Certificate of Incorporation of KeySpan effective May 26, 1998, Amendment to Certificate of Incorporation of KeySpan effective June 1, 1998, Amendment to the Certificate of Incorporation of KeySpan effective April 7, 1999 and Amendment to the Certificate of Incorporation of KeySpan effective May 20, 1999 (filed as Exhibit 3.1 to KeySpan's Form 10-Q for the quarterly period ended June 30, 1999)

3.2 By-Laws of KeySpan in effect as of June 25, 2003, as amended (filed as Exhibit 3.1 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2003)

4.1 Credit Agreement dated as of June 24, 2005 among KeySpan Corporation, the several lenders, The Royal Bank of Scotland PLC and Citibank, N.A., as Co-Syndication Agents, The Bank of New York and The Bank of Nova Scotia, as Co-Documentation Agents, and JPMorgan Chase Bank, N.A., as Administrative Agent (filed as Exhibit 4.1 to KeySpan's Form 8-K dated as of June 29, 2005)

4.2 Amended and Restated Credit Agreement dated as of June 24, 2005 among KeySpan Corporation, the several lenders, The Royal Bank of Scotland PLC and Citibank, N.A., as Co-Syndication Agents, The Bank of New York and The Bank of Nova Scotia, as Co-Documentation Agents, and JPMorgan Chase Bank, N.A., as Administrative Agent (filed as Exhibit 4.2 to KeySpan's Form 8-K dated as of June 29, 2005)

4.3 Indenture, dated as of November 1, 2000, between KeySpan Corporation and the Chase Manhattan Bank, as Trustee, with respect to the issuance of Debt Securities (filed as Exhibit 4-a to Amendment No. 1 to Form S-3 Registration Statement No. 333-43768 and filed as Exhibit 4-a to KeySpan's Form 8-K on November 20, 2000)

4.4 Form of Note issued in connection with the issuance of the KeySpan Corporation $700 million of 7.625% Notes due 2010 issued on November 20, 2000 (filed as Exhibit 4-c to KeySpan's Form 8-K on November 20, 2000)

4.5 Form of Note issued in connection with the issuance of the KeySpan Corporation $250 million of 8.0% Notes due 2030 issued on November 20, 2000 (filed as Exhibit 4-d to KeySpan's Form 8-K on November 20, 2000)

4.6 Form of Note issued in connection with the issuance of the KeySpan Corporation $150 million of 4.65% Notes issued on April 1, 2003 (filed as Exhibit 4.1 to KeySpan's Form 8-K dated as of April 8, 2003)

4.7 Form of Note issued in connection with the issuance of the KeySpan Corporation $150 million of 5.875% Notes issued on April 1, 2003 (filed as Exhibit 4.2 to KeySpan's Form 8-K dated as of April 8, 2003)

4.8 Form of Note issued in connection with the issuance of the KeySpan Corporation $307.2 million of 5.803% Notes issued on March 29, 2005 (filed as Exhibit 4.1 to KeySpan's Form 8-K dated as of March 31, 2005)

4.9 Supplemental Remarketing Agreement dated as of March 21, 2005 among KeySpan Corporation, J.P. Morgan Securities Inc. and JPMorgan Chase Bank, N.A. in connection with the remarketing of the 4.9% Notes due 2008 (filed as Exhibit 99.1 to KeySpan's Form 8-K dated as of March 24, 2005)

4.10 Indenture, dated December 1, 1999, between KeySpan and KeySpan Gas East Corporation, the Registrants, and the Chase Manhattan Bank, as Trustee, with respect to the issuance of Medium-Term Notes, Series A, (filed as Exhibit 4-a to Amendment No. 1 to KeySpan's and KeySpan Gas East Corporation's Form S-3 Registration Statement No. 333-92003)

| | |
|---|---|
| 4.11 | Form of Medium-Term Note issued in connection with the issuance of KeySpan Gas East Corporation 7 7/8% Notes issued on February 1, 2000 (filed as Exhibit 4 to KeySpan's Form 8-K on February 1, 2000) |
| 4.12 | Form of Medium-Term Note issued in connection with the issuance of KeySpan Gas East Corporation 6.9% Notes issued on January 19, 2001 (filed as Exhibit 4.3 to KeySpan's Form 10-K for the year ended December 31, 2000) |
| 4.13 | Participation Agreement, dated as of July 1, 1991, between New York State Energy Research and Development Authority ("NYSERDA") and The Brooklyn Union Gas Company relating to the Gas Facilities Revenue Bonds ("GFRBs") Series 1991A and 1991B (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1991) |
| 4.14 | Indenture of Trust, dated as of July 1, 1991, between NYSERDA and Manufacturers Hanover Trust Company, as Trustee, relating to the GFRBs Series 1991A and 1991B (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1991) |
| 4.15 | Participation Agreement, dated as of July 1, 1992, between NYSERDA and The Brooklyn Union Gas Company relating to the GFRBs Series 1993A and 1993B (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1992) |
| 4.16 | Indenture of Trust, dated as of July 1, 1992, between NYSERDA and Chemical Bank, as Trustee, relating to the GFRBs Series 1993A and 1993B (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company Form 10-K for the year ended September 30, 1992) |
| 4.17 | Participation Agreement dated as of July 1, 1991 between NYSERDA and The Brooklyn Union Gas Company relating to the GFRBs Series D (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1991) |
| 4.18 | First Supplemental Participation Agreement dated as of June 1, 1993 between NYSERDA and The Brooklyn Union Gas Company relating to GFRBs Series D (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1993) |

4.19 Trust Indenture, dated as of July 1, 1991 between NYSERDA and Manufacturers Hanover Trust Company relating to the GFRBs Series D (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1991)

4.20 First Supplemental Trust Indenture, dated as of June 1, 1993 between NYSERDA and Chemical Bank (as successor to Manufacturers Hanover Trust Company) relating to the GFRBs Series D (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1993)

4.21 Participation Agreement, dated January 1, 1996, between NYSERDA and The Brooklyn Union Gas Company relating to GFRBs Series 1996 (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1996)

4.22 Indenture of Trust, dated January 1, 1996, between NYSERDA and Chemical Bank, as Trustee, relating to GFRBs Series 1996 (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1996)

4.23 Participation Agreement, dated as of January 1, 1997, between NYSERDA and The Brooklyn Union Gas Company relating to GFRBs 1997 Series A (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1997)

4.24 Indenture of Trust, dated January 1, 1997, between NYSERDA and Chase Manhattan Bank, as Trustee, relating to GFRBs 1997 Series A (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1997)

4.25 Supplemental Trust Indenture, dated as of January 1, 2000, by and between NYSERDA and The Chase Manhattan Bank, as Trustee, relating to the GFRBs 1997 Series A (The Brooklyn Union Gas Company Project) (filed as Exhibit 4.11 to KeySpan's Form 10-K for the year ended December 31, 1999)

4.26 Bond Purchase Agreement, dated as of October 26, 2005, among The Brooklyn Union Gas Company and NYSERDA and Morgan Stanley & Co. Incorporated, BNY Capital Markets, Inc., Sovereign Securities Corporation, LLC and The Williams Capital Group, L.P., as Series A Underwriters, for the issuance of $82 million aggregate principal amount of 4.7% GFRBs, 2005, Series A. (The Brooklyn Union Gas Company Project) (filed as Exhibit 10.1 to KeySpan's Form 8-K dated November 1, 2005)

4.27 Indenture of Trust, dated as of November 1, 2005, between NYSERDA and Citibank, N.A., as Trustee, relating to the issuance of $82 million GFRBs, 2005 Series A, 4.7% due February 2024 (The Brooklyn Union Gas Company Project)

(filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.28 Participation Agreement, dated as of November 1, 2005, between NYSERDA and The Brooklyn Union Gas Company relating to the issuance of $82 million GFRBs, 2005 Series A, 4.7% due February 2024 (filed as Exhibit 10.2 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.29 Promissory Note, dated as of November 1, 2005, executed by the Brooklyn Union Gas Company for issuance of $82 million GFRBs, 2005 Series A, 4.7% due February 2024 (filed as Exhibit 10.3 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.30 Bond Purchase Agreement, dated as of October 26, 2005, among The Brooklyn Union Gas Company and NYSERDA and Goldman Sachs & Co., BNY Capital Markets, Inc., Sovereign Securities Corporation, LLC and The Williams Capital Group, L.P., as Series A Underwriters, for the issuance of $55 million aggregate principal amount of GFRBs, 2005, Series B (filed as Exhibit 10.2 to KeySpan's Form 8-K dated November 1, 2005)

4.31 Indenture of Trust, dated as of November 1, 2005, between NYSERDA and Citibank, N.A., as Trustee, relating to the issuance of $55 million GFRBs, 2005 Series B due June 2025 (filed as Exhibit 10.4 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.32 Participation Agreement, dated as of November 1, 2005, between NYSERDA and The Brooklyn Union Gas Company relating to the issuance of $55 million GFRBs, 2005 Series B, due February 2025 (filed as Exhibit 10.5 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.33 Promissory Note, dated as of November 1, 2005, executed by the Brooklyn Union Gas Company for the issuance of $55 million GFRBs, 2005 Series B, due June 2025 (filed as Exhibit 10.6 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.34 Letter of Credit and Reimbursement Agreement, dated December 9, 2003, by and between KeySpan Generation LLC and Royal Bank of Scotland Bank PLC (filed as Exhibit 4.34 to KeySpan's Form 10-K for the year ended December 31, 2003)

4.35 Participation Agreement dated as of December 1, 1997 by and between NYSERDA and Long Island Lighting Company relating to the 1997 Electric Facilities Revenue Bonds ("EFRBs"), Series A (KeySpan Generation LLC) (filed as Exhibit 10(a) to KeySpan's Form 10-Q for the quarterly period ended September 30, 1998)

4.36 Indenture of Trust, dated as of December 1, 1997, by and between NYSERDA and The Chase Manhattan Bank, as Trustee, relating to the 1997 EFRBs, Series A

(KeySpan Generation LLC) (filed as Exhibit 10(a) to KeySpan's Form 10-Q for the quarterly period ended September 30, 1998)

4.37 Participation Agreement, dated as of October 1, 1999, by and between NYSERDA and KeySpan Generation LLC relating to the 1999 Pollution Control Refunding Revenue Bonds ("PCRB's"), Series A (filed as Exhibit 4.10 to KeySpan's Form 10-K for the year ended December 31, 1999)

4.38 Trust Indenture, dated as of October 1, 1999, by and between NYSERDA and The Chase Manhattan Bank, as Trustee, relating to the 1999 PCRBs, Series A (filed as Exhibit 4.10 to KeySpan's Form 10-K for the year ended December 31, 1999)

4.39 Indenture, dated as of December 1, 1989, between Boston Gas Company and The Bank of New York, as Trustee (filed as Exhibit 4.2 to Boston Gas Company's Form S-3 (File No. 33-31869))

4.40 Second Amended and Restated First Mortgage Indenture for Colonial Gas Company, dated as of June 1, 1992 (filed as Exhibit 4(b) to Colonial Gas Company's Form 10-Q for the quarter ended June 30, 1992)

4.41 First Supplemental Indenture for Colonial Gas Company dated as of June 15, 1992 (filed as Exhibit 4(c) to Colonial Gas Company's Form 10-Q for the quarter ended June 30, 1992)

4.42 Second Supplemental Indenture for Colonial Gas Company dated as of September 27, 1995 (filed as Exhibit 4(c) to Colonial Gas Company's Form 10-K for the fiscal year ended December 31, 1995)

4.43 Amendment to Second Supplemental Indenture for Colonial Gas Company dated as of October 12, 1995 (filed as Exhibit 4(d) to Colonial Gas Company's Form 10-K for the fiscal year ended December 31, 1995)

4.44 Third Supplemental Indenture for Colonial Gas Company dated as of December 15, 1995 (filed as Exhibit 4(f) to Colonial Gas Company's Form S-3 Registration Statement dated January 5, 1998)

4.45 Fourth Supplemental Indenture for Colonial Gas Company dated as of March 1, 1998 (filed as Exhibit 4(l) to Colonial Gas Company's Form 10-Q for the quarter ended March 31, 1998)

4.46 Trust Agreement, dated as of June 22, 1990, between Colonial Gas Company, as Trustor, and Shawmut Bank, N.A., as Trustee (filed as Exhibit 10(d) to Colonial Gas Company's Form 10-Q for the quarterly period ended June 30, 1990)

4.47 Lease Agreement, dated as of November 1, 2003, by and between the Suffolk County Industrial Development Agency and KeySpan-Port Jefferson Energy

Center, LLC (filed as Exhibit 4.14-a to KeySpan's Form 10-K for the year ended December 31, 2003)

4.48 Company Lease Agreement, dated as of November 1, 2003, by and between KeySpan-Port Jefferson Energy Center, LLC and the Suffolk County Industrial Development Agency (filed as Exhibit 4.14-b to KeySpan's Form 10-K for the year ended December 31, 2003)

4.49 Guaranty, dated as of November 26, 2003, from KeySpan Corporation to the Suffolk County Industrial Development Agency (filed as Exhibit 4.14-c to KeySpan's Form 10-K for the year ended December 31, 2003)

4.50 Lease Agreement, dated as of November 1, 2003, by and between the Nassau County Industrial Development Agency and KeySpan-Glenwood Energy Center, LLC (filed as Exhibit 4.15-a to KeySpan's Form 10-K for the year ended December 31, 2003)

4.51 Company Lease Agreement, dated as of November 1, 2003, by and between KeySpan-Glenwood Energy Center, LLC and the Nassau County Industrial Development Agency (filed as Exhibit 4.15-b to KeySpan's Form 10-K for the year ended December 31, 2003)

4.52 Guaranty, dated as of November 26, 2003, from KeySpan Corporation to the Nassau County Industrial Development Agency (filed as Exhibit 4.14-c to KeySpan's Form 10-K for the year ended December 31, 2003)

4.53 Lease Agreement, dated June 9, 1999, between KeySpan-Ravenswood, LLC and LIC Funding, Limited Partnership (filed as Exhibit 10.2 to KeySpan's Form 10-Q for the quarterly period ended June 30, 1999)

4.54 First Amendment to the Lease Agreement between KeySpan-Ravenswood, LLC and LIC Funding, Limited Partnership, dated as of June 27, 2002 (filed as Exhibit 10.25 to KeySpan's Form 10-K for the year ended December 31, 2002)

4.55 KeySpan Corporation Guaranty dated June 9, 1999, from KeySpan in favor of LIC Funding, Limited Partnership (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended June 30, 1999)

4.56 KeySpan Corporation Guaranty dated May 25, 2004, relating to the 250 MW Ravenswood Expansion (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2004)

4.57 Facility Lease Agreement, dated as of May 25, 2004, between SE Ravenswood Trust, a Delaware statutory trust, and KeySpan-Ravenswood, LLC relating to the 250 MW Ravenswood Expansion(filed as Exhibit 10.2 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2004)

4.58 Site Lease and Easement Agreement, dated as of May 25, 2004, between KeySpan-Ravenswood, LLC and SE Ravenswood Trust relating to the 250 MW Ravenswood Expansion (filed as Exhibit 10.3 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2004)

4.59 Site Sublease, dated as of May 25, 2004, between SE Ravenswood Trust and KeySpan-Ravenswood, LLC relating to the 250 MW Ravenswood Expansion (filed as Exhibit 10.4 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2004)

4.60 Amendment, Assignment and Assumption Agreement, dated as of September 29, 1997, by and among The Brooklyn Union Gas Company, Long Island Lighting Company and KeySpan Energy Corporation (filed as Exhibit 2.5 to Schedule 13D by Long Island Lighting Company on October 24, 1997)

10.1 Agreement and Plan of Merger, dated as of June 26, 1997, by and among BL Holding Corp., Long Island Lighting Company, Long Island Power Authority and LIPA Acquisition Corp. (filed as Annex D to the Joint Registration Statement on Form S-4 of The Brooklyn Union Gas Company and Long Island Lighting Company, Registration No. 333-30353 on June 30, 1997)

10.2 Management Services Agreement between Long Island Power Authority and Long Island Lighting Company dated as of June 26, 1997 (filed as Annex D to the Joint Registration Statement on Form S-4 of The Brooklyn Union Gas Company and Long Island Lighting Company, Registration No. 333-30353 on June 30, 1997)

10.3 Amendment, dated as of March 29, 2002, to Management Services Agreement between Long Island Lighting Company d/b/a LIPA and KeySpan Electric Services LLC dated as of June 26, 1997 (filed as Exhibit 10.4-b to KeySpan's Form 10-K for the year ended December 31, 2002)

10.4 Management Services Agreement dated as of January 1, 2006 between the Long Island Lighting Company ("LILCO") d/b/a LIPA and KeySpan Electric Services LLC (filed as Exhibit 10.1 to KeySpan's Form 8-K filed on February 6, 2005)

10.5 Power Supply Agreement between Long Island Lighting Company and Long Island Power Authority dated as of June 26, 1997 (filed as Annex D to the Joint Registration Statement on Form S-4 of The Brooklyn Union Gas Company and Long Island Lighting Company, Registration No. 333-30353 on June 30, 1997)

10.6 Energy Management Agreement between Long Island Lighting Company and Long Island Power Authority dated as of June 26, 1997 (filed as Annex D to Registration Statement on Form S-4, No. 333-30353, on June 30, 1997)

10.7 Amendment, dated as of March 29, 2002, to Energy Management Agreement between Long Island Lighting Company d/b/a LIPA and KeySpan Energy Trading Services LLC dated as of June 26, 1997 (filed as Exhibit 10.6-b to KeySpan's Form 10-K for the year ended December 31, 2002)

10.8 Generation Purchase Rights Agreement between Long Island Lighting Company and Long Island Power Authority dated as of June 26, 1997 (filed as Exhibit 10.17 to KeySpan's Form 10-K for the year ended December 31, 2001)

10.9 Amendment, dated as of March 29, 2002, to Generation Purchase Rights Agreement by and between KeySpan Corporation, as Seller, and Long Island Lighting Company d/b/a LIPA, as Buyer, dated as of June 26, 1997 (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended March 31, 2002)

10.10 Generation Purchase Right Extension Agreement between KeySpan and the Long Island Power Authority dated as of March 28, 2005 (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended March 31, 2005)

10.11 Option Agreement dated as of January 1, 2006 between LILCO d/b/a LIPA and KeySpan Electric Services LLC (filed as Exhibit 10.2 to KeySpan's Form 8-K filed on February 6, 2005)

10.12 Settlement Agreement dated as of January 1, 2006 among KeySpan, KeySpan Generation LLC, KeySpan Electric Services LLC, KeySpan Energy Trading Services LLC and LIPA (filed as Exhibit 10.3 to KeySpan's Form 8-K filed on February 6, 2005)

10.13 Agreement of Lease between Forest City Jay Street Associates and The Brooklyn Union Gas Company dated September 15, 1988 (filed as an Exhibit to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1996)

10.14 Second Amendment, dated as of March 24, 2005, to the Lease Agreement dated as of September 15, 1998 between The Brooklyn Union Gas Company and Forest City Jay Street Associates, L.P. (filed as Exhibit 10 to KeySpan's Form 8-K dated as of March 30, 2005)

10.15 ISDA Master Agreement, dated as of January 18, 2006, between KeySpan Corporation and Morgan Stanley Capital Group Inc. (filed as Exhibit 10.1 to KeySpan's Form 8-K dated January 24, 2006)

10.16 Restated Exploration Agreement between The Houston Exploration Company and KeySpan Exploration and Production, L.L.C. dated June 30, 2000 (filed as Exhibit 10.1 to The Houston Exploration Company's Form 10-Q for the quarter ended September 30, 2000, File No. 001-11899)

10.17 Distribution Agreement, dated June 2, 2004, by and among The Houston Exploration Company, Seneca-Upshur Petroleum, Inc., THEC Holdings Corp. and KeySpan Corporation (filed as Exhibit 99.2 to The Houston Exploration Company's Form 8-K dated as of June 3, 2004)

10.18 Asset Contribution Agreement, dated June 2, 2004, between The Houston Exploration Company and Seneca-Upshur Petroleum, Inc. (filed as Exhibit 99.3 to The Houston Exploration Company's Form 8-K dated as of June 3, 2004)

10.19 Tax Matters Agreement, dated June 2, 2004, by and among The Houston Exploration Company, Seneca-Upshur Petroleum, Inc., THEC Holdings Corp. and KeySpan Corporation (filed as Exhibit 99.4 to The Houston Exploration Company's Form 8-K dated as of June 3, 2004)

10.20 Share Sale and Purchase Agreement dated February 25, 2005 with BG Energy Holdings Limited and Premier Transmission Financing Public Limited Company (filed as Exhibit 10.37 to KeySpan's Form 10-K for the year ended December 31, 2004)

10.21 Purchase Agreement, dated January 28, 2005, among Robert B. Snyder, Frank J. Sullivan, Robert B. Snyder, Jr., Philip J. Andreoli, William J. McKean, Binsky & Snyder, LLC, Binsky & Snyder Service, LLC and KeySpan Business Solutions, LLC (filed as Exhibit 10.35 to KeySpan's Form 10-K for the year ended December 31, 2004)

10.22 Purchase Agreement, dated February 11, 2005, among WDF Holding Corp., WDF, Inc. and KeySpan Business Solutions, LLC (filed as Exhibit 10.36 to KeySpan's Form 10-K for the year ended December 31, 2004)

## Compensation Agreements

10.23* Cash Compensation for Non-Management Directors of KeySpan

10.24* Base Salaries of Named Executive Officers of KeySpan in effect as of February 23, 2006

10.25 Employment Agreement, dated February 24, 2005, between KeySpan and Robert B. Catell (filed as Exhibit 10.10 to KeySpan's Form 10-K for the year ended December 31, 2004)

10.26 Employment Agreement, dated January 1, 2005, between KeySpan and Anthony Sartor (filed as Exhibit 10.01 to KeySpan's Form 8-K dated as of January 4, 2005)

| | |
|---|---|
| 10.27 | Supplemental Retirement Agreement, dated January 1, 2005, between KeySpan and Anthony Sartor (filed as Exhibit 10.12 to Company's Form 8-K dated as of January 4, 2005) |
| 10.28 | Supplemental Retirement Agreement, dated July 1, 2002, between KeySpan and Steven L. Zelkowitz (filed as Exhibit 10.12 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.29 | Supplemental Retirement Agreement, dated July 1, 2002, between KeySpan and Gerald Luterman (filed as Exhibit 10.11 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.30 | Supplemental Retirement Agreement, dated July 1, 2002, between KeySpan and David J. Manning (filed as Exhibit 10.13 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.31 | Supplemental Retirement Agreement, dated July 1, 2002, between KeySpan and Elaine Weinstein (filed as Exhibit 10.15 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.32 | Directors' Deferred Compensation Plan effective April 2003 (filed as Exhibit 10.16 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2003) |
| 10.33 | Officers' Deferred Stock Unit Plan of KeySpan Corporation (filed as Exhibit 10.17 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.34 | Officers' Deferred Stock Unit Plan of KeySpan Services, Inc. (filed as Exhibit 10.18 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002) |
| 10.35 | Corporate Annual Incentive Compensation and Gainsharing Plan (filed as Exhibit 10.20 to KeySpan's Form 10-K for the year ended December 31, 2000) |
| 10.36* | Corporate Annual Incentive Compensation Plan Target Performance Award Level for Fiscal Year 2006 |
| 10.37 | Senior Executive Change of Control Severance Plan effective as of October 29, 2003 (filed as Exhibit 10.20 to KeySpan's Form 10-K for the year ended December 31, 2003) |
| 10.38 | KeySpan's Amended Long-Term Performance Incentive Compensation Plan (filed as Exhibit A to KeySpan's 2001 Proxy Statement filed on March 23, 2001) |

| | |
|---|---|
| 10.39* | KeySpan's Long-Term Performance Incentive Compensation Plan Performance Target Award Level for Fiscal 2006 |
| 14 | Code of Ethics (filed as Exhibit 14 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2003). |
| 21* | Subsidiaries of the Registrant |
| 23.1* | Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm |
| 24.1* | Power of Attorney executed by Andrea S. Christensen on February 22, 2006 |
| 24.2* | Power of Attorney executed by Robert J. Fani on February 22, 2006 |
| 24.3* | Power of Attorney executed by Alan H. Fishman on February 22, 2006 |
| 24.4* | Power of Attorney executed by James R. Jones on February 22, 2006 |
| 24.5* | Power of Attorney executed by James L. Larocca on February 22, 2006 |
| 24.6* | Power of Attorney executed by Gloria C. Larson on February 22, 2006 |
| 24.7* | Power of Attorney executed by Stephen W. McKessy on February 22, 2006 |
| 24.8* | Power of Attorney executed by Edward D. Miller on February 22, 2006 |
| 24.9* | Power of Attorney executed by Vikki L. Pryor on February 22, 2006 |
| 24.10* | Certified copy of the Resolution of the Board of Directors authorizing signatures pursuant to power of attorney |
| 31.1* | Certification of the Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2* | Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1* | Certification of the Chairman and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2* | Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* filed herewith

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KEYSPAN CORPORATION
(Registrant)

| **Signature:** | **Date:** |
|---|---|
| By: /s/Gerald Luterman<br>Gerald Luterman<br>Executive Vice President<br>and Chief Financial Officer | February 28, 2006 |

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| **Signatures:** | **Date:** |
|---|---|
| By: /s/Robert B. Catell<br>Robert B. Catell<br>Chairman of the Board of Directors<br>and Chief Executive Officer | February 28, 2006 |
| By: /s/Gerald Luterman<br>Gerald Luterman<br>Executive Vice President and<br>Chief Financial Officer | February 28, 2006 |
| By: /s/Theresa A. Balog<br>Theresa A. Balog<br>Vice President and<br>Chief Accounting Officer | February 28, 2006 |

*

Andrea S. Christensen
Director

*

Robert J. Fani
President, Chief Operating Officer and Director

*

Alan H. Fishman
Director

*

James R. Jones
Director

*

James L. Larocca
Director

*

Gloria C. Larson
Director

*

Stephen W. McKessy
Lead Director

*

Edward D. Miller
Director

*

Vikki L. Pryor
Director

* Such signature has been affixed pursuant to a Power of Attorney filed as an exhibit hereto and incorporated herein by reference thereto

## CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement Nos. 333-119491, 333-104230, 333-82230, 333-92003 and 333-13429 on Form S-3 and Registration Statement Nos. 333-119474, 333-53765, 333-40472 and 333-79151 on Form S-8 of our reports dated February 28, 2006, relating to the financial statements and financial statement schedules of KeySpan Corporation [which report expresses an unqualified opinion and includes an explanatory paragraph related to (i) the adoption of FASB Interpretation (“FIN”) 46 "Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51" discussed in Note 1(P) and (ii) the adoption of FIN 47, " Accounting for Conditional Asset Retirement Obligations, an interpretation of FASB Statement No. 143” discussed in Notes 1(O), 1(P) and 7] and to management's report on the effectiveness of internal control over financial reporting appearing in this Annual Report on Form 10-K of KeySpan Corporation for the year ended December 31, 2005.

/s/DELOITTE & TOUCHE LLP
New York, New York
February 28, 2006

Exhibit 31.1

**CERTIFICATION OF THE**
**CHAIRMAN AND CHIEF EXECUTIVE OFFICER**
**PURSUANT TO SECTION 302**
**OF THE SARBANES-OXLEY ACT OF 2002**

I, Robert B. Catell, certify that:

1. I have reviewed this Annual Report on Form 10-K for the year ended December 31, 2005 of KeySpan Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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 principals;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter

(the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

    a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 28, 2006

/s/ Robert B. Catell
Robert B. Catell
Chairman of the Board of Directors
and Chief Executive Officer

Exhibit 31.2

**CERTIFICATION OF THE**
**EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER**
**PURSUANT TO SECTION 302**
**OF THE SARBANES-OXLEY ACT OF 2002**

I, Gerald Luterman, certify that:

1. I have reviewed this Annual Report on Form 10-K for the year ended December 31, 2005 of KeySpan Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

    a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

    b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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 principals;

    c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter

(the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 28, 2006

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President
and Chief Financial Officer

Exhibit 32.1

**CERTIFICATION OF THE**
**CHAIRMAN AND CHIEF EXECUTIVE OFFICER**
**PURSUANT TO SECTION 906**
**OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report on Form 10-K for the year ended December 31, 2005 of KeySpan Corporation (the “Corporation”), as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Robert B. Catell, Chairman and Chief Executive Officer of the Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 28, 2006

/s/ Robert B. Catell
Robert B. Catell
Chairman of the Board of Directors
and Chief Executive Officer

Exhibit 32.2

**CERTIFICATION OF THE
EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER
PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Annual Report on Form 10-K for the year ended December 31, 2005 of KeySpan Corporation (the "Corporation"), as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gerald Luterman, Executive Vice President and Chief Financial Officer of the Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(3) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(4) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: February 28, 2006

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President
and Chief Financial Officer

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**Washington, D.C. 20549**

**FORM 10-K**

**[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2006

**Commission file number 1-14161**

**KEYSPAN CORPORATION**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **NEW YORK** | **11-3431358** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| **One MetroTech Center, Brooklyn, New York** | **11201** |
| **175 East Old Country Road, Hicksville, New York** | **11801** |
| (Address of principal executive offices) | (Zip code) |

**(718) 403-1000 (Brooklyn)**
**(516) 755-6650 (Hicksville)**

(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

| Title of each class | Name of each exchange on which registered |
|---|---|
| Common Stock, $.01 par value | New York Stock Exchange |

**SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:**
None
(Title of class)

Indicate by check mark if the registrant is a well known seasoned issuer, as defined in Rule 405 of the Securities Act.

_X_ Yes ___ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

__ Yes _X_ No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

_X_ Yes ___ No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. _X_ Yes __ No

Indicate by check mark whether the registrant is a large accelerated filer, or a non-accelerated filler.

Large accelerated filer _X_ Accelerated filer ___ Non-accelerated filer __

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). __ Yes _X_ No

The aggregate market value of the voting and non-voting common equity held by non-affiliates (174,772,562 shares) of the registrant was $7,223,349,984 based on the closing price of the New York Stock Exchange on February 20, 2007, of $41.33 per share.

As of February 20, 2007, there were 175,588,130 shares of common stock, $.01 par value, outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

None.

**KEYSPAN CORPORATION**
**INDEX TO FORM 10-K**

Page

**PART I**



**PART II**



**PART III**



**PART IV**

# PART I

## ITEM 1. BUSINESS

## CORPORATE OVERVIEW

KeySpan Corporation ("KeySpan") is a member of the Standard and Poor's 500 Index. KeySpan is a New York corporation and a holding company under the Public Utility Holding Company Act of 2005 ("PUHCA 2005"). KeySpan 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"), now known as KeySpan New England, LLC ("KNE"), a Massachusetts limited liability company, which primarily owns Boston Gas Company ("Boston Gas"), Colonial Gas Company ("Colonial Gas") and Essex Gas Company ("Essex Gas"), gas utilities operating in Massachusetts, as well as EnergyNorth Natural Gas, Inc. ("EnergyNorth"), a gas utility operating principally in central New Hampshire. 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. KeySpan also owns, leases and operates electric generating plants in Nassau and Suffolk Counties on Long Island and in Queens County in New York City and is the largest electric generation operator in New York State. Under contractual arrangements, KeySpan provides 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 ("LNG") storage; retail electric marketing; large energy-system ownership, installation and management; service and maintenance of energy systems; and engineering and consulting services. KeySpan also invests and participates in the development of natural gas pipelines, electric generation and other energy-related projects. As used herein, "KeySpan," "we," "us" and "our" refers to KeySpan Corporation, its six principal gas distribution subsidiaries and its other regulated and unregulated subsidiaries, individually and in the aggregate.

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 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 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. 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.

KeySpan is a holding company under the Public Utility Holding Company Act of 2005, as amended ("PUHCA 2005"). 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 the Public Utility Holding Company Act of 1935, as amended ("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 PUHCA 2005. See "Regulation and Rate Matters" for additional information on the Energy Act and PUHCA 2005.

Under our holding company structure, we have no independent operations and conduct substantially all of our operations through our subsidiaries. Our subsidiaries operate in the following four business segments: Gas Distribution, Electric Services, Energy Services and Energy Investments.

The Gas Distribution segment consists of our six regulated gas distribution subsidiaries, which operate in New York, Massachusetts and New Hampshire and serve approximately 2.6 million customers.

The Electric Services segment consists of subsidiaries that manage the electric transmission and distribution system ("T&D System") owned by LIPA; provide generating capacity and, to the extent required, energy conversion services for LIPA from our approximately 4,200 megawatts ("MW") of generating facilities located on Long Island; and manage fuel supplies for LIPA to fuel our Long Island generating facilities. The Electric Services segment also includes subsidiaries that own, lease and operate the 2,200 MW Ravenswood electric generation facility (the "Ravenswood Facility"), located in Queens County in New York City, and the 250 MW combined cycle generating unit (the "Ravenswood Expansion") which began full commercial operation in May 2004 (collectively, the Ravenswood Facility and the Ravenswood Expansion are referred to herein as the "Ravenswood Generating Station" and have a total electric capacity of 2,450 MW). Moreover, subsidiaries in this segment also provide retail marketing of electricity to commercial customers.

The Energy Services segment provides energy-related services to customers primarily located within the Northeastern United States, with concentrations in the New York City and Boston metropolitan areas.

The Energy Investments segment includes our gas production and development activities, domestic pipelines, gas storage facilities and LNG facilities and operations.

KeySpan's principal executive offices are located at One MetroTech Center, Brooklyn, New York 11201 and 175 East Old Country Road, Hicksville, New York 11801, and its telephone numbers are (718) 403-1000 (Brooklyn) and (516) 755-6650 (Hicksville).

KeySpan makes available free of charge on or through its website, http://www.keyspanenergy.com (Investor Relations section), its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. You may also read and copy any of these documents at the SEC's public reference room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the public reference room. Our SEC filings are also available to the public on the SEC's web site at www.sec.gov.

## GAS DISTRIBUTION OVERVIEW

Our gas distribution activities are conducted by our six regulated gas distribution subsidiaries, which operate in three states in the Northeast: New York, Massachusetts and New Hampshire. We are the fifth largest gas distribution company in the United States and the largest in the Northeast, with approximately 2.6 million customers served within an aggregate service area covering 4,273 square miles. In New York, The Brooklyn Union Gas Company, doing business as KeySpan Energy Delivery New York ("KEDNY"), provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Queens and Staten Island; and KeySpan Gas East Corporation, doing business as KeySpan Energy Delivery Long Island ("KEDLI"), provides gas distribution services to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. In Massachusetts, Boston Gas provides gas distribution services in eastern and central Massachusetts; Colonial Gas provides gas distribution services on Cape Cod and in eastern Massachusetts; and Essex Gas provides gas distribution services in eastern Massachusetts. In New Hampshire, EnergyNorth provides gas distribution services to customers principally located in central New Hampshire. Our New England gas companies all do business as KeySpan Energy Delivery New England ("KEDNE").

In New York, there are two separate, but contiguous service territories served by KEDNY and KEDLI, comprising approximately 1,417 square miles and 1.68 million customers. In Massachusetts, Boston Gas, Colonial Gas and Essex Gas serve three service territories consisting of 1,934 square miles and approximately 792,000 customers. In New Hampshire, EnergyNorth has a service territory that is contiguous to Colonial Gas' and ranges from within 30 to 85 miles of the greater Boston area. EnergyNorth provides service to approximately 80,000 customers over a service area of approximately 922 square miles. Collectively, KeySpan owns and operates gas distribution, transmission and storage systems that consist of approximately 23,336 miles of gas mains and distribution pipelines.

Natural gas is offered for sale to residential and small commercial customers on a "firm" basis, and to most large commercial and industrial customers on either a "firm" or "interruptible" basis. "Firm" service is offered to customers under tariffed schedules or contracts that anticipate no interruptions, whereas "interruptible" service is offered to customers under tariffed schedules or contracts that anticipate and permit interruption on short notice, generally in peak-load seasons or for system reliability reasons. We maintain a diverse portfolio of firm gas supply, storage and pipeline transportation capacity contracts to adequately serve the requirements of our gas sales customers, to maintain system reliability and system operations, and to meet our obligation to serve our customers. We also engage in the use of derivative financial instruments from time to time to reduce the cash flow volatility associated with the purchase price for a portion of future natural gas purchases.

KeySpan actively promotes a competitive retail gas market by offering tariff firm transportation services to firm gas customers who elect to purchase their gas supplies from natural gas marketers rather than from the utility. In New York, KeySpan further facilitates competition by releasing its pipeline transportation capacity and offering bundled gas supply to natural gas marketers that would otherwise not be able to obtain their own capacity. In Massachusetts and New Hampshire, there are mandatory capacity assignment programs in place whereby capacity is released to natural gas marketers on behalf of customers they serve. However, net gas revenues are not significantly 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.

KeySpan also participates in interstate markets by releasing pipeline capacity and by selling bundled gas services to customers located outside of our service territory ("off-system" customers).

KeySpan purchases natural gas for firm gas customers under both long and short-term supply contracts, as well as on the spot market, and utilizes its firm pipeline transportation contracts to transport the gas from the point of purchase to the market. KeySpan also contracts for firm capacity in natural gas underground storage facilities to store gas during the summer for later withdrawal during the winter heating season when gas customer demand is higher. KeySpan also contracts for firm winter peaking supplies to meet firm gas customer demand on the coldest days of the year.

KeySpan sells gas to firm gas customers at its cost for such gas, plus a charge designed to recover the costs of distribution (including a return of and a return on capital invested in our distribution facilities). We share with our firm gas customers net revenues (operating revenues less the cost of gas and associated revenue taxes) from off-system sales and capacity release transactions. Further, net revenues from tariff gas balancing services and certain interruptible on-system sales are refunded, for most of our subsidiaries, to firm customers subject to certain sharing provisions.

Our gas operations can be significantly affected by seasonal weather conditions. Annual revenues are substantially realized during the heating season as a result of higher sales of gas due to cold weather. Accordingly, operating results historically are most favorable in the first and fourth calendar quarters. KEDNY and KEDLI each operate under a utility tariff that contains a weather normalization adjustment that largely offsets variations in firm net revenues due to fluctuations in normal weather. However, the tariffs for our four KEDNE gas distribution companies do not contain such a weather normalization adjustment and, therefore, fluctuations in seasonal weather conditions between years may have a significant effect on results of operations and cash flows for these four subsidiaries. We utilize weather derivatives for KEDNE to mitigate variations in firm net revenues due to warmer-than-normal weather during the heating season.

**New York Gas Distribution Systems – KEDNY and KEDLY Supply and Storage**

KEDNY and KEDLI have firm long-term contracts for the purchase of transportation and underground storage services. Gas supplies are purchased under long and short-term firm contracts, as well as on the spot market. Gas supplies are transported by interstate pipelines from domestic and Canadian supply basins. Peaking supplies are available to meet system requirements on the coldest days of the winter season.

***Peak-Day Capability.*** The design criteria for the New York gas system assumes an average temperature of 0ºF for peak-day demand. Under such criteria, we estimate that the requirements to supply our firm gas customers would amount to approximately 2,129 MDTH (one MDTH equals 1,000 DTH or 1 billion British Thermal Units) of gas for a peak-day during the 2006/07 winter season and that the gas available to us on such a peak-day amounts to approximately 2,235 MDTH.

The highest daily throughput most recently experienced occurred on February 5, 2007 in which the demand of the firm New York customers was 1,874 MDTH, and the average temperature was 14°F. KEDNY and KEDLI have sufficient gas supply available to meet the requirements of their firm gas customers for the 2006/07 winter season.

Our New York firm gas peak-day capability is summarized in the following table:

| Source | MDTH per day | % of Total |
|---|---|---|
| Pipeline | 865 | 39% |
| Underground Storage | 800 | 36% |
| Peaking Supplies | 570 | 25% |
| Total | 2,235 | 100% |

***Pipelines.*** Our New York based gas distribution utilities purchase natural gas for sale under contracts with suppliers of natural gas located in domestic and Canadian supply basins and arrange for its transportation to our facilities under firm long-term contracts with interstate pipeline companies. For the 2006/07 gas year, approximately 73% of our New York natural gas supply was available from domestic sources and 27% from Canadian sources. We have available under firm contract 865 MDTH per day of year-round and seasonal pipeline transportation capacity. Our major providers of interstate pipeline capacity and related services include: Transcontinental Gas Pipe Line Corporation ("Transco"), Texas Eastern Transmission Corporation ("Tetco"), Iroquois Gas Transmission System, L.P. ("Iroquois"), Tennessee Gas Pipeline Company ("Tennessee"), Dominion Transmission Incorporated ("Dominion"), Texas Gas Transmission Company, TransCanada Corporation and Union Gas.

***Underground Storage.*** In order to meet winter demand in our New York service territories, we also have long-term contracts with Transco, Tetco, Tennessee, Dominion, Equitrans, Inc., National Fuel Gas Supply Corporation ("National Fuel") and Honeoye Storage Corporation ("Honeoye") for underground storage capacity of 60,766 MDTH and 800 MDTH per day of maximum deliverability.

***Peaking Supplies.*** In addition to the pipeline and underground storage supply, we supplement our winter supply portfolio with peaking supplies that are available on the coldest days of the year to economically meet the increased requirements of our heating customers. Our peaking supplies include: (i) two LNG plants; (ii) peaking supply contracts with dual-fuel power producers located in our franchise areas; and (iii) third-party peaking supply contracts with suppliers located outside our franchise area. For the 2006/07 winter season, we have the capability to provide maximum peaking supplies of 570 MDTH on extremely cold days. The LNG plants provide us with peak-day capacity of 395 MDTH and winter season availability of

2,053 MDTH. The peaking supply contracts with the dual fuel power producers provide us with peak-day capacity of 175 MDTH and winter season availability of 4,846 MDTH.

***Gas Supply Management.*** We currently perform our New York-based gas supply management services internally.

***Gas Costs.*** The current gas rate structure of each of these companies includes a gas adjustment clause pursuant to which variations between actual gas costs incurred and gas costs billed are deferred and subsequently refunded to or collected from firm customers.

***Combined Gas Supply Portfolios.*** KEDNY and KEDLI combined the planning, management and utilization of their respective gas supply portfolios to enable each company to serve its customers more reliably and cost effectively. Specifically, these companies plan the acquisition of incremental pipeline capacity, underground storage, gas supply and peaking supply contracts to meet projected growth in firm customer demand on a combined portfolio basis. This approach enables these companies to realize synergies that would otherwise not be attainable if they were to plan independently for the development of their respective portfolios. These two companies, by virtue of their geographic proximity, complementary customer demand profiles and similar gas contracts are able to add incremental capacity more effectively to meet expected customer demand growth by planning the portfolios on a combined basis.

***Deregulation.*** Regulatory actions, economic factors and changes in customers and their preferences continue to reshape our gas operations. A number of customers currently purchase their gas supplies from natural gas marketers and then contract with us for local transportation, balancing and other unbundled services. In addition, our New York gas distribution companies release firm capacity on our interstate pipeline transportation contracts to natural gas marketers to ensure the marketers' gas supply is delivered on a firm basis and in a reliable manner. As of January 1, 2007, approximately 98,968 gas customers on the New York gas distribution system are purchasing their gas from marketers. However, net gas revenues are not significantly 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.

**New England Gas Distribution Systems – KEDNE Supply and Storage**

KEDNE has firm long-term contracts for the purchase of transportation and underground storage services. Gas supplies are purchased under long and short-term firm contracts, as well as on the spot market. Gas supplies are transported by interstate pipelines from domestic and Canadian supply basins. Peaking supplies are available to meet system requirements on the coldest days of the winter season.

***Peak-Day Capability.*** The design criteria for the New England gas systems assumes an average temperature of -6ºF in Massachusetts and -8ºF in New Hampshire for peak-day demand. Under such criteria, we estimate that the requirements to supply our firm gas customers would amount to approximately 1,389 MDTH of gas for a peak-day during the 2006/07 winter season and that the gas available to us on such a peak-day amounts to approximately 1,420 MDTH.

The highest daily throughput most recently experienced occurred on January 26, 2007 in which the demand of the firm New England customers (which includes both firm sales and firm transportation) was 1,210 MDTH, and the average temperature was 9ºF. KEDNE has sufficient gas supply available to meet the requirements of their firm gas customers for the 2006/07 winter season.

Our New England firm gas peak-day capability is summarized in the following table:

| Source | MDTH per day | % of Total |
|---|---|---|
| Pipeline | 500 | 35% |
| Underground Storage | 248 | 18% |
| Peaking Supplies | 672 | 47% |
| Total | 1,420 | 100% |

***Pipelines.*** Our New England based gas distribution utilities purchase natural gas for sale under contracts with suppliers of natural gas located in domestic and Canadian supply basins and arrange for transportation to our facilities under firm long-term contracts with interstate pipeline companies. We have available under firm contract 500 MDTH per day of year-round and seasonal pipeline transportation capacity. Our major providers of interstate pipeline capacity and related services include: Algonquin Gas Transmission Company, Iroquois, Maritimes and Northeast Pipelines, Portland Natural Gas Transmission System, Tennessee and TETCO.

***Underground Storage.*** In order to meet winter demand in our New England service territories, we also have long-term contracts with Tetco, Tennessee, Dominion, National Fuel and Honeoye for underground storage capacity of 23,280 MDTH and 248 MDTH per day of maximum deliverability.

***Peaking Supplies.*** In addition to the pipeline and underground storage supply, we supplement our winter supply portfolio with peaking supplies that are available on the coldest days of the year to economically meet the increased requirements of our heating customers. Our peaking supplies include (i) local production plants that store LNG and liquid propane until vaporized, which are located strategically across the service territory and (ii) contracts for LNG storage and delivery with our LNG subsidiary, KeySpan LNG LP, located in Providence, Rhode Island and with Distrigas of Massachusetts located in Everett, Massachusetts. For the 2006/07 winter season, we have the capability to provide maximum peaking supplies of 672 MDTH on extremely cold days.

***Gas Supply Management.*** KeySpan has 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 Hampshire gas distribution subsidiaries.

***Gas Costs.*** The current gas rate structure of each of the KEDNE companies includes a gas adjustment clause pursuant to which variations between actual gas costs incurred and gas costs billed are deferred and subsequently refunded to or collected from firm customers.

For additional information and for financial information concerning the gas distribution segment, see the discussion in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – "Gas Distribution" and Note 2 to the Consolidated Financial Statements, "Business Segments".

## ELECTRIC SERVICES OVERVIEW

We are the largest electric generator in New York State. Our subsidiaries own and operate 5 large generating plants and 13 smaller facilities which are comprised of 57 generating units in Nassau and Suffolk Counties on Long Island and the Rockaway Peninsula in Queens. In addition, we own, lease and operate the Ravenswood Generating Station located in Queens County, which is the largest generating facility in New York City. The Ravenswood Generating Station is comprised of 3 large steam-generating units, a 250 MW combined cycle generating unit and 17 gas turbine generators. We also operate and maintain a 55 MW gas turbine unit in Greenport, Long Island under an agreement with a third party.

As more fully described below, we: (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 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 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 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.

Portions of our Electric Services business can be affected by seasonal weather conditions and market conditions. The majority of the capacity revenue associated with the Ravenswood Generating Station is realized during the six months between May and October of each year. Energy and ancillary service sales from our Ravenswood Generating Station are directly correlated to the demand for electricity and competition from other resources. Typically, the demand and price for electricity increases during the extreme temperature conditions of summer. However, depending on the availability of alternative competitive supply, extreme temperature conditions may not result in increased revenue. As a result, fluctuations in weather and competitive supply between years may have a significant effect on results of operations in this portion of our Electric Services business.

**Generating Facility Operations**

In June 1999, we acquired the 2,200 MW Ravenswood Facility located in New York City from Consolidated Edison Company of New York, Inc. (“Consolidated Edison”) for approximately $597 million. In order to reduce our initial cash requirements to finance this acquisition, we entered into an arrangement with an unaffiliated variable interest entity through which we lease a portion of the Ravenswood Facility. Under the arrangement, the variable interest entity acquired a portion of the facility directly from Consolidated Edison and leased it to our wholly owned subsidiary, KeySpan-Ravenswood, LLC (“KSR”). For more information concerning this lease arrangement, see Note 7 to the Consolidated Financial Statements, “Contractual Obligations, Financial Guarantees and Contingencies.”

In 2004, we completed construction of the Ravenswood Expansion, a 250 MW combined cycle generating unit at the Ravenswood Facility, thereby increasing the total electric capacity of the Ravenswood Facility to 2,450 MW. In mid-May 2004, the Ravenswood Expansion began full commercial operations. To finance the Ravenswood Expansion, we entered into a leveraged lease financing arrangement pursuant to which the Ravenswood Expansion was acquired by an unaffiliated lessor from KSR and simultaneously leased back to it. 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.” See Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation – “Electric Services Revenue Mechanisms” for a further discussion of these matters.

The Ravenswood Generating Station sells capacity, energy and ancillary services into the New York Independent System Operator (“NYISO”) electricity market at market-based rates, subject to mitigation. The Ravenswood Generating Station Facility has the ability to provide approximately 25% of New York City’s capacity requirements and is a strategic asset that is available to serve residents and businesses in New York City.

## The Ravenswood Generating Station and our New York City Operations

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. 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.

KeySpan continues to believe that New York City represents a strong capacity market and has entered into an International Swap Dealers Association ("ISDA") Master Agreement for a fixed for float unforced capacity financial swap (the "Swap Agreement") with Morgan Stanley Capital Group Inc. ("Morgan Stanley") dated as of January 18, 2006. The Swap Agreement has a three year term that began on May 1, 2006. 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. Settlement occurs 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 equals the Fixed Price minus the Floating Price. If such price difference is less than zero, Morgan Stanley pays 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 pays Morgan Stanley an amount equal to the product of (a) the Notional Quantity and (b) the absolute value of such price difference.

The New York State competitive wholesale market for capacity, energy and ancillary services administered by the NYISO is still evolving and FERC has adopted several price mitigation measures which are subject to rehearing and possible judicial review. See Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation – "Regulatory Issues and Competitive Environment" for a further discussion of these matters.

Forty-six of our seventy-eight generating units are dual fuel units. In recent years, we have reconfigured several of our facilities to enable them to burn either natural gas or oil, thus enabling us to switch periodically between fuel alternatives based upon cost and seasonal environmental requirements. Through other innovative technological approaches, we instituted a program to reduce nitrogen oxides for improved environmental performance while recovering 80 MW of energy output.

The following table indicates the 2006 summer capacity of all of our steam generation facilities and gas turbine ("GT") units as reported to the NYISO:

| Location of Units | Description | Fuel | Units | MW |
|---|---|---|---|---|
| Long Island City | Steam Turbine | Dual* | 3 | 1,651 |
| Long Island City | Combined Cycle | Dual* | 1 | 231 |
| Northport, L.I. | Steam Turbine | Dual* | 4 | 1,552 |
| Port Jefferson, L.I. | Steam Turbine | Dual* | 2 | 383 |
| Glenwood, L.I. | Steam Turbine | Gas | 2 | 239 |
| Island Park, L.I. | Steam Turbine | Dual* | 2 | 385 |
| Far Rockaway, L.I. | Steam Turbine | Dual* | 1 | 111 |
| Long Island City | GT Units | Dual* | 17 | 423 |
| Glenwood and Port Jefferson Energy Center, L.I. | GT Units | Dual | 4 | 159 |
| Throughout L.I. | GT Units | Dual* | 12 | 305 |
| Throughout L.I. | GT Units | Oil | 30 | 1,067 |
| TOTAL | | | 78 | 6,506 |

*Dual - Oil (#2 oil or #6 residual oil) or kerosene, and natural gas.

For additional information and for financial information concerning the Electric Services segment, see the discussion in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – "Electric Services" and Note 2 to the Consolidated Financial Statements, "Business Segments".

**Agreements with LIPA**

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 Agreement, KeySpan and LIPA will enter into an amendment to the 1998 EMA reflecting that the facilities that LIPA acquires pursuant to the Option Agreement are no longer covered under the 1998 EMA and as noted above, an operation and maintenance agreement, whereby KeySpan will continue to operate the newly acquired facilities for a fixed management fee plus reimbursement for certain costs. It is anticipated that the fees received pursuant to the operation and maintenance agreement will offset the reduction in any fees earned by KeySpan pursuant to the 1998 EMA.

Under the 1998 LIPA Agreements and the 2006 LIPA 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.

***Power Purchase Agreements.*** KeySpan-Glenwood Energy Center, LLC and KeySpan-Port Jefferson Energy Center LLC each have 25 year power purchase agreements with LIPA expiring in 2027 (the "2002 LIPA PPAs"). Under the terms of the 2002 LIPA PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Each plant is designed to produce 79.9 MW. Pursuant to the 2002 LIPA 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.

***Other Rights.*** Pursuant to other agreements between LIPA and KeySpan, certain future rights have been granted to LIPA. Subject to certain conditions, these rights include the right for 99 years (from May 1998) to lease or purchase, at fair market value, parcels of land and to acquire unlimited access to, as well as appropriate easements at, the Long Island generating facilities for the purpose of constructing new electric generating facilities to be owned by LIPA or its designee. Subject to this right granted to LIPA, KeySpan has the right to sell or lease property on or adjoining the Long Island generating facilities to third parties.

We own common plant assets (such as administrative office buildings and computer systems) formerly owned by LILCO and recover an allocable share of the carrying costs of such plant assets through the MSA. KeySpan has agreed to provide LIPA, for a period of 99 years (from May 1998), the right to enter into leases at fair market value for common plant assets or sub-contract for common services which it may assign to a subsequent manager of the transmission and distribution system. We have also agreed: (i) for a period of 99 years (from May 1998) not to compete with LIPA as a provider of transmission or distribution service on Long Island; (ii) that LIPA will share in synergy (*i.e.*, efficiency) savings over a 10-year period attributed to the May 28, 1998 transaction which resulted in the formation of KeySpan (estimated to be approximately $1 billion), which savings are incorporated into the cost structure under the 1998 LIPA Agreements; and (iii) generally not to commence any tax certiorari case (during the pendency of the 1998 PSA) challenging certain property tax assessments relating to the former LILCO Long Island generating facilities.

***Guarantees and Indemnities.*** We have entered into agreements with LIPA to provide for the guarantee of certain obligations, indemnification against certain liabilities and allocation of responsibility and liability for certain pre-existing obligations and liabilities. In general, liabilities associated with the LILCO assets transferred to KeySpan, have been assumed by KeySpan; and liabilities associated with the assets acquired by LIPA, are borne by LIPA, subject to certain specified exceptions. We have assumed all liabilities arising from all manufactured gas plant ("MGP") operations of LILCO and its predecessors, and LIPA has assumed certain liabilities relating to the former LILCO Long Island generating facilities and all liabilities traceable to the business and operations conducted by LIPA after completion of the 1998 KeySpan/LILCO transaction. An agreement also provides for an allocation of liabilities which relates to the assets that were common to the operations of LILCO and/or shared services or liabilities which are not traceable directly to either the business or operations conducted by LIPA or KeySpan. In addition, 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.

## ENERGY SERVICES OVERVIEW

The Energy Services segment includes companies that provide energy-related services to customers located primarily within the Northeastern United States, with concentrations in the New York City and Boston metropolitan areas. 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. Our subsidiaries in this segment have over 200,000 service contracts in place to provide home energy services, completed over 240,000 service calls during 2006 and completed more than 16,000 installations during 2006.

For additional information and financial information concerning the Energy Services segment, see the discussion in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – "Energy Services", Item 8. "Financial Statements and Supplementary Data", Note 2 to the Consolidated Financial Statements, "Business Segments", and Note 10, "Energy Services – Discontinued Operations".

## ENERGY INVESTMENTS OVERVIEW

We are also engaged in Energy Investments which includes gas production and development activities, domestic pipelines, gas storage facilities and LNG facilities and operations.

### Gas Production and Development

KeySpan is engaged in the production and development of domestic natural gas and oil through wholly-owned subsidiaries Seneca-Upshur Petroleum, Inc., d/b/a KeySpan Production & Development Company ("Seneca-Upshur") and KeySpan Exploration and Production, LLC ("KeySpan Exploration and Production"). Seneca-Upshur's assets consist of 38 billion cubic feet of low risk, mature, onshore gas producing properties. Specifically, Seneca-Upshur, headquartered in Buckhannon, West Virginia, owns and operates onshore gas producing properties, and operates approximately 1,300 wells in north central West Virginia. To manage the inherent volatility in commodity prices, Seneca-Upshur entered into a three-year hedge for a majority of its production. 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 The Houston Exploration Company ("Houston Exploration"). See Item 7. Management's Discussion and Analysis of Financial Conditions and Results of Operations – "Energy Investments" for a further discussion of these matters.

### Domestic Pipelines and Gas Storage Facilities

We own a 20.4% interest in Iroquois Gas Transmission System LP, a partnership of affiliates of six U.S. and Canadian energy companies, which is the owner of a 411-mile interstate natural gas pipeline extending from the U.S.-Canadian border at Waddington, NY through western Connecticut to its terminus in Commack, NY, and from Huntington to the Bronx. Its wholly owned subsidiary, the Iroquois Pipeline Operating Company, headquartered in Shelton, Connecticut, is the agent for and operator of the pipeline. The Iroquois pipeline can transport up to 1,124,500 DTH per day of Canadian gas supply from the New York-Canadian border to markets in the Northeastern United States. KeySpan is also a shipper on Iroquois and currently transports up to 304,950 DTH of gas per day.

We also have a 50% interest in Islander East Pipeline Company, LLC ("Islander East"), which 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. In addition, we own a 26.25% interest in the Millennium Pipeline project which 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.

We are also the owner and operator of a 600,000 barrel LNG storage and receiving facility located in Providence, Rhode Island, known as KeySpan LNG. Our subsidiary, Boston Gas is the facility's largest customer and contracts for more than half of the LNG facility's storage. KeySpan LNG is regulated by FERC.

We also have equity investments in two gas storage facilities in the State of New York: Honeoye Storage Corporation and Steuben Gas Storage Company. We own a 52% interest in Honeoye, an underground gas storage facility which provides up to 4.3 billion cubic feet of storage service to New York and New England. Additionally, we own 34% of a partnership that has a 50% interest in the Steuben facility that provides up to 6.2 billion cubic feet of storage service to New Jersey and Massachusetts.

For additional information concerning these energy related investments in pipelines and gas storage facilities, see the discussion on "Energy Investments" in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations contained herein.

## ENVIRONMENTAL MATTERS OVERVIEW

KeySpan's ordinary business operations subject it to regulation in accordance with various federal, state and local laws, rules and regulations dealing with the environment, including air, water, and hazardous substances. These requirements govern both our normal, ongoing operations and the remediation of impacted properties historically used in utility operations. Potential liability associated with our historical operations may be imposed without regard to fault, even if the activities were lawful at the time they occurred.

Except as set forth below, or in Note 7 to the Consolidated Financial Statements "Contractual Obligations and Contingencies - Environmental Matters," no material proceedings relating to environmental matters have been commenced or, to our knowledge, are contemplated by any federal, state or local agency against KeySpan, and we are not a defendant in any material litigation with respect to any matter relating to the protection of the environment. We believe that our operations are in substantial compliance with environmental laws and that requirements imposed by existing environmental laws are not likely to have a material adverse impact upon us. We are also pursuing claims against insurance carriers and potentially responsible parties which seek the recovery of certain environmental costs associated with the investigation and remediation of contaminated properties. We believe that investigation and remediation costs prudently incurred at facilities associated with utility operations, not recoverable through insurance or some other means, will be recoverable from our customers in accordance with the terms of our rate recovery agreements for each regulated subsidiary.

***Air.*** The Federal Clean Air Act ("CAA") provides for the regulation of a variety of air emissions from new and existing electric generating plants. Final, five year renewable permits in accordance with the requirements of Title V of the 1990 amendments to the CAA have been issued for all of our electric generating facilities except that renewal applications were submitted in a timely manner in 2006 for the Ravenswood Expansion and Far Rockaway generating station. Renewal permits are expected to be issued in 2007. The existing permits and timely renewal applications allow our electric generating plants to continue to operate without any additional significant expenditures, except as described below.

Our generating facilities are located within a 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 $NO_X$ 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. 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 of between \$20 to \$30 million. However, such amounts are recoverable from LIPA.

In 2003, New York State promulgated regulations which establish separate $NO_X$ and $SO_2$ emission reduction requirements on electric generating facilities in New York State, which commenced in late 2004 for $NO_X$ emissions and in 2005 for $SO_2$ emissions. KeySpan's facilities have been able to comply with the $NO_X$ requirements without material additional capital expenditures because of previously installed emissions control equipment and gas combustion capability. $SO_2$ compliance was achieved through a reduction in the sulfur content of the fuel oil used in our Northport and Port Jefferson facilities. Further reduction in $SO_2$ emissions expected to be required in 2008 will be achieved either through reliance on natural gas or lower sulfur oil fuel.

In 2004, the EPA issued regulations that require reductions, on a national basis, of mercury emissions from electric generating facilities. The mercury regulations have no impact on KeySpan facilities since their application is limited to coal-fired plants. EPA determined that nickel emissions from oil fired plants do not pose health risks that require regulation. This determination has been challenged and litigation is pending. Until a final outcome is obtained, the nature and extent of the financial impact on KeySpan from nickel regulation, if any, cannot be determined.

KeySpan recognizes the growing concern about greenhouse gas emissions and their contribution to global climate change. Our investments in additional natural gas firing capability have resulted in approximately a 15% reduction in carbon dioxide emissions since 1990, while the electric generation industry as a whole increased carbon dioxide emissions by more than 25%. The addition of the efficient, combined cycle unit which began operation at the Ravenswood Generating Station in 2004 has further reduced average KeySpan $CO_2$ emission rates.

In 2003, the Governor of New York initiated a Regional Greenhouse Gas Initiative ("RGGI") that seeks to establish a coordinated multi-state plan to reduce greenhouse gas emissions (primarily carbon dioxide ("$CO_2$") from electric generating emission sources in the Northeast. In December of 2005, seven northeast states, including New York, issued a memorandum of understanding ("MOU") capping $CO_2$ emissions from electric generating facilities beginning in 2009 and, beginning in 2015, gradually requiring a 10 percent reduction in regional emissions by 2018. Each of the states will be promulgating individual state rules to implement the MOU. Several congressional initiatives under consideration may also require greenhouse gas reductions from electric generating facilities nationwide. At the present time it is not possible to predict the nature of the requirements which ultimately will be imposed on KeySpan, nor what, if any, financial impact such requirements would have on KeySpan electric generation facilities. However, KeySpan believes that the ability of its major generating facilities to burn low $CO_2$ emitting natural gas positions them for future compliance requirements better than plants which burn exclusively coal or oil. Additionally, KeySpan believes that the relatively low greenhouse gas emissions associated with the commercial and residential use of natural gas may present business opportunities for further growth of its gas business.

***Water.*** The Federal Clean Water Act provides for effluent limitations, to be implemented by a permit system, to regulate the discharge of pollutants into United States waters. We possess permits for our generating units which authorize discharges from cooling water circulating systems and chemical treatment systems. These permits are renewed from time to time, as required by regulation. Additional capital expenditures associated with the renewal of the surface water discharge permits for our power plants will likely be required by the New York State Department of Environmental Conservation ("NYSDEC"). We continue to conduct studies as directed by the NYSDEC to determine the impacts of our discharges on aquatic resources and are engaged in discussions with the NYSDEC regarding the nature of capital upgrades or other mitigation measures necessary to reduce any impacts. It is difficult to predict with any certainty the costs of such capital investments, but these upgrades are expected to cost up to $60 million. 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 NYSDEC 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.*** The Federal Comprehensive Environmental Response, Compensation and Liability Act of 1980 and certain similar state laws (collectively "Superfund") impose liability, regardless of fault, upon generators of hazardous substances even before Superfund was enacted for costs associated with investigating and remediating contaminated property. In the course of our business operations, we generate materials which, after disposal, may become subject to Superfund. From time to time, we have received notices under Superfund concerning possible claims with respect to sites where hazardous substances generated by KeySpan or its predecessors and other potentially responsible parties were allegedly disposed. Normally, the costs associated with such claims are allocated among the potentially responsible parties on a pro rata basis. Superfund does, however, provide for joint and several liability against a single potentially responsible party. In the unlikely event that Superfund claims were pursued against us on that basis, the costs may be material to our financial condition, results of operations or cash flows.

KeySpan has identified certain MGP sites which were historically owned or operated by its subsidiaries (or such companies' predecessors). Operations at these sites between the mid-1800s to mid-1900s may have resulted in the release of hazardous substances. For a discussion on our MGP sites and further information concerning environmental matters, see Note 7 to the

Consolidated Financial Statements, "Contractual Obligations and Contingencies - Environmental Matters."

## COMPETITION, REGULATION AND RATE MATTERS

***Competition.*** Over the last several years, the natural gas and electric industries have undergone significant change as market forces moved towards replacing or supplementing rate regulation through the introduction of competition. A significant number of natural gas and electric utilities reacted to the changing structure of the energy industry by entering into business combinations, with the goal of reducing common costs, gaining size to better withstand competitive pressures and business cycles, and attaining synergies from the combination of operations. We engaged in two such combinations, the KeySpan/LILCO transaction in 1998 and our November 2000 acquisition of Eastern and EnergyNorth and are anticipating the consummation of the Merger with National Grid plc.

The Ravenswood Generating Station, the merchant plant in our Electric Services segment, is subject to competitive and other risks that could adversely impact the market price for the plant's output. Such risks include, but are not limited to, the construction of new generation or transmission capacity serving the New York City market.

***Regulation.*** Public utility holding companies, like KeySpan, are now regulated by the FERC pursuant to PUHCA 2005 and to some extent by state utility commissions through the regulation of certain affiliate transactions. Our utility subsidiaries are subject to extensive federal and state regulation by FERC and state utility commissions. In general, state public utility commissions, such as the New York Public Service Commission ("NYPSC"), the MADTE and the New Hampshire Public Utilities Commission ("NHPUC") regulate the provision of retail services, including the distribution and sale of natural gas and electricity to consumers. Each of the federal and state regulators also regulates certain transactions among our affiliates. FERC also regulates interstate natural gas transportation and electric transmission, and has jurisdiction over certain wholesale natural gas sales and wholesale electric sales.

In addition, our non-utility subsidiaries are subject to a wide variety of federal, state and local laws, rules and regulations with respect to their business activities, including but not limited to those affecting public sector projects, environmental and labor laws and regulations, and state licensing requirements.

***State Utility Commissions.*** As noted above, our regulated gas distribution utility subsidiaries are subject to regulation by the NYPSC, MADTE and NHPUC. The NYPSC regulates KEDNY and KEDLI. Although KeySpan is not regulated by the NYPSC, it is impacted by conditions that were included in the NYPSC order authorizing the 1998 KeySpan/LILCO transaction. Those conditions address, among other things, the manner in which KeySpan, its service company subsidiaries and its unregulated subsidiaries may interact with KEDNY and KEDLI. The NYPSC also regulates the safety, reliability and certain financial transactions of our Long Island generating facilities and our Ravenswood Generating Station under a lightened regulatory standard. Our KEDNE subsidiaries and to some extent our service companies are also subject to regulation by the MADTE and NHPUC.

***Securities and Exchange Commission.*** As a result of the acquisition of Eastern and EnergyNorth, we became a holding company under PUHCA 1935. The Energy Act repealed PUHCA 1935 and replaced it with PUHCA 2005 effective February 8, 2006. Whereas our corporate and financial activities and those of our subsidiaries had been subject to regulation by the SEC, FERC now has jurisdiction over certain of our holding company activities. However, the SEC continues to have jurisdiction over the registration and issuance of our securities under the federal securities laws.

Under our holding company structure, we have no independent operations or source of income of our own and conduct substantially 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 and to pay dividends to our shareholders. 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.

In addition, KeySpan operates three mutual service companies: KeySpan Corporate Services LLC ("KCS"), KeySpan Utility Services LLC ("KUS") and KeySpan Engineering & Survey, Inc. ("KENG"). These companies operate to provide various services to KeySpan subsidiaries, including regulated utility companies and LIPA, at cost fairly and equitably allocated among them. The regulation of our three service companies has also been transferred to FERC under PUHCA 2005.

***Federal Energy Regulatory Commission.*** FERC 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. In addition to its new authority pursuant to PUHCA 2005, FERC also regulates the sale of electricity at wholesale and the transmission of electricity in interstate commerce as well as certain corporate and financial activities of companies that are engaged in such activities. The Long Island generating facilities and the Ravenswood Generating Station are subject to FERC regulation based on their wholesale energy transactions.

Our Ravenswood Generating Station's rates are based on a market-based rate application approved by FERC. The rates that our Ravenswood Generating Station may charge are subject to FERC mandated mitigation measures due to market power issues. The mitigation measures are administered by the NYISO. FERC retains the ability in future proceedings, either on its own motion or upon a complaint filed with FERC, to modify the Ravenswood Generating Station's rates, as well as the mitigation measures, if FERC concludes that it is in the public interest to do so.

KeySpan currently offers and sells the energy, capacity and ancillary services from the Ravenswood Generating Station through the energy market operated by the NYISO. For information concerning the NYISO, see Item 7. Management's Discussion and Analysis of

Financial Condition and Results of Operation – "Regulatory Issues and Competitive Environment."

FERC also has jurisdiction to regulate certain natural gas sales for resale in interstate commerce, the transportation of natural gas in interstate commerce and, unless an exemption applies, companies engaged in such activities. The natural gas distribution activities of KEDNY, KEDLI, KEDNE and certain related intrastate gas transportation functions are not subject to FERC jurisdiction. However, to the extent that KEDNY, KEDLI or KEDNE purchases or sells gas for resale in interstate commerce, such transactions are subject to FERC jurisdiction and have been authorized by FERC. Our interests in Iroquois, Honeoye, Steuben and KeySpan LNG are also fully regulated by FERC as natural gas companies.

## EMPLOYEE MATTERS

As of December 31, 2006, KeySpan and its wholly-owned subsidiaries had approximately 9,594 employees. Of that total, approximately 6,168 employees are covered under collective bargaining agreements. KeySpan has not experienced any work stoppage during the past five years and considers its relationship with employees, including those covered by collective bargaining agreements, to be good.

## ITEM 1A. RISK FACTORS

Certain statements contained in this Annual Report on Form 10-K concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are other than statements of historical facts, are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Without limiting the foregoing, all statements under the captions "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk" relating to our future outlook, anticipated capital expenditures, future cash flows and borrowings, pursuit of potential acquisition opportunities and sources of funding, are forward-looking statements. Such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties, and actual results may differ materially from those discussed in such statements.
The risks, uncertainties and factors that could cause actual results to differ materially include but are not limited to the following:

### We are a Holding Company, and Our Subsidiaries are Subject to State Regulation Which Limits Their Ability to Pay Dividends and Make Distributions to Us

We are a holding company with no business operations or sources of income of our own. We conduct all of our operations through our subsidiaries and 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 and to pay dividends on our common stock.

In addition, a substantial portion of our consolidated assets, earnings and cash flow is derived from the operation of our regulated utility subsidiaries, whose legal authority to pay dividends or make other distributions to us is subject to regulation by the utility regulatory commissions of New York, Massachusetts and New Hampshire. Pursuant to NYPSC orders, the ability of KEDNY and KEDLI to pay dividends to us is conditioned upon their 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 a customer service performance program. At the end of KEDNY's and KEDLI's rate years (September 30, 2006 and November 30, 2006, respectively), their ratios of debt to total utility capitalization were in compliance with the ratios set forth above and we have incurred no penalties under the outstanding customer service performance program.

**Our Gas Distribution and Electric Services Businesses May Be Adversely Affected by Changes in Federal and State Regulation**

The regulatory environment applicable to our gas distribution and our electric services businesses has undergone substantial changes in recent years, on both the federal and state levels. These changes have significantly affected the nature of the gas and electric utility and power industries and the manner in which their participants conduct their businesses. Moreover, existing statutes and regulations may be revised or reinterpreted, new laws and regulations may be adopted or become applicable to us or our facilities and future changes in laws and regulations may affect our gas distribution and our electric services businesses in ways that we cannot predict.

In addition, our operations are subject to extensive government regulation and require numerous permits, approvals and certificates from various federal, state and local governmental agencies. A significant portion of our revenues in our Gas Distribution and Electric Services segments are directly dependent on rates established by federal or state regulatory authorities, and any change in these rates and regulatory structure could significantly impact our financial results. Increases in utility costs other than gas, not otherwise offset by increases in revenues or reductions in other expenses, could have an adverse effect on earnings due to the time lag associated with obtaining regulatory approval to recover such increased costs and expenses in rates.

Various rulemaking proposals and market design revisions related to the wholesale power market are being reviewed at the federal level. These proposals, as well as legislative and other attention to the electric power industry could have a material adverse effect on our strategies and results of operations for our electric services business and our financial condition. In particular, we sell capacity, energy and ancillary services from our Ravenswood Generating Station facility into the New York Independent System Operator, or NYISO, energy market at market-based rates, subject to mitigation measures approved by the FERC. The pricing for capacity, energy sales and ancillary services in to the NYISO market is still evolving and some of the FERC's price mitigation measures are subject to rehearing and possible judicial review, as well as revision in response to market participant complaints or NYISO requests.

### Our Risk Mitigation Techniques Such as Hedging and Purchase of Insurance May Not Adequately Provide Protection

To mitigate our financial exposure related to commodity price fluctuations, KeySpan routinely enters into contracts to hedge a portion of our purchase and sale commitments, weather fluctuations, electricity sales, natural gas supply and other commodities. However, we do not always cover the entire exposure of our assets or our positions to market price volatility and the coverage will vary over time. To the extent we have unhedged positions or our hedging strategies do not work as planned, fluctuating commodity prices could cause our sales and net income to be volatile.

In addition, our business is subject to many hazards from which our insurance may not adequately provide coverage. An unexpected outage at our Ravenswood Generating Station, especially in the significant summer period, could materially impact our financial results. Damage to pipelines, equipment, properties and people caused by natural disasters, accidents, terrorism or other damage by third parties could exceed our insurance coverage. Although we do have insurance to protect against many of these contingent liabilities, this insurance is capped at certain levels, has self-insured retentions and does not provide coverage for all liabilities.

### SEC Rules for Exploration and Production Companies May Require Us to Recognize a Non-Cash Impairment Charge at the End of Our Reporting Periods

Our investments in natural gas and oil consist of our ownership of KeySpan Exploration and Production and Seneca-Upshur. We use the full cost method for KeySpan Exploration and Production and Seneca-Upshur. Under the full cost method, all costs of acquisition, exploration and development of natural gas and oil reserves are capitalized into a full cost pool as incurred, and properties in the pool are depleted and charged to operations using the unit-of-production method based on production and proved reserve quantities. To the extent that these 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, those excess costs are charged to operations. If a write-down is required, it would result in a charge to earnings but would not have an impact on cash flows. Once incurred, an impairment of gas properties is not reversible at a later date, even if gas prices increase.

### Our Operating Results May Fluctuate on a Seasonal and Quarterly Basis

Our gas distribution business is a seasonal business and is subject to weather conditions. We receive most of our gas distribution revenues in the first and fourth quarters, when demand for natural gas increases due to colder weather conditions. As a result, we are subject to seasonal variations in working capital because we purchase natural gas supplies for storage in the second and third quarters and must finance these purchases. Accordingly, our results of operations fluctuate substantially on a seasonal basis. In addition, our New England-based gas distribution subsidiaries do not have weather normalization tariffs, as we do in New York. In addition, portions of our Electric Service business are seasonal and subject to weather and market conditions. The majority of the capacity revenue associated with the Ravenswood Generating Station facility is realized during the six months between May and October of each year. Energy and ancillary service sales from our Ravenswood

Generating Station facility are directly correlated to the demand for electricity and competition from other resources. Typically, the demand and price for electricity increases during extreme temperature conditions. However, depending on the availability of alternative competitive supply, extreme temperature conditions may not result in increased revenue. As a result, fluctuations in weather and competitive supply between years may have a significant effect on our results of operations for these subsidiaries; both gas and electric.

**A Substantial Portion Of Our Revenues Are Derived From Our Agreements With LIPA And No Assurances Can Be Made That These Arrangements Will Not Be Discontinued At Some Point In The Future Or That The New Agreements Will Become Effective**

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. On February 1, 2006, KeySpan and LIPA entered into amended and restated agreements whereby KeySpan will continue to operate and maintain the electric T&D System owned by LIPA on Long Island. The parties also entered into the 2006 Option Agreement, where LIPA had the right to acquire two of our facilities, our Far Rockaway and/or E.F. Barrett Generating Stations during the period January 1, 2006 to December 31, 2006. On December 13, 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 Option Agreement. Additionally, the new agreements resolve many outstanding issues between the parties regarding the current LIPA Agreements and provide new pricing and extensions of the Agreements. There is a risk that these agreements will not receive the necessary governmental approvals, which are pending, and the effectiveness of each of the 2006 LIPA Agreements and the amendment to the 2006 Option Agreement is conditioned upon all of the 2006 LIPA Agreements becoming effective. If the 2006 LIPA Agreements do not become effective, there is uncertainty as to whether LIPA will exercise their option under the GPRA and the status of the resolution of the various disputes between KeySpan and LIPA. 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.

**A Decline or an Otherwise Negative Change in the Ratings or Outlook on Our Securities Could Have a Materially Adverse Impact on Our Ability to Secure Additional Financing on Favorable Terms**

The credit rating agencies that rate our debt securities regularly review our financial condition and results of operations. We can provide no assurances that the ratings or outlook on our debt securities will not be reduced or otherwise negatively changed. A negative change in the ratings or outlook on our debt securities could have a materially adverse impact on our ability to secure additional financing on favorable terms.

**Our Costs of Compliance with Environmental Laws are Significant, and the Cost of Compliance with Future Environmental Laws Could Adversely Affect Us**

Our operations are subject to extensive federal, state and local environmental laws and regulations relating to air quality, water quality, waste management, natural resources and the health and safety of our employees. These environmental laws and regulations expose us to costs and liabilities relating to our operations and our current and formerly owned properties. Compliance with these legal requirements requires us to commit significant capital toward environmental monitoring, installation of pollution control equipment and permits at our facilities. Costs of compliance with environmental regulations, and in particular emission regulations, could have a material impact on our Electric Services segment and our results of operations and financial position, especially if emission limits are tightened, more extensive permitting requirements are imposed, additional substances become regulated or the number and type of electric generating plants we operate increase.

In addition, we are responsible for the clean-up of contamination at certain MGP sites and at other sites and are aware of additional MGP sites where we may have responsibility for clean-up costs. While our gas utility subsidiaries' rate plans generally allow for the full recovery of the costs of investigation and remediation of most of our MGP sites, these rate recovery mechanisms may change in the future. To the extent rate recovery mechanisms change in the future, or if additional environmental matters arise in the future at our currently or historically owned facilities, at sites we may acquire in the future or at third-party waste disposal sites, costs associated with investigating and remediating these sites could have a material adverse effect on our results of operations, cash flows and financial condition.

**Our Businesses are Subject to Competition and General Economic Conditions Impacting Demand for Services**

The Ravenswood Facility and Ravenswood Expansion are subject to competition that could adversely impact the market price for the capacity, energy and ancillary services they sell. In addition, if new generation and/or transmission facilities are constructed, and/or the availability of our Ravenswood Generating Station deteriorates, then the quantities of capacity and energy sales could be adversely affected. We cannot predict, however, when or if new power plants or transmission facilities will be built or the nature of the future New York City capacity and energy requirements.

Competition facing our unregulated Energy Services businesses, including but not limited to competition from other 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, could adversely impact our financial results and the value of those businesses, resulting in decreased earnings as well as write-downs of the carrying value of those businesses.

Our Gas Distribution segment faces competition with distributors of alternative fuels and forms of energy, including fuel oil and propane. Our ability to continue to add new gas distribution customers may significantly impact financial results. The gas distribution industry has experienced a decrease in consumption per customer over time, partially due to increased efficiency of customers' appliances, economic factors and price elasticity. In addition, our Gas Distribution segment's future growth is dependent upon the ability to add new customers to our system in a cost-effective manner. While our Long Island and New England utilities have significant growth potential, we cannot be sure new customers will continue to offset the decrease in consumption of our existing customer base. There are a number of factors outside of our control that impact customer conversions from an alternative fuel to gas, including general economic factors impacting customers' willingness to invest in new gas equipment.

**Risk Associated with our Financial Swap Agreement for In-City Unforced Capacity**

KeySpan believes that the New York City market represents a strong capacity market due to, among other things, its local reliability rules, increasing demand and the time required for new resources to be constructed. KeySpan anticipates that demand will increase and that the high cost to construct capacity in New York City will result in favorable In-City Unforced Capacity prices. Therefore, KeySpan entered into an ISDA Master Agreement for a fixed for floating unforced capacity financial swap for a notional quantity of 1,800,000kW at the Fixed Price is $7.57/kW-month. If the demand is less than KeySpan's estimates, additional resources enter the market, or costs are less than forecast, In-City Unforced Capacity prices could be on average less than the Fixed Price resulting in a loss to KeySpan, which under certain circumstances could be material.

**Labor Disruptions at Our Facilities Could Adversely Affect Our Results of Operations and Cash Flow**

Approximately 6,168 employees, or 64% of our employees, are represented by unions through various collective bargaining agreements that expire between 2007 and 2011. The bargaining agreements expiring in 2007 affect approximately 5% of the unionized workforce; 230 employees who work for KeySpan Home Energy Services in New York and another 70 employees at KEDNE in Cape Cod, Massachusetts. KeySpan is currently engaging in discussions with these unions for new collective bargaining agreements. It is possible that our employees may seek an increase in wages and benefits at the expiration of these agreements, and that we may be unable to negotiate new agreements without labor disruption.

**Counterparties to Our Transactions May Fail to Perform their Obligations, Which Could Harm Our Results of Operations**

Our operations are exposed to the risk that counterparties to our transactions that owe us money or supplies will not perform their obligations. Should the counterparties to arrangements with us fail to perform, we might be forced to enter into alternative hedging arrangements or honor our underlying commitment at then-current market prices that may exceed our contractual prices. In such event, we might incur additional losses to the extent of amounts, if any, already paid to counterparties. This risk is most significant where we have concentrations of receivables from natural gas and electric utilities and their affiliates, as well as industrial customers and marketers throughout the Northeastern United States.

**We Are Exposed to Risks That Are Beyond Our Control**

The cost of repairing damage to our operating subsidiaries' facilities and the potential disruption of their operations or supplier operations due to storms, natural disasters, wars, terrorist acts and other catastrophic events could be substantial. The occurrence or risk of occurrence of future terrorist attacks or related acts of war may lead to increased political, economic and financial market instability and volatility in prices for natural gas which could materially adversely affect us in ways we cannot predict at this time. A lower level of economic activity for these or other reasons could result in a decline in energy consumption, which could adversely affect our net revenues.

**The Long-Term Financial Condition of Our Gas Distribution Business Depends on the Continued Availability of Natural Gas Reserves**

The development of additional natural gas reserves requires significant capital expenditures by others for exploring, drilling and installing production, gathering, storage, transportation and other facilities that permit natural gas to be produced and delivered to our distribution systems. Low prices for natural gas, regulatory restrictions, or the lack of available capital for these projects could adversely affect the development of additional natural gas reserves. Additional natural gas reserves may not be developed in sufficient amounts to fill the capacities of our distribution systems, thus limiting our prospects for long-term growth.

**Gathering, Processing and Transporting Activities Involve Numerous Risks that May Result in Accidents and Other Operating Risks and Costs**

Our gas distribution facilities pose a variety of hazards and operating risks, such as leaks, explosions and mechanical problems caused by natural disasters, accidents, terrorism or other damage by third parties, which could cause substantial financial losses. In addition to impairing our operations, these risks could also result in loss of human life and environmental pollution. In accordance with standard industry practice, we maintain insurance against some, but not all, of these potential risks and losses. The occurrence of any of these events not fully covered by insurance could have a material adverse effect on our financial position and results of operations.

**Additional risks, uncertainties and factors that could cause actual results to differ materially include, but are not limited to, the following:**

- the occurrence of any event, change or other circumstances that could give rise to the termination of the Merger Agreement with National Grid plc or the failure of the Merger to close for any reason;
- volatility of fuel prices 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 manage our cost structure and operate efficiently;
- our ability to successfully contract for natural gas supplies required to meet the needs of our customers;

- implementation of new accounting standards or changes in accounting standards or Generally Accepted Accounting Principles which may require adjustments to financial statements;

- inflationary trends and interest rates;

- the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of such acquisitions;

- available sources and cost of fuel;

- creditworthiness of counterparties to derivative instruments and commodity contracts;

- the resolution of certain disputes with LIPA concerning each party's rights and obligations under various agreements;

- retention of key personnel;

- federal and state regulatory initiatives that threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses and conduct operations;

- the impact of federal, state and local utility regulatory policies, legislation 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 facing our unregulated Energy Services businesses;

- 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;

- a change in the fair market value of our investments that could cause a significant change in the carrying value of such investments or the carrying value of related goodwill;

- timely receipts of payments from LIPA and the NYISO, our two largest customers;

- changes in the unforced capacity financial swap pricing structure;

- receipt of approval for, and the timing thereof, the 2006 LIPA Agreements; and

- other risks detailed from time to time in other reports and other documents filed by KeySpan with the SEC

For any of these statements, KeySpan claims the protection of the safe harbor for forward-looking information contained in the Private Securities Litigation Reform Act of 1995, as amended. For additional discussion on these risks, uncertainties and assumptions, see Item 1. "Description of the Business," Item 2. "Properties," Item 7. "Management's Discussion and

Analysis of Financial Condition and Results of Operations" and Item 7A. "Quantitative and Qualitative Disclosures About Market Risk" contained herein.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

## ITEM 2. PROPERTIES

Information with respect to KeySpan's material properties used in the conduct of its business is set forth in, or incorporated by reference in, Item 1 hereof. Except where otherwise specified, all such properties are owned or, in the case of certain rights-of-way, used in the conduct of its gas distribution business, held pursuant to municipal consents, easements or long-term leases, and in the case of gas and oil properties, held under long-term mineral leases. In addition to the information set forth therein with respect to properties utilized by each business segment, KeySpan leases the executive headquarters located in Brooklyn, New York. In addition, we lease other office and building space, office equipment, vehicles and power operated equipment. Our properties are adequate and suitable to meet our current and expected business requirements. Moreover, their productive capacity and utilization meet our needs for the foreseeable future. KeySpan continually examines its real property and other property for its contribution and relevance to our businesses and when such properties are no longer productive or suitable, they are disposed of as promptly as possible. In the case of leased office space, we anticipate no significant difficulty in leasing alternative space at reasonable rates in the event of the expiration, cancellation or termination of a lease.

## ITEM 3. LEGAL PROCEEDINGS

See Note 7 to the Consolidated Financial Statements, "Contractual Obligations and Contingencies - Legal Matters."

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of the security holders during the last quarter of the 12 months ended December 31, 2006.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

KeySpan's common stock is listed and traded on the New York Stock Exchange under the symbol "KSE." As of February 20, 2007, there were approximately 64,664 registered record holders of KeySpan's common stock. In the fourth quarter of 2006 KeySpan increased its dividend to an annual rate of $1.90 per common share beginning with the quarterly dividend to be paid in February 2007. 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 approximately at the $1.90 level to be paid on a quarterly basis at a rate of approximately $0.475. KeySpan's scheduled dividend payment dates are February 1, May 1, August 1 and November 1, or the next business day, if such date is not a business day.

The following table sets forth, for the quarters indicated, the high and low sales prices and dividends declared per share for the periods indicated:

| 2006 | High | Low | Dividends per Share |
|---|---|---|---|
| First Quarter | $41.52 | $35.38 | $0.465 |
| Second Quarter | $41.10 | $39.68 | $0.465 |
| Third Quarter | $41.42 | $39.95 | $0.465 |
| Fourth Quarter | $41.36 | $40.40 | $0.465 |

| 2005 | High | Low | Dividends per Share |
|---|---|---|---|
| First Quarter | $40.90 | $38.04 | $0.455 |
| Second Quarter | $40.88 | $36.83 | $0.455 |
| Third Quarter | $41.03 | $36.35 | $0.455 |
| Fourth Quarter | $37.10 | $32.66 | $0.455 |

## EQUITY COMPENSATION PLAN INFORMATION

The following table sets forth securities authorized for issuance under equity compensation plans for the year ended December 31, 2006:

| Plan category | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|---|---|---|---|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders | | | |
| **KeySpan Long Term Incentive Compensation Plan** | | | |
| Stock Options | 9,403,104 | $33.82 | - |
| Restricted Stock | 175,414 | N/A | - |
| Performance Shares | 512,176 (1) | N/A | - |
| Equity compensation plans not approved by security holders | N/A | N/A | N/A |
| Total | (2) | $33.82 | 3,036,898(3) |

(1) Performance shares shown at target, or 100% payout.

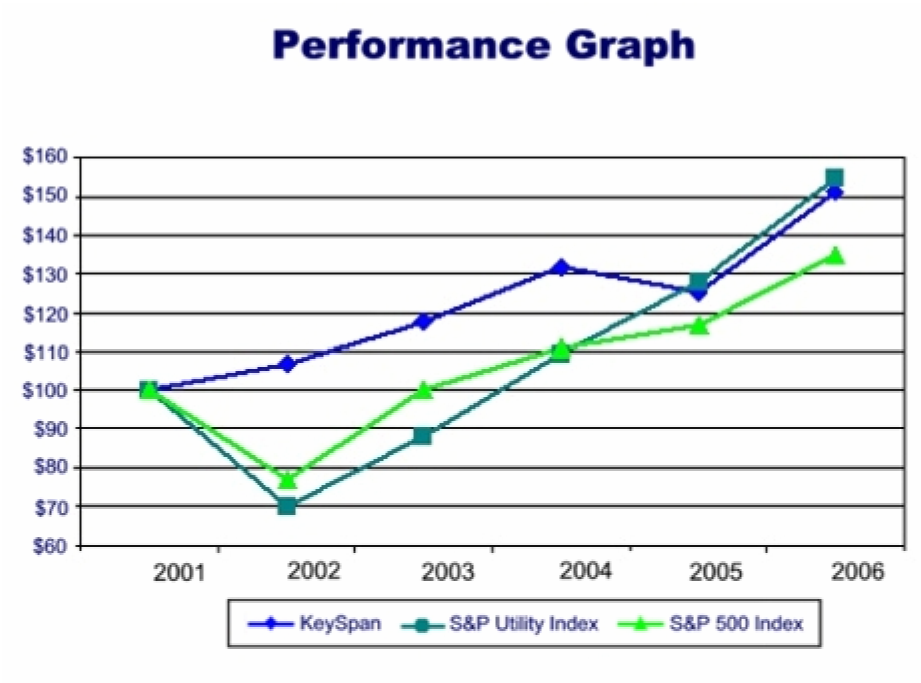
(2) Includes grants of options, restricted stock, and performance shares pursuant to KeySpan's Long-Term Incentive Compensation Plan, as amended, and options granted pursuant to the Brooklyn Union Long-Term Incentive Compensation Plan, the Eastern Enterprises 1995 Stock Option Plan and the Eastern Enterprises 1996 Non-Employee Trustee's Stock Option Plan.

(3) This total amount reflects the aggregate number of stock options, restricted stock and performance shares available for issuance pursuant to KeySpan's Long-Term Incentive Compensation Plan.

See Item 11. Executive Compensation for more information on the equity compensation plans.

**PERFORMANCE GRAPH**

The following graph presents, for the period beginning December 31, 2001 through December 31, 2006, a comparison of cumulative total shareholder returns for KeySpan, the Standard & Poor's Utilities Index and the Standard & Poor's 500 Index.




| | December 31, 2001 | December 31, 2002 | December 31, 2003 |
|---|---|---|---|
| KeySpan | $100.00 | $106.89 | $117.43 |
| S&P Utility Index | $100.00 | $70.06 | $88.27 |
| S&P 500 Index | $100.00 | $77.05 | $100.27 |

| | December 31, 2004 | December 31, 2005 | December 31, 2006 |
|---|---|---|---|
| KeySpan | $131.83 | $125.09 | $151.01 |
| S&P Utility Index | $109.57 | $127.89 | $154.70 |
| S&P 500 Index | $111.15 | $116.59 | $134.96 |

Assumes $100 invested on December 31, 2001 in shares of KeySpan Common Stock, the S&P Utilities Index and the S&P 500 Index, and that all dividends were reinvested.

## ITEM 6. SELECTED FINANCIAL DATA

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | **2006** | **2005** | **2004** | **2003** | **2002** |
| **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 |

## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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) |
| Cummulative 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.

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | 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 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 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 increased $24.3 million for the twelve months ended December 31, 2005, compared to same period of 2004. 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 Performance Based Rate Plan (the "Plan") that was approved by the 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 in 2004 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 of 2004.

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 a similar amount was expensed 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 resulting from the Plan, 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.

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 of 2004, 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 that 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 expiration of this agreement, these services have been provided by KeySpan employees. KeySpan also provides these services internally for its 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 distribution subsidiaries, as well as providing city-gate delivered supply. As noted above, beginning in April 2006, KeySpan and Merrill Lynch Trading have a new three-year agreement under which KeySpan and Merrill Lynch share the responsibilities for managing KeySpan's upstream gas contracted assets associated with its Massachusetts gas distribution subsidiaries.

**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 in 2004. 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 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.

**Gas Supply and Pricing**

KeySpan has adequate gas supply available to meet its gas load demand in its service territories for the 2006/2007 winter heating season as KeySpan's gas storage was 100% full at the start of the winter heating season. The current gas rate structure of each of our gas distribution utilities includes 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 financial 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 (formerly 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 natural gas to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. In addition, KeySpan has a 26.25% interest 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 of 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 charges and property taxes of approximately $14 million. These recoveries had no impact on operating income since actual expenses increased by a like amount. Therefore, only approximately $7 million of the increase in net revenues resulted in a benefit to operating income. This increase in net revenues from the LIPA service agreements was driven by higher off-system electric energy sales and emission credit sales, as well as the recovery of certain past service costs, offset by lower performance incentives. In 2006, KeySpan earned $9.0 million associated with non-cost performance incentives provided for under these agreements, compared to $16.4 million earned in 2005, due to the discontinuation of certain performance incentives contained in the MSA.

Net revenues associated with KeySpan's electric marketing activities increased $3.6 million during the twelve months ended December 31, 2006, compared to the same period of 2005.

Net revenues from the Ravenswood Generating Station decreased $110.3 million, or 25% for the twelve months ended December 31, 2006, compared to the same period of 2005 reflecting lower capacity revenues of $80.5 million and a decrease in energy margins of $29.8 million. The decrease in capacity revenues was primarily due to the planned installation of 1,000 megawatts of additional electric capacity in New York City in 2006.

The decrease in energy margins in 2006 reflects, in part, a 50% decrease in realized "spark-spreads" (the selling price of electricity less the cost of fuel, exclusive of hedging gains or losses). Further, the level of megawatt hours ("MWh") sold into the NYISO energy market decreased 30% due to increased competition and cooler weather in the summer of 2006 compared to the summer of 2005 – the peak cooling season. As measured in cooling-degree days, weather was 25% cooler during the summer of 2006 compared to the summer of 2005, and 2% warmer than normal. Combined, these two items reduced energy margins by $124.9 million or 63%. It should be noted, that in 2005 KeySpan benefited from the pricing differential between number 6-grade fuel oil and natural gas used in the Ravenswood Generating Station. Due to the dual-fuel capability of the Ravenswood Generating Station, KeySpan was able to take advantage of the ability to switch to cheaper fuel as the gap between number 6 grade fuel oil and gas prices spread during the later part of the 2005 summer. The two hurricanes which occurred in the summer of 2005 in the Gulf Coast of the United States contributed to the gap between number 6-grade fuel oil and natural gas prices.

Partially offsetting these adverse impacts to comparative energy margins were the benefits recognized from derivative financial instruments. We employ derivative financial instruments to economically hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil consumed at the Ravenswood Generating Station, as well as for a portion of forecasted electric energy sales. These derivative instruments, the impacts of which are reflected in net electric margins, resulted in a comparative gain of $95.1 million year-over-year. Hedging gains realized in 2006 were $79.1 million compared to hedging losses of $16.0 million 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 pricing. The increase in net revenues was partially offset by an increase in operating expenses associated with the Ravenswood Generating Station of $11.8 million, as well as lower net revenues associated with KeySpan's retail electric marketing activities of $7.6 million.

## Net Revenues

Total electric net revenues realized during the twelve months ended December 31, 2005, were $96.8 million, or 8% higher than such revenues realized during the corresponding period of 2004.

For the year ended December 31, 2005, net revenues from the Ravenswood Generating Station increased $78.7 million, or 22%, compared to the same period in 2004 reflecting higher energy margins of $66.0 million, as well as increased capacity revenues of $12.7 million. The increase in capacity revenues reflected the operation of the Ravenswood Expansion which went into full commercial operation in May 2004, as well as load growth in New York City.

The increase in energy margins for 2005 reflects an increase of 54% in "spark-spreads" (the selling price of electricity less the cost of fuel, exclusive of hedging gains or losses), as well as from an increase of 2% in the level of MWh sold into the NYISO energy market. These favorable energy results were primarily driven by the pricing differential between number 6-grade fuel oil and natural gas used in the Ravenswood Generating Station in 2005. As noted previously, due to the dual-fuel nature of the Ravenswood Generating Station, KeySpan was able to take advantage of the ability to switch to cheaper fuel as the gap between number 6 grade fuel oil and gas prices spread during the later part of the 2005 summer. Further, in 2005 KeySpan received $9.2 million from the NYISO to settle billing issues regarding the sale of energy provided by the Ravenswood Generating Station to the NYISO in May 2000. Weather for 2005, as measured in cooling degree days, was 40% warmer than 2004 and 28% warmer than normal.

As mentioned previously, 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 Generating Station as well as a portion of forecasted electric energy sales. These derivative instruments resulted in hedging losses, which are reflected in net electric margins, of $16.0 million in 2005, compared to hedging gains of $23.0 million in 2004.

Net revenues for the twelve months ended December 31, 2005, from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $25.7 million compared to the corresponding period of 2004. The increase was due, in part, to recovery of operating expenses billed to LIPA of approximately $14 million and the recovery of depreciation charges and property taxes of approximately $8 million. These recoveries had no impact on operating income since actual expenses increased by a like amount. The remaining increase primarily reflects an increase in emission credits earned and variable revenues, which are a function of electric generation output. In 2005 and 2004, we earned a total of $16.4 million associated with non-cost performance incentives provided for under these agreements.

Net revenues associated with KeySpan's retail electric marketing activities decreased $7.6 million in 2005 compared to 2004, due to a significant curtailment in these activities. In 2005, KeySpan terminated all indexed price contracts and elected to maintain only its fixed priced contracts. As a result, the retail electric marketing business had approximately 40 MW under contract during 2005.

## Operating Expenses

For the twelve months ended December 31, 2005, operating expenses increased $43.5 million, or 5%, compared to the same period of 2004. Operations and maintenance expense in 2005 increased $31.2 million, or 5% over 2004 reflecting an increase of $7.5 million in operating lease costs associated with our financing arrangement for the Ravenswood Expansion, as well as an increase in overhaul work and plant retirement costs associated with the Ravenswood Generating Station amounting to approximately $8 million. The remaining increase reflected operating costs billed to LIPA of approximately $14 million.

Depreciation expense and operating taxes increased $12.3 million in 2005 compared to 2004. Of this amount, approximately $8 million was associated with KeySpan's Long Island based electric generating units and were fully recoverable from LIPA, as noted above. The remaining increase 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 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 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 long-term 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.

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 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:

| | Year Ended December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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.

KeySpan does not anticipate issuing permanent financing in 2007.

The following table represents the ratings of our long-term debt at December 31, 2006. 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, 2006. 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 $65.2 million of surety bonds associated with certain construction projects currently being performed by former subsidiaries; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of $64.6 million; and (iii) $80.3 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, 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)*<br>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 | $ 5,017.6 |
| Commercial Paper | $ 85.0 | 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.

### 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 Agreement, KeySpan and LIPA will enter into an amendment to the 1998 EMA reflecting that the facilities that LIPA acquires pursuant to the Option Agreement are no longer covered under the 1998 EMA and as noted above, an operation and maintenance agreement, whereby KeySpan will continue to operate the newly acquired facilities for a fixed management fee plus reimbursement for certain costs. It is anticipated that the fees received pursuant to the operation and maintenance agreement will offset the reduction in any fees earned by KeySpan pursuant to the 1998 EMA.

Under the 1998 LIPA Agreements and the 2006 LIPA 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.

***Power Purchase Agreements.*** KeySpan-Glenwood Energy Center, LLC and KeySpan-Port Jefferson Energy Center LLC each have 25 year power purchase agreements with LIPA expiring in 2027 (the "2002 LIPA PPAs"). Under the terms of the 2002 LIPA PPAs, these subsidiaries sell capacity, energy conversion services and ancillary services to LIPA. Each plant is designed to produce 79.9 MW. Pursuant to the 2002 LIPA 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.

## 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

In 2005, 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 were discussed above. 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.

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 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.

We estimate that the remaining cost of our MGP related environmental 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 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 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 rerunning 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.

<u>NYISO In-City Capacity Mitigation</u>

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.

## ITEM 7A. 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 | Year of Maturity | Volumes (mmcf) | Fixed Price ($) | Current Price ($) | Fair Value ($Millions) |
|---|---|---|---|---|---|
| **Gas** | | | | | |
| 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 | Year of Maturity | Volumes (Barrels) | Fixed Price ($) | Current Price ($) | Fair Value ($Millions) |
|---|---|---|---|---|---|
| **Oil** | | | | | |
| 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 | Year of Maturity | MWh | Fixed Price ($) | Current Price ($) | Fair Value ($Millions) |
|---|---|---|---|---|---|
| **Electricity** | | | | | |
| 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:

| *(In Millions of Dollars)* **Change in Fair Value of Derivative Hedging Instruments** | | **2006 ($Millions)** |
|---|---|---|
| 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** | **Year of Maturity** | **Volumes (mmcf)** | **Ceiling ($)** | **Fixed Price ($)** | **Current Price ($)** | **Fair Value ($Millions)** |
|---|---|---|---|---|---|---|
| **Gas** | | | | | | |
| 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.

## ITEM 8. Financial Statements and Supplementary Data

### CONSOLIDATED BALANCE SHEET

| *(In Millions of Dollars)* | December 31, 2006 | 2005 |
|---|---|---|
| **ASSETS** | | |
| **Current 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 |
| **Equity Investments and Other** | **269.7** | 242.4 |
| **Property** | | |
| 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 |
| **Deferred 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 |
| **Total Assets** | **$ 14,437.5** | $ 13,812.6 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED BALANCE SHEET

| *(In Millions of Dollars)* | December 31, 2006 | 2005 |
|---|---|---|
| **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 & 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

| *(In Millions of Dollars)* | **2006** | 2005 | 2004 |
|---|---|---|---|
| | Year Ended December 31, | | |
| ***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/leasback 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

| (In Millions of Dollars) | Year Ended December 31, 2006 | 2005 | 2004 |
|---|---|---|---|
| **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

| (In Millions of Dollars) | Year Ended December 31, 2006 | 2005 | 2004 |
|---|---|---|---|
| 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 (losses) gains 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 (losses) gains 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 (Benefit) Expense | $ 27.2 | $ (12.9) | $ 2.9 |

See accompanying Notes to the Consolidated Financial Statements.

# CONSOLIDATED STATEMENT OF CAPITALIZATION

| (In Millions of Dollars) | December 31, 2006 | December 31, 2005 | December 31, 2006 | December 31, 2005 |
|---|---|---|---|---|
| **Common Shareholders' Equity** | **Shares Issued** | | | |
| 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.

## 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.

| | December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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:

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | 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.

| | Year Ended December 31, | | |
|---|---|---|---|
| (*In Millions of Dollars*) | 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.

| Remaining Contractual 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 |
|---|---|---|---|---|---|---|
| 1 year | - | - | - | - | - | - |
| 2 years | 185,000 | 32.63 | 32.63 | 185,000 | 32.63 | 32.63 |
| 3 years | 681,958 | 28.00 | 24.73 - 29.38 | 681,958 | 28.00 | 24.73 - 29.38 |
| 4 years | 382,181 | 26.97 | 21.99 - 27.06 | 382,181 | 26.97 | 21.99 - 27.06 |
| 5 years | 960,947 | 22.69 | 22.50 - 32.76 | 960,947 | 22.69 | 22.50 - 32.76 |
| 6 years | 1,511,064 | 39.50 | 39.50 | 1,511,064 | 39.50 | 39.50 |
| 7 years | 1,750,205 | 32.66 | 32.66 | 1,422,105 | 32.66 | 32.66 |
| 8 years | 1,165,112 | 32.40 | 32.40 | 766,552 | 32.40 | 32.40 |
| 9 years | 1,414,766 | 37.54 | 37.54 | 655,231 | 37.54 | 37.54 |
| 10 years | 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 options which have not yet vested. The unearned compensation cost related to these stock option awards is $3.2 million which is expected to be recognized over a weighted average period of 2 years.

## O. Recent Accounting Pronouncements

In February 2007, Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") 159 "The Fair Value Option for Financial Assets and Financial Liabilities." This statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement requires a business entity to report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. An entity may decide whether to elect the fair value option for each eligible item on its election date, subject to certain requirements described in the statement. This statement shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007. KeySpan is currently reviewing the requirements of this statement and, at this point in time, we can not determine the impact, if any, that this statement may have on results of operations, financial position or cash flows.

On September 29, 2006, the FASB issued SFAS 158 Employers' Accounting for Defined Benefit Pensions and Other Postretirement Benefit Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)." SFAS 158 requires employers to fully recognize all postretirement plans funded status on the balance sheet as a net liability or asset and requires an offsetting adjustment to accumulated other comprehensive income in shareholders' equity. Certain of KeySpan's subsidiaries are subject to deferral accounting requirements pursuant to rate agreements with the NYPSC, MADTE and NHPUC. Further, KeySpan has certain contractual rights to reimbursement for postretirement liabilities in its agreements with LIPA. As such, a portion of the offsetting position to the increase in the total postretirement liabilities has been reflected as a regulatory asset and contractual 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 "Post Retirement 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:

| | December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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 | Other 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:

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 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:

| | December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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) |
| Employess 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:

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 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:

| | Year Ended December 31, | | |
|---|---|---|---|
| *(In Millions of Dollars)* | 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 expenses | 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 benefit | - | 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.

| *(In Millions of Dollars)* | Year Ended December 31, 2006 | 2005 |
|---|---|---|
| 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 / (losss) | $ (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 / (losss) | $ (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:

| *(In Millions of Dollars)* | Gross Benefit Payments | Subsidiary Receipts Expected** |
|---|---|---|
| 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 postretiment 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 Post Retirement 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 income | $ (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 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 $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 August 2007. To accomplish our stated risk management strategy, KeySpan employs financially-settled electric-power swap contracts with offsetting financially-settled oil swap contracts, physical natural gas forward contracts and OTC natural gas swaps. We use market quoted forward prices to value the electric-power swap contracts. The fair value of the electric power derivative instruments at December 31, 2006 was $21.9 million. We use market quoted forward prices to value the oil swap contracts and natural gas contracts. The fair value of these derivative instruments at December 31, 2006, was a liability of $23.7 million.

During most of 2006 and in prior years, the derivative transactions associated with the Ravenswood Generating Station qualified for hedge accounting treatment. As a result, there is a net $1.2 million balance currently in accumulated other comprehensive income which is expected to be reclassified into earnings within the next twelve months. In 2006, KeySpan reclassified a $1.4 million loss from accumulated other comprehensive income to earnings, based on management's assessment that certain future oil purchases were not probable of occurrence. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial in 2006.

On January 18, 2006, KeySpan entered into an International SWAP Dealers Association Master Agreement for a fixed for float unforced capacity financial swap (the "Swap Agreement") with Morgan Stanley Capital Group Inc. ("Morgan Stanley"). The Swap Agreement has a three year term that began on May 1, 2006. The notional quantity was 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 occurs on a monthly 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 purchases 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 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, 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 contracts that combine a forward contract and a purchase option contract to qualify for the normal purchases and sales exception. Certain contracts for the 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 71. At December 31, 2006, these derivatives had a net fair value of $101.2 million.

KeySpan has a management contract with Merrill Lynch Trading, under which KeySpan and Merrill Lynch Trading will share the responsibilities for managing KeySpan's upstream gas distribution assets associated with its Massachusetts gas distribution subsidiaries, as well as providing city-gate delivered supply. This contract, which replaces the prior arrangement with Merrill Lynch Trading, allows for both KeySpan and Merrill Lynch Trading to employ derivative instruments to maximize the profitability of KeySpan's portfolio of gas distribution assets. Profits associated with these activities are shared between KeySpan, Merrill Lynch Trading and KeySpan's Massachusetts ratepayers. The accounting for this contract is subject to SFAS 71 since the contract was executed by KeySpan's regulated gas distribution utilities. At December 31, 2006, KeySpan's proportionate share of the fair value associated with these derivative instruments amounted to $10.4 million, $9.5 million of which has been deferred for future sharing among the alliance members and Massachusetts ratepayers. The remaining amount was recorded as a benefit to revenues. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

*Interest Rate Derivative Instruments:* In the fourth quarter of 2006, KeySpan issued $400 million Senior Unsecured Notes at KEDNY and $100 million Senior Unsecured Notes at KEDLI. 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 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

| | December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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

| | | December 31, | | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | | 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.

| | For the Year Ended December 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 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) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Year Ended December 31, 2006 | | | | |
| **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) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Year Ended December 31, 2005 | | | | |
| **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) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Year Ended December 31, 2004 | | | | |
| **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) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | December 31, 2006 | | | | |
| **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) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | | | December 31, 2005 | | |
| **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* 3/31/2006 | 6/30/2006 | | 9/30/2006 | 12/31/2006 | |
|---|---|---|---|---|---|---|
| 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.

| | Quarter Ended | | | | |
|---|---|---|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | 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 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."

## 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. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and financial statement schedule 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. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

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.

/s/ DELOITTE & TOUCHE LLP
New York, New York
February 22, 2007

## ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## ITEM 9A. 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, 2006. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures were effective at the reasonable assurance level in alerting them timely to material information required to be included in KeySpan's periodic SEC reports.

Furthermore, there has been no change in KeySpan's internal control over financial reporting 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 accounting principles generally accepted in the United States of America.

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, 2006. 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, 2006, 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, 2006, which is included herein.

## 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 and financial statement schedule 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 financial statement schedule 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.

/s/ DELOITTE & TOUCHE LLP
New York, New York
February 22, 2007

## PART III

## ITEM 10. DIRECTORS, EXECUTIVE OFFICERS and CORPORATE GOVERNANCE

### Directors of KeySpan

The following individuals were elected as directors of KeySpan at our last annual meeting of shareholders held on August 17, 2006, to hold such position for a one year term or until his or her successor is duly elected or chosen and qualified:

**Robert B. Catell - Age 70 - Director since May 1998**
Chairman and Chief Executive Officer of KeySpan Corporation since July 1998. Joined KeySpan's subsidiary, The Brooklyn Union Gas Company, in 1958 and was elected Assistant Vice President in 1974, Vice President in 1977, Senior Vice President in 1981 and Executive Vice President in 1984. Elected Brooklyn Union's Chief Operating Officer in 1986 and President in 1990. Served as President and Chief Executive Officer from 1991 to 1996. He was then elected Chairman and Chief Executive Officer in 1996 and held such position through the transformation of Brooklyn Union to KeySpan. He served as President and Chief Operating Officer of KeySpan from May 1998 through July 1998 and was then elected as the Chairman in July 1998. Serves on the boards of Alberta Northeast Gas, Ltd., Edison Electric Institute, New York State Energy Research and Development Authority, the Business Council of New York State, Inc. and the New York City Partnership, and as Chairman of the Long Island Association. Mr. Catell also serves on the board of directors of The Houston Exploration Company (NYSE:THX) and Keyera Energy Management Ltd. (TSX:KEY.UN).

**Andrea S. Christensen - Age 67 - Director since January 2001**
Special Counsel to the law firm of Kaye Scholer LLP since January 1, 2005. Previously was a partner of Kaye Scholer LLP since 1976. Joined that firm in 1968 and previously was an associate with the law firm of Kelley, Drye & Warren. Adjunct Professor at New York University School of Law from 1984 to 1994. Member of the Association of the Bar of the City of New York, American Bar Association and International Society for Labor Law and Social Security. Former Chairperson of New York County Lawyers Association Committee on Labor Relations. Served as a director of Brooklyn Union from 1980 to 2000, and the American Arbitration Association from 1988 to 1999. Serves as a Member of the board of Inwood House since 2000.

**Robert J. Fani – Age 52 - Director since January 2005**
President and Chief Operating Officer of KeySpan since October 2003. Joined KeySpan's subsidiary, The Brooklyn Union in 1976 and has since held a variety of management positions in distribution, engineering, planning, marketing, and business development. Elected Vice President in 1992 and promoted to Senior Vice President of Marketing and Sales in 1997 and was responsible for all marketing, sales, rate and regulation activities. In September 1999, he became Senior Vice President for Gas Operations and was promoted to Executive Vice President for Strategic Services in February 2000 and then to President of the KeySpan Energy Services and Supply Group in 2001 until assuming his current position as President and Chief Operating Officer. Former Director of The Houston Exploration Company (NYSE:THX) and serves as a

director of the New York Building Congress, the City College of New York, Stony Brook University and the Energy Partnership of Long Island. He is also a member of the Society of Gas Lighters and sits on the Board of the Gas Technology Institute.

**Alan H. Fishman - Age 60 - Director since May 1998**
President, Sovereign Bank, from June 2006 to December 2006. Former president, Chief Executive Officer and a director of Independence Community Bank Corp. (NASDAQ:ICBC), the parent savings and loan holding company of Independence Community Bank. Joined Chemical Bank in 1969, named Chief Financial Officer in 1979 and elected Senior Vice President responsible for worldwide investment banking activities in 1983. Joined Neuberger & Berman in 1988 and was responsible for an investment partnership. Joined American International Group, Inc. in 1989 as Senior Vice President of AIG. Joined the firm of Adler & Shaykin in 1990 as a Managing Partner. Former Managing Partner and founder of Columbia Financial Partners, L.P. in 1992. President and Chief Executive Officer of ContiFinancial Corporation from July 1999 to March 2001. Chairman of the Brooklyn Academy of Music and the Brooklyn Navy Yard and co-chairman of the Downtown Brooklyn Partnership.

**James R. Jones - Age 67 - Director since May 1998**
Co-Chairman and Chief Executive Officer of Manatt Jones Global Strategies, LLP since October 2001 and Chairman of GlobeRanger Corporation since September 1999. Senior Counsel to the law firm of Manatt, Phelps & Phillips, LLP from March 1999 to present. Retired as President of Warnaco, Inc. - International Division in 1998. Director of Anheuser Busch (NYSE:BUD) since 1998 and Kansas City Southern (NYSE:KSU) since 1997. White House Staff, Special Assistant and Appointments Secretary from 1965 to 1969 and Congressman from Oklahoma from 1973 to 1987. Partner in the law firm of Dickstein Shapiro Morin & Oshinsky LLP from 1987 to 1989. Chairman and Chief Executive Officer of the American Stock Exchange from 1989 to 1993. Served as United States Ambassador to Mexico from 1993 to 1997.

**James L. Larocca - Age 63 - Director since January 2001**
Distinguished Professor of Public Policy and former Dean of the College at Long Island University's Southampton Graduate Campus since April 2000 and Adjunct Professor of Public Policy at Hofstra University since January 1999. Chairman of the Long Island Regional Planning Board. Practiced law with the firm of Cullen and Dykman immediately prior to his appointment to Southampton College. Served in the cabinets of two New York State governors as Commissioner of Transportation, Commissioner of Energy, Director of Federal Affairs, Trustee of the New York Power Authority and Chairman of the Energy Research and Development Authority. Served as the President of the Long Island Association from 1985 to 1993. Served as a director of Brooklyn Union from 1992 to 1993 and from 1995 to 2000. Former director of European American Bank and ContiFinancial Corporation. Current director and past Chairman of the Long Island Nature Conservancy.

**Gloria C. Larson - Age 56 - Director since June 2003**
Partner and Co-chair of the Government Practices Group at the law firm of Foley Hoag LLP. Has held senior positions within the federal government and the Commonwealth of Massachusetts government, including serving as the Massachusetts Secretary of Economic Affairs, Deputy Director of Consumer Protection and Attorney Advisor for the Federal Trade Commission. Current Chairperson of the Massachusetts Convention Center Authority since

1998. Director of Unum Provident Corp. (NYSE:UNM). Serves as a member of the Rose F. Kennedy Greenway Conservancy board, as well as several Boston-based not-for-profit organizations, including the Greater Boston Chamber of Commerce, the New England Council, the Massachusetts Women's Forum and Blue Cross Blue Shield of Massachusetts. Serves as co-Chair of the board of directors of MassINC.

**Stephen W. McKessy - Age 69 - Director since May 1998**
Elected as the Lead Director of KeySpan effective January 1, 2006. Retired partner of PricewaterhouseCoopers. Served in various management and leadership positions at PricewaterhouseCoopers from 1960 to 1997. Serves as a director of The Houston Exploration Company (NYSE:THX), and the Boy Scouts of America. Member of the board of advisors of St. John's University College of Business Administration, past president and current member of the board of governors of the Silver Spring Country Club, and member of the Property Owners Association at SailFish Point, Florida.

**Edward D. Miller - Age 65 - Director since May 1998**
Served as a member of the supervisory board and senior advisor to the Chief Executive Officer of AXA Group from June 2001 to April 2003. Served as President and Chief Executive Officer of AXA Financial, Inc. from August 1997 through May 2001. Chairman and Chief Executive Officer of The Equitable Life Assurance Society, the principal insurance subsidiary of AXA Financial, Inc., from August 1997 through May 2001. Served as Senior Vice Chairman of The Chase Manhattan Bank from 1996 through 1997. Serves as a member of the board of directors of American Express Company (NYSE:AXP) and Korn/Ferry International (NYSE:KFY). Member of the board of governors of the United Way of Tri-State and Chairman of the board of directors of Phoenix House. Trustee of the Inner-City Scholarship Fund and the New York City Police Foundation. Chairman for New York City's Partnership Security and Risk Management Task Force.

**Vikki L. Pryor - Age 53 - Director since March 2004**
President and Chief Executive Officer of SBLI USA Mutual Life Insurance Company, Inc. and its family of companies since 1999. Served as Senior Vice President of Oxford Health Plans from June 1998 to January 1999. Served in various Senior Vice President and Vice President positions at Blue Cross Blue Shield of Massachusetts from 1993 to 1997. Served as Director and in a variety of senior level positions at Allstate Life Insurance Company from 1986 to 1992. Served in various positions including acting assistant district counsel, senior attorney and associate in the Office of Chief Counsel of the Internal Revenue Service, Chicago office, from 1978 to 1986. Served on the boards of the Life Insurance Council of New York (LICONY), New Jersey Chamber of Commerce, UST Corporation, Pension Reserves Investment Management and River Source Funds, a mutual fund company Serves on the Dean's Advisory Council of the University at Buffalo Law School. Ms. Pryor is also a member of the board of the New York City Partnership and the Forum 500 Board of Directors.

## EXECUTIVE OFFICERS OF KEYSPAN

Certain information regarding executive officers of KeySpan and certain of its subsidiaries is set forth below:

**Robert B. Catell**
Mr. Catell's biography appears under "Directors of KeySpan".

**Robert J. Fani**
Mr. Fani's biography appears under "Directors of KeySpan".

**Wallace P. Parker Jr.**
Mr. Parker, age 57, was elected President of the KeySpan Energy Delivery and Customer Relations Group in January 2003. He also serves as Vice Chairman and Chief Executive Officer of KeySpan Services, Inc. since January 2003. He had previously served as President, KeySpan Energy Delivery, since June 2001, and from February 2000 served as Executive Vice President of Gas Operations. He joined KEDNY in 1971 and served in a wide variety of management positions. In 1987, he was named Assistant Vice President for marketing and advertising and was elected Vice President in 1990. In 1994, Mr. Parker was promoted to Senior Vice President of Human Resources for KEDNY and in August 1998 was promoted to Senior Vice President of Human Resources of KeySpan.

**Steven L. Zelkowitz**
Mr. Zelkowitz, age 57, was elected President of KeySpan's Energy Assets and Supply Group in October 2003. Prior to that, he served as Executive Vice President and Chief Administrative Officer since January 2003. He joined KeySpan as Senior Vice President and Deputy General Counsel in October 1998, and was elected Senior Vice President and General Counsel in February 2000. In July 2001, Mr. Zelkowitz was promoted to Executive Vice President and General Counsel, and in November 2002, he was named Executive Vice President, Administration and Compliance, with responsibility for the offices of General Counsel, Human Resources, Regulatory Affairs, Enterprise Risk Management and administratively for Internal Auditing. Before joining KeySpan, Mr. Zelkowitz practiced law with Cullen and Dykman LLP in Brooklyn, New York, specializing in energy and utility law and had been a partner since 1984. He served on the firm's Executive Committee and was head of its Corporate/Energy Department.

**John J. Bishar, Jr.**
Mr. Bishar, age 57, was elected Executive Vice President, General Counsel, Chief Governance Officer and Secretary effective March 1, 2005. He became Senior Vice President, General Counsel and Secretary in May 2003, with responsibility for KeySpan's Legal Department and the Corporate Secretary's Office. Prior to that, he joined KeySpan as Senior Vice President and General Counsel in November 2002. Before joining KeySpan, Mr. Bishar practiced law with Cullen and Dykman LLP since 1987. He was the Managing Partner from 1993 through 2002 and was a member of the firm's Executive Committee. From 1980 to 1987, Mr. Bishar was Vice President, General Counsel and Corporate Secretary of LITCO Bancorporation of New York, Inc.

**John A. Caroselli**
Mr. Caroselli, age 51, was elected Executive Vice President and Chief Strategy Officer in January 2003. Mr. Caroselli is responsible for Brand Management, Strategic Marketing, Corporate Marketing, Sales and Account Management and Customer Service, Strategic Planning, Strategic Performance and Information Technology Strategy and Governance. Mr. Caroselli came to KeySpan in 2001 and at that time served as Executive Vice President of Strategic Development. Before joining KeySpan, Mr. Caroselli held the position of Executive Vice President of Corporate Development at AXA Financial. Prior to that, he held senior officer positions with Chase Manhattan, Chemical Bank and Manufacturers Hanover Trust. He has extensive experience in strategic planning, brand management, marketing, communications, human resources, and strategic execution.

**Gerald Luterman**
Mr. Luterman, age 63, was elected Executive Vice President and Chief Financial Officer in February 2002. He previously served as Senior Vice President and Chief Financial Officer since joining KeySpan in July 1999. He formerly served as Chief Financial Officer of barnesandnoble.com and Senior Vice President and Chief Financial Officer of Arrow Electronics, Inc. Prior to that, from 1985 through 1996, he held executive positions with American Express. Mr. Luterman also serves on the Board of Directors for IKON Office Solutions Inc. (NYSE:IKN), U.S. Shipping Partners L.P. (NYSE:USS) and Technology Solutions Company (NASDAQ:TSCC).

**David J. Manning**
Mr. Manning, age 56, was elected Executive Vice President Corporate Affairs and Chief Environmental Officer effective March 1, 2005. He became Senior Vice President for Corporate Affairs in April 1999. Before joining KeySpan, Mr. Manning had been President of the Canadian Association of Petroleum Producers since 1995. From 1993 to 1995, he was Deputy Minister of Energy for the Province of Alberta, Canada. From 1988 to 1993, he was Senior International Trade Counsel for the Government of Alberta, based in New York City. Previously, he was in the private practice of law in Canada as Queen's Counsel.

**Anthony Nozzolillo**
Mr. Nozzolillo, age 58, was elected Executive Vice President of Electric Operations in February 2000. He previously served as Senior Vice President of KeySpan's Electric Business Unit from December 1998 to January 2000. He joined LILCO in 1972 and held various positions, including Manager of Financial Planning and Manager of Systems Planning. Mr. Nozzolillo served as LILCO's Treasurer from 1992 to 1994 and as Senior Vice President of Finance and Chief Financial Officer from 1994 to 1998.

**Nickolas Stavropoulos**
Mr. Stavropoulos, age 47, was elected President, KeySpan Energy Delivery, in June, 2004 and Executive Vice President in April 2002. He previously served as President of KeySpan Energy New England since April 2002, and Senior Vice President of sales and marketing in New England since 2000. Prior to joining KeySpan, Mr. Stavropoulos was Senior Vice President of marketing and gas resources for Boston Gas Company. Before joining Boston Gas, he was Executive Vice President and Chief Financial Officer for Colonial Gas Company. In 1995, Mr. Stavropoulos was elected Executive Vice President – Finance, Marketing and CFO, and assumed responsibility for all of Colonial's financial, marketing, information technology and customer service functions. Mr. Stavropoulos was a director of Colonial Gas Company and currently

serves on the Board of Directors for Enterprise Bank and Trust Company (NASDAQ:EBTC) and Dynamics Research Corporation (NASDAQ:DRCO).

**Joseph F. Bodanza**

Mr. Bodanza, age 59, was elected Senior Vice President Regulatory Affairs and Asset Optimization effective March 1, 2005. He became Senior Vice President, Regulatory Affairs and Chief Accounting Officer in April 2003. Prior to that, he served as Senior Vice President of Finance Operations and Regulatory Affairs since August 2001 and was Senior Vice President and Chief Financial Officer of KEDNE. Mr. Bodanza previously served as Senior Vice President of Finance and Management Information Systems and Treasurer of Eastern Enterprise's Gas Distribution Operations. Mr. Bodanza joined Boston Gas Company in 1972, and held a variety of positions in the financial and regulatory areas before becoming Treasurer in 1984. He was elected Vice President and Treasurer in 1988.

**Coleen A. Ceriello**

Ms. Ceriello, age 48, was named Senior Vice President of Shared Services of KeySpan Corporate Services, LLC, effective March 1, 2005. She had been KeySpan's Vice President – Property, Security and Employee Related Services since January 2005. Prior to that time, she served as Vice President of Property and Security since June 2004 and Vice President of Strategic Planning since August 1999. She joined KEDNY in 1980 and over the years held a succession of positions in Corporate Planning, Regulatory Relations, Information Technology and Strategic Planning and Performance.

**John F. Haran**

Mr. Haran, age 56, was elected Senior Vice President of KeySpan Energy Delivery and Chief Gas Engineer in March 2004. He had been Senior Vice President of gas operations for KEDNY and KEDLI in April 2002. Mr. Haran joined KEDNY in 1972, and has held management positions in operations, engineering and marketing and sales. He was named Vice President of KEDNY gas operations in 1996 and in 2000 moved to the position of Vice President of KEDLI gas operations.

**Michael J. Taunton**

Mr. Taunton, age 51, was elected Senior Vice President, Treasurer and Chief Risk Officer effective March 1, 2005. He became Senior Vice President and Treasurer in March 2004, and had been KeySpan's Vice President and Treasurer since June 2000. Prior to that time, he served as Vice President of Investor Relations since September 1998. He joined KEDNY in 1975 and held a succession of positions in Accounting, Customer Service, Corporate Planning, Budgeting and Forecasting, Marketing and Sales, and Business Process Improvement. During the KeySpan/LILCO merger, Mr. Taunton co-managed the day-to-day transition process of the merger and then served on the Transition Team during the acquisition of Eastern Enterprises.

**Elaine Weinstein**

Ms. Weinstein, age 59, was named Senior Vice President for Human Resources and Chief Diversity Officer in March 2004. She previously served as Senior Vice President of KeySpan's Human Resources division since November 2000, and as Vice President of Staffing and Organizational Development from September 1998, to her election as Senior Vice President. Prior to that time, Ms. Weinstein was General Manager of Employee Development since joining KEDNY in June of 1995. Prior to 1995, Ms. Weinstein was Vice President of Training and Organizational Development at Merrill Lynch.

**Lawrence S. Dryer**
Mr. Dryer, age 47, was elected Vice President and General Auditor in June 2003. He previously served in this position from September 1998 to August 2001. In August 2001, he was named Senior Vice President and Chief Financial Officer of KeySpan Services, Inc. Prior to such positions, Mr. Dryer had been with LILCO from 1992 to 1998 as Director of Internal Audit. Prior to joining LILCO, Mr. Dryer was an Audit Manager with Coopers & Lybrand.

**Theresa A. Balog**
Ms. Balog, age 44, was elected Vice President and Chief Accounting Officer effective March 1, 2005. She became Vice President and Controller of KeySpan in April 2003. She joined KeySpan in 2002 as Assistant Controller. Prior to joining KeySpan, Ms. Balog was Chief Accounting Officer for NiSource Inc. and held a variety of positions with the Columbia Energy Group.

**Joseph E. Hajjar**
Mr. Hajjar, age 54, was named Vice President and Controller effective March 1, 2005. He had been Senior Vice President and Chief Financial Officer of KeySpan Services, Inc. since June 2003 and Senior Vice President and Chief Financial Officer of KeySpan Business Solutions, LLC, since November 2001. Before joining KeySpan from 1998 to 2001, Mr. Hajjar was Executive Vice President and Chief Operating Officer of Opportunity America. He also was previously an officer of the Bovis group and served for over 12 years with Price Waterhouse.

**Michael A. Walker**
Mr. Walker, age 50, was named Vice President and Deputy General Counsel of KeySpan Corporation, effective March 1, 2005. He had been Senior Vice President of KeySpan Services, Inc. since June 2004 and Senior Vice President and COO of KeySpan Business Solutions, LLC, since June 2003. Prior to that time he was Senior Vice President and General Counsel of KeySpan Services, Inc. from January 2001 to December 2003. Before joining KeySpan, Mr. Walker was a shareholder in the Corporate Finance Section in the law firm of Buchanan Ingersoll. Prior to joining Buchanan Ingersoll he worked for several law firms in the north east representing both private and public sector clients on a wide variety of energy, utility, regulatory, corporate and structured finance matters.

There are no family relationships among any of our executive officers or directors.

## Compliance with Section 16(a) of the Exchange Act

Section 16(a) of the Exchange Act requires KeySpan's directors, executive officers and persons who own more than ten percent (10%) of a registered class of KeySpan's equity securities to file with the SEC initial reports of beneficial ownership and reports of changes in beneficial ownership of common stock and other equity securities of KeySpan. Executive officers, directors and greater than ten percent (10%) shareholders are required by SEC regulation to furnish KeySpan with copies of all Section 16(a) forms that they file.

To KeySpan's knowledge, based solely on review of information furnished to us, reports filed through KeySpan and representations that no other reports were required, all Section 16(a) filing requirements applicable to our directors, executive officers and greater than ten percent (10%) beneficial owners were complied with during the twelve-month period ended December 31, 2006.

## Codes of Ethics

We adopted a code of ethics applicable to our directors, a code of ethics applicable to our senior financial officers, and an ethical business conduct statement applicable to all of our directors, officers and employees. Our codes of ethics, ethical business conduct statement, corporate governance guidelines and committee charters can each be found on the Investor Relations section of our website, (http://www.keyspanenergy.com) or directly at the Corporation's corporate governance website (http://governance.keyspanenergy.com), and provide information on the framework and high standards set by us relating to our corporate governance. Additionally, these documents are available in print to any stockholder requesting a copy. The codes of ethics, ethical business conduct statement, corporate governance guidelines and committee charters have all been approved by the board of directors and are vital to securing the confidence of our stockholders, customers, employees, governmental authorities and the investment community.

## Audit Committee

The Audit Committee provides oversight with respect to the quality and integrity of our financial statements; compliance with legal and regulatory requirements; the independent auditor's qualifications and independence; the performance of our internal audit function and independent auditors, our business practices, risk assessment and risk management, and the preparation of the Audit Committee report required to be included in our annual proxy statement. The Audit Committee is comprised of Mr. Fishman, Ms. Christensen, Mr. Larocca, Mr. McKessy and Ms. Pryor. Pursuant to the rules of New York Stock Exchange ("NYSE") all members of the Audit Committee of our board of directors are independent directors. Our board of directors has determined that Mr. Fishman and Ms. Pryor meet the qualifications of an "audit committee financial expert," as that term is defined by the rules of the Securities and Exchange Commission ("SEC"). In addition, our board of directors has determined that Mr. Fishman, Mr. McKessy and Ms. Pryor have "accounting or related financial management expertise," in accordance with the NYSE corporate governance standards rules, section 303A.07. Each of the members of the Audit Committee is financially literate, in accordance with the NYSE corporate governance standards rules, section 303A.07. None of the Audit Committee members simultaneously serves on the audit committees of more than three public companies. The Audit Committee is composed of five independent directors and operates under a written charter adopted by our board of directors, as amended and restated as of January 26, 2006; and can be found on the Investor Relations section of our website at http://www.keyspanenergy.com or directly at our corporate governance website (http://governance.keyspanenergy.com).

## ITEM 11. EXECUTIVE COMPENSATION

## COMPENSATION DISCUSSION AND ANALYSIS

### Objectives of Executive Compensation Programs

Through the Compensation and Management Development Committee of the Board of Directors (the "Committee"), which is responsible for the administration of our executive compensation programs, a "pay for performance" executive compensation philosophy was developed and adopted by the Board of Directors. Our executive compensation philosophy for named executive officers and other executives is intended to provide compensation at market competitive levels in order to attract, motivate and retain talented executives and to align the interests of these executives with those of our shareholders. The Committee, which has the primary governance authority over our executive compensation programs, is composed of five directors, each of whom are "independent" under all applicable New York Stock Exchange and Securities and Exchange Commission rules and regulations. The Committee operates pursuant to a written charter and is authorized by the Board of Directors to retain outside consultants, advisors or legal counsel to provide independent advice to the Committee. The overall objective of the program is to provide a total compensation plan designed to focus on our strategic business initiatives, financial performance objectives and shareholder value.

We adhere to the following compensation principles in the design of our compensation programs, which are intended to support our business objectives and further our strategic vision:

- The executive compensation programs emphasize pay for performance and encourage retention of those employees who enhance our overall performance.
- Compensation plan design maintains a reasonable balance among base salary, annual incentive and long-term equity-based incentive compensation and other benefits and should further the creation of long-term value for shareholders.
- Incentive compensation is linked to the achievement of specific financial and strategic objectives, which are established in advance and approved by the Board of Directors, upon recommendation of the Committee.
- Annual and long-term incentive compensation for executives are competitive with the levels of comparable executives within the energy industry, as well as general industry, on a nationwide basis, with a focus on energy companies for those positions unique to the energy industry.
- Total direct compensation, including base salary, annual and long-term incentives, should be benchmarked to the $50^{th}$ percentile of the nationwide marketplace.
- If our performance results exceed that of our peer group, compensation should be above the $50^{th}$ percentile for such peer group; likewise, if performance falls below that of our peer group, compensation should be below the $50^{th}$ percentile.

- In addition to external comparisons, compensation levels also reflect the internal value of each executive compared to other executives within our organization, as well as other factors such as succession planning and the achievement of exceptional individual results.

Towers Perrin, a nationally recognized compensation consultant, was selected by the Committee as their independent compensation consultant in 2005. Towers Perrin attends Committee meetings in order to provide advice and counsel to the Committee in regard to compensation plan design and recommendations made by management. In addition, Towers Perrin provides advice regarding changes in legislative and accounting considerations that may impact compensation plan design.

To assist us in implementing our compensation programs, surveys are prepared by Towers Perrin to provide an independent review of the compensation levels of executives in peer energy companies and companies in general industry. The primary survey source is the Towers Perrin Energy Industry database with data from approximately 100 energy companies, as well as their general industry database with data from approximately 800 companies nationwide. This survey data is used as our peer group in assessing pay levels.

Both energy and general industry peer group data are used to benchmark base salary and annual incentives, but, because of factors unique to the energy industry, only energy industry data is used to benchmark the long-term incentive component of our pay programs. Ultimately, Towers Perrin uses statistical analysis to ensure comparability of our base salary, annual and long-term incentive compensation levels and to correlate the market data to an organization of our size and scope.

Our compensation plan design and philosophy is reviewed annually by the Committee, with no material changes made during 2006. In 2006 the Committee met five times. In addition to a review of the peer group data provided by Towers Perrin, the Committee conducted a comprehensive assessment of our executive compensation programs to ensure that our philosophy and programs are consistent with best practices and provide a reasonable level of total compensation to our named executive officers. In conducting this assessment, the Committee reviewed and relied upon comprehensive reports or "tally sheets" for each executive, which identified all elements of compensation provided to the executives in the prior year or to which they are otherwise entitled. In addition, the Committee held one executive session without management participation to enable discussion of the key elements of the named executive officers' performance evaluation and compensation recommendations.

## Role of Executives in Establishing Compensation

Mr. Catell and Mr. Fani attend all Committee meetings. At such Committee meetings, they each periodically review KeySpan's financial and operating performance, major changes in organizational plans and the performance of key officers. Certain other senior executives also attend Committee meetings and are responsible for developing potential compensation programs, incentive compensation, plan design and individual salary recommendations with input from both Mr. Catell and Mr. Fani, utilizing the survey data and advice provided by Towers Perrin. With respect to Mr. Catell and Mr. Fani, all discussions regarding their compensation is conducted by the Committee in Executive Session without their attendance.

## Compensation Program

Our compensation program reflects our compensation philosophy and principles as set forth above. To achieve our objectives, direct compensation includes three basic components: base salary, annual incentive compensation and long-term incentive compensation.

We place significant emphasis on variable pay (i.e. pay that is contingent upon performance), with the greatest proportion of total compensation being variable for Mr. Catell when compared to the other named executive officers. In terms of the variable pay component, which includes annual and long-term incentives, more emphasis is placed on the long-term component than the annual component. Mr. Catell has the highest portion of pay linked to long-term compensation, placing greater emphasis on long-term shareholder value. All variable pay programs are linked directly to performance measures that drive financial results, strategic performance measures and other goals and objectives that are intended to increase shareholder value.

The following provides a summary of the mix of compensation for the named executive officers for 2006:

### 2006 Mix of Total Direct Compensation Components

| Name | Base Pay | Annual Incentive | Long-Term Incentive | Total |
|---|---|---|---|---|
| Mr. Catell | 22% | 22% | 56% | 100% |
| Mr. Fani | 30% | 22% | 48% | 100% |
| Mr. Parker | 34% | 24% | 42% | 100% |
| Mr. Zelkowitz | 34% | 24% | 42% | 100% |
| Mr. Luterman | 36% | 24% | 40% | 100% |

Executives are provided with benefits and perquisites that are intended to be comparable to those provided to executives in our peer group. These other programs include the following:

- ability to allocate a portion of any annual incentive payment into a deferred stock unit plan

- ability to allocate a portion of base salary into a deferred compensation plan

- retirement plans

- 401(k) plan with employer match (available to all employees)

- executive group replacement life insurance

- severance and change in control termination protection

- other reasonable and customary perquisites

In the design of our programs, the compensation amounts realized in prior years are not taken into consideration when establishing compensation targets or awards. We also have no policy that would automatically result in an adjustment to payments if the relevant performance measures upon which they are based are restated or otherwise adjusted in subsequent years in a manner that would reduce or increase the size of a previous payment. However, in an instance such as this, the Committee would have discretion to consider an adjustment, if warranted.

Base Salary

We provide a base salary program in order to compete for executive talent in the marketplace. Base salaries for our executives are established based on the scope of their responsibilities, taking into account competitive market compensation levels for similar positions. Generally, we believe that executive base salaries should be targeted near the median of the range of salaries for executives in similar positions with similar responsibilities at comparable companies. Base salaries are reviewed annually and adjusted from time to time to realign salaries with market levels, taking into account individual responsibilities, performance and experience. Other factors such as internal equity and succession planning are also considered when setting base salary.

In determining the base salary level for the named executive officers, the Committee considers individual contributions, internal equity, succession planning and performance, as well as competitive market data. In terms of performance results and contributions, the named executive officers are evaluated on an increase in overall earnings per share, continued focus on the core business and the achievement of our short and long-term strategic initiatives and financial goals. For further discussion of the named executive officers' base salary in 2006 and 2007, see the narrative following the Summary Compensation Table and the Grants of Plan-Based Awards table.

Annual Incentive Compensation

Annual incentive compensation is intended to encourage management to achieve critical short-term goals that we believe are integrally linked to long-term value creation. The Board of Directors adopted the Corporate Annual Incentive Compensation and Gainsharing Plan (the "Corporate Plan") in September 1998. The Corporate Plan provides annual incentive awards to officers and all management employees based on the achievement of corporate goals that the Committee believes enhance shareholder value. For 2006, the performance measurement period included the twelve-month period from January 1, 2006 to December 31, 2006. The awards for this period were approved by the Committee and the Board of Directors in February 2007 and will be paid in March 2007. The specific corporate goals for the Corporate Plan are proposed by management and reviewed and approved by the Committee and the Board of Directors.

In 2006, the performance objectives for each of the named executive officers included financial and strategic objectives consisting of the following:

- earnings per share
- cash flow
- business unit operating income
- customer satisfaction
- control of operating expenses
- employee diversity, and
- individual strategic initiatives

The incentive award ranges are established annually by the Committee for executives and management employees. Incentive award levels provide awards that are competitive both within and outside the energy industry when target performance results are achieved.

Under the Corporate Plan, award payouts can range from zero for below threshold performance up to a maximum award potential of two times the target level established for each named executive officer. Actual award payouts are calculated using cumulative base earnings paid during the calendar year and are determined based upon each named executive officer's performance measured against the established financial, strategic and individual performance objectives set by the Committee and the Board of Directors. Actual awards also reflect modification based upon each named executive officer's individual performance rating using a modifier percentage as approved by the Committee. The modifier allows the Committee to use its discretion to increase or decrease an award with a maximum modification of +/- 15%, based on the named executive officers' performance relative to leadership, teamwork, strategic thinking, urgency for results, enterprise-wide commitment, developing organizational talent and integrity.

For each named executive officer, the specific performance objectives are weighted dependent upon the executive's level of responsibility for delivering results against these objectives. The weightings for the named executive officers with respect to each objective ranged as follows:

<u>Earnings Per Share</u>: 35% to 50%

<u>Corporate/Business Unit Operating Income</u>: zero to 25%

<u>Free Cash Flow</u>: 10% to 20%

<u>Control of Operation and Maintenance Costs</u>: zero to 20%

<u>Diversity</u>: 10% for each named executive officer

<u>Customer Satisfaction</u>: 10% for each named executive officer

<u>Other Strategic Initiatives</u>: zero to 10%

The overall assessment of the achievement of each named executive's goals determines the percent of the target award that will be paid to the executive as an annual incentive award. In addition, the Committee may take into consideration certain unanticipated or extraordinary items, such as changes in accounting or tax rules, that may have impacted the difficulty or ease of achieving the desired targets and has discretion to adjust award payouts.

The performance metrics used in the 2006 Corporate Plan are summarized in the chart below. These objectives were selected as key performance indicators in support of our annual objectives and long-term strategy. The setting of the target level of performance generally reflects a reasonable level of improvement in performance when compared to the actual results achieved in the prior year. The threshold level of performance reflects the minimum acceptable level of performance. The maximum level of performance reflects performance results that would be considered exceptional when compared to the expected target level of results. The corporate performance objectives and the threshold, target and maximum levels are reviewed and approved by both the Committee and the Board of Directors at the beginning of each year.

**2006 Performance Goals**

| Performance Objective | Threshold | Target | Maximum | Actual Performance Results (1) | Actual Results as a % of Target |
|---|---|---|---|---|---|
| Earnings Per Share (2) | $2.40 | $2.46 | $2.60 | $2.63 | 200% |
| Corporate Operating Income (3) | $876M | $918M | $1,100M | $970.4M | 181.1% |
| Operating Income Gas Business Unit and Energy Services (4) | $548M | $567M | $606M | $598.8M | 181.1% |
| Operating Income Electric Business Unit and Energy Related Investments (5) | $319M | $341M | $385M | $371.6M | 169.1% |
| Free Cash Flow (2) | $0 | $150M | $450M | $511M | 200% |
| Control of Operation and Maintenance Costs (6) | $22.3M | $21.7M | $20.4M | $19.957M | 200% |
| Diversity (2) (7) | 63% | 70% | 85% | 52% | 0% |
| Customer Satisfaction (2) (8) | 87% | 89% | 93% | 89% | 100% |

(1) Actual performance results reflect adjustment for certain unanticipated expenses associated with the pending transaction with National Grid.
(2) Goal applicable to all named executive officers.
(3) Goal applicable to Mr. Fani. Payout result reflects business unit weightings of gas, electric, energy development and energy services business units.
(4) Goal applicable to Mr. Parker.
(5) Goal applicable to Mr. Zelkowitz.
(6) The performance measure for the Control of Operation and Maintenance Costs for Mr. Luterman reflects the expense levels associated with his areas of responsibility.
(7) The Diversity goal measures the percentage of diverse candidates selected for positions as compared to the total candidate population for those positions that are underrepresented by diverse incumbents.
(8) The Customer Satisfaction goal measures the percentage of customers who have had contact with us and have provided a satisfactory rating or better with respect to the level of service provided to them. A random sample of customers is used for this survey process. The survey is conducted by an outside agency.

The Corporate Plan includes both primary and secondary performance trigger mechanisms. The primary trigger is earnings per share. In order for the named executives and all other participants in the Corporate Plan to receive any incentive award payment, at least the threshold performance level of earnings per share must be achieved. If earnings per share results are between threshold and target, the award payout for all goals is pro-rated downward consistent with the level of performance. Once the target level of earnings per share performance is achieved, all goals are paid based upon actual performance results, with results in excess of target paid up to the maximum award level in the plan. The secondary performance trigger for the business units is operating income. The secondary performance trigger for all corporate staff and administrative areas is operation and maintenance expense. If the secondary trigger for any business unit or the corporate staff/administrative area is below threshold, the award payout for this measure is forfeited and award payouts for any other performance measures are reduced by 75% for that particular business unit.

We believe that the existence of these trigger mechanisms clearly emphasizes the importance of enhancing shareholder value and ensures that incentive awards are not paid (or are paid at substantially reduced levels) if key objectives are not achieved. For further discussion of the Corporate Plan and awards relative to 2006 performance, see the narrative to the Summary Compensation Table and the Grants of Plan-Based Awards table.

Long-Term Incentive Compensation

The purpose of long-term compensation is to encourage actions that are directly aligned with the interests of our shareholders. We directly link officer compensation to shareholder return by awarding a portion of compensation in equity. The Committee recommended, and the Board of Directors adopted, the KeySpan Long-Term Performance Incentive Compensation Plan (the "Incentive Plan") in March 1999. The Incentive Plan was approved by shareholders at the May 1999 Annual Meeting. Under the Incentive Plan, we have awarded executives with three types of equity-based compensation: (1) stock options, (2) performance shares and (3) restricted stock.

The Committee is responsible for approving all equity awards granted under the Incentive Plan. The type and amount of long-term compensation (as a percentage of base salary) awarded to each named executive officer is determined, in part, by the compensation value of the long-term component at the 50th percentile in the Towers Perrin energy industry peer group. The actual shares awarded reflect modification based upon each named executive officer's individual performance rating using a modifier percentage as approved by the Committee. The modifier allows the Committee to increase or decrease an award using discretion, with a maximum modification of +/- 20%.

All equity awards are granted on the same day the Committee approves the awards (typically at a meeting in February), and are priced based upon the closing price of our stock on that date. With respect to newly hired or promoted executives, grants of equity awards may be approved and granted on their date of hire or promotion.

Below is a brief discussion of each type of equity-based compensation awarded pursuant to the Incentive Plan. For more detailed information regarding long-term compensation and each form of equity, see the 2006 Outstanding Equity Awards at Fiscal Year-End table and accompanying narrative.

Stock Options

The stock option component of the Incentive Plan permits the participants to purchase shares of KeySpan common stock at an exercise price per share determined by the Committee that is no less than the closing price of the common stock on the New York Stock Exchange on the date of the grant. We have been expensing stock options since 2003. We did not grant stock options in 2006 or 2007. The decision not to grant stock options in 2006 and 2007 was based upon the fact that the expense associated with such stock options would exceed the compensation value of the award and offer little incentive to executives due to the pending transaction with National Grid.

Stock option awards have never been re-priced or granted at less than market value. For a discussion of options granted prior to 2006, see the 2006 Outstanding Equity Awards at Fiscal Year-End table and the following narrative.

Restricted Stock

The restricted stock component of the Incentive Plan provides for the award of common stock that may not be traded or otherwise disposed of by the participant until specific restrictions have lapsed. Due to the fact that restricted stock does not vest until after a multi-year period has lapsed, the interests of executives are aligned with the interests of shareholders and we believe the award encourages the retention of key executives.

For further discussion of the restricted stock awards in 2006, see the narrative following the Summary Compensation Table and Grants of Plan-Based Awards table.

For 2007, the named executive officers received their entire long-term incentive award in restricted stock. On February 20, 2007, the Committee approved the following grants of restricted stock: Mr. Catell: 26,000; Mr. Luterman: 5,110; Mr. Fani: 15,000; Mr. Parker: 10,000; and Mr. Zelkowitz: 10,000. Restricted stock was considered the most appropriate form of equity in view of the fact that the establishment of multi-year performance goals was not realistic considering the pending acquisition of us by National Grid. Moreover, in order to account for the expected timing of this pending transaction, named executive officers' long-term grant levels were adjusted to provide approximately one-third of the target share level.

Performance Shares

The performance share component of the Incentive Plan entitles the participants to receive shares of common stock if certain performance goals are achieved. Executives may earn from 0% to 150% of the target level of performance shares granted based upon our total shareholder return relative to the Standard and Poor's Utility Group. This type of equity compensation encourages officers to increase shareholder return because of the contingent nature of the award, which remains at risk unless the goals are achieved.

The performance goal for performance shares granted in 2003, 2004 and 2005 was linked solely to total shareholder return ("TSR"). The performance goal measures KeySpan's cumulative TSR for a three year performance period as compared to the Standard and Poor's Utilities Group. For the performance shares granted to officers in 2003 and 2004, the threshold performance level was not achieved and as a result all performance shares granted in 2003 and 2004 were forfeited without payment, reinforcing KeySpan's "pay for performance" compensation philosophy.

For a complete discussion of 2005 and 2006 performance share grants, see the narrative following the Summary Compensation Table and Grants of Plan-Based Awards table, and the narrative following the 2006 Outstanding Equity Awards at Fiscal Year-End table.

## Other Compensation Programs

Executive Group Replacement Life Insurance

The named executive officers as well as all other executives and eligible management employees are also provided with KeySpan paid individual life insurance. The executives do not participate in the group term life insurance plan that is provided to all other employees. The level of benefit provided to the executives under this replacement coverage is equal to the level of benefit that was formerly provided to all employees in the group plan. We determined that the cost of this coverage as a group term policy would be more expensive to us than the replacement coverage that is now provided.

The life insurance benefit for executives provides a benefit level of three times base salary and annual bonus up to a maximum of $1,500,000. All named executive officers are at the $1,500,000 limit. At retirement, if the executive is under age 65, the benefit level decreases to a maximum of $500,000 and thereafter, decreases again each year between ages 66 and age 70 to a maximum of $250,000. For executives who terminate employment prior to retirement age, we discontinue the payment of premiums. These are variable life insurance policies that are individually owned by the executive and accumulate cash value so that at age 65 or later, if premiums have not been paid for a 10 year period, there is sufficient value within the policy to allow us to discontinue premium payments and continue to provide the benefit level stated above in retirement. The cash surrender values as of December 31, 2006, for the named executives are as follows: Mr. Catell - $163,500; Mr. Luterman $99,700; Mr. Fani - $25,900; Mr. Parker - $45,300; and Mr. Zelkowitz - $45,200. The premiums paid by us are taxable to each named executive officer.

Perquisites

We maintain a perquisite program for our named executive officers, all other executives and key management employees. The perquisites provided to the executives are designed to provide a level of benefit to help attract and retain executives. Our named executive officers are reimbursed for an annual medical exam up to a cost of $1,000 and are also eligible for health club membership reimbursement up to annual limit of $ 900. The annual medical exam and health club subsidy are viewed as part of our initiative to encourage a healthy lifestyle. There is also a financial and estate planning perquisite that provides reimbursement up to $2,000 annually to the named executive officers. The reimbursements for health club and financial and estate planning are taxable to each named executive officer.

Due to the nature of our business which requires emergency response to ensure public safety, as well as our geographically dispersed facilities, cars and drivers are available for Mr. Catell, Mr. Fani, Mr. Parker and Mr. Zelkowitz. The incremental cost of personal use of the company car for commutation purposes has been valued, and a portion of the cost of the annual lease, the driver and maintenance of the vehicle is imputed as income to the executives.

Each named executive officer is also provided a leased vehicle for business and personal use. The lease term is 48 months, with an upper dollar limit of $30,000 plus sales tax on the value of the lease paid by us for 2006. If the value of the vehicle exceeds $30,000, the named executive is responsible for payment of the full amount in excess of this limit including taxes. The named executives are eligible for reimbursement of up to $1,700 annually for maintenance expense. The executive is taxed each year for personal use of the leased vehicle.

All such perquisites are reflected in the All Other Compensation column of the Summary Compensation Table and the accompanying footnotes.

Post-Retirement and Post-Employment Plans

We also provide the following post-retirement and post-employment plans to our executives:

- Our qualified pension plan, supplemental retirement plan and individual agreements are discussed in detail in the narrative following the Pension Benefits table. We provide a qualified pension plan to all employees in order to be competitive in the marketplace, to provide a tax effective method for us to fund retirement benefits, and to help attract and retain executives. In addition to the qualified plan, the named executive officers also participate in the KeySpan supplemental pension plan. We maintain this unfunded plan to provide named executive officers and other eligible employees with a pension benefit that will make up for the lost pension benefits that result from the Internal Revenue Code limits on the qualified plan.

  We have established a deferred compensation trust and have contributed assets to purchase corporate owned life insurance to provide a source of funds for these supplemental benefits.

Individual supplemental retirement agreements have been provided to Mr. Catell, Mr. Zelkowitz and Mr. Luterman. The agreement for Mr. Catell was negotiated when he accepted the role of Chairman and CEO following the merger of the Brooklyn Union Gas Company and the Long Island Lighting Company in 1998. Effective January 1, 2005, we entered into a new agreement with Mr. Catell that supersedes the 1998 agreement and continues to provide for supplemental pension benefits.

We also provided both Mr. Zelkowitz and Mr. Luterman individual supplemental pension agreements due to their shorter length of service as compared to other executives and to provide incentives to remain with us. For a more detailed discussion, see the narrative following the 2006 Pension Benefits table below.

- Executives may elect to defer until retirement or termination of employment from 10% to 50% of their annual incentive awards to the Officers' Deferred Stock Unit Plan (the "ODSUP"). We provide this unfunded plan to encourage officers to increase their stock ownership in KeySpan and further align the interests of the executives with that of our shareholders. The ODSUP is discussed in detail in the narrative following the Nonqualified Deferred Compensation table.

- Executives may elect to defer until retirement or termination of employment up to 10% of their base salary to the Deferred Compensation Plan. We provide this unfunded plan to allow executives an opportunity to defer income and associated income taxes on their compensation. In addition, when recruiting senior executives, the opportunity to defer compensation is an attractive feature in the recruitment process. The Deferred Compensation Plan is discussed in the narrative following the Nonqualified Deferred Compensation table.

- Change of control protection and severance benefits are provided in Mr. Catell's, Mr. Luterman's and Mr. Zelkowitz's employment agreements as well as to all officers in the KeySpan Senior Executive Change of Control Severance Plan (the "Change of Control Plan"). Change of control severance benefits are discussed in detail in the narrative following the Nonqualified Deferred Compensation table. These individual agreement benefits and the Change of Control Plan benefits are provided to ensure the continued employment of the executive leadership team during a period of time when there may be a great deal of uncertainty pending a change of control.

## Policy with Respect to Section 162(m) Deduction Limit

Under Section 162(m) of the Internal Revenue Code of 1986, as amended, we cannot deduct compensation in excess of $1,000,000 paid in any year to the Chief Executive Officer or any of the other named executive officers. Certain benefit plans and compensation paid under plans that are performance based are not subject to the $1,000,000 annual limit if certain requirements are satisfied. Although our compensation policy is designed to relate compensation to performance, certain payments do not meet such requirement because they allow the Committee and the Board of Directors to exercise discretion in setting compensation. The Committee is of the opinion that it is in our best interest for the Committee and the Board of Directors to retain this discretion in order to preserve flexibility in compensating such executive officers, especially in light of an increasingly competitive marketplace.

## KeySpan Executive Stock Ownership Policy

The KeySpan Executive Stock Ownership Policy was adopted by the Committee in January 2005. The policy requires increased ownership of KeySpan common stock to ensure that the interests of the executives are closely aligned with the interest of shareholders. The policy establishes target levels of ownership of KeySpan stock for officers which must be achieved within a five-year period. Officers that do not meet the stock ownership requirements or are not on target to meet such requirements within a five year period are subject to certain remedial actions by the Corporation.

Our officers are expected to own shares of KeySpan common stock with a value equal to a specific multiple of such officer's base salary, as follows:

| Position | Multiple of Base Salary |
|---|---|
| Chief Executive Officer | 5x |
| Chief Operating Officer | 4x |
| Presidents | 3x |
| Executive Vice Presidents | 2x |
| Senior Vice Presidents | 1.5x |
| Vice Presidents | 1x |

All named executive officers are currently in compliance with the ownership policy. In the event an executive is not in compliance, any one or more of the following measures will apply to the executive:

- May not liquidate any holdings in KeySpan stock.
- Can not reduce or discontinue any payroll deductions for the purchase of KeySpan stock.
- 50% of the after-tax proceeds from the exercise of stock options, or the sale of restricted stock or performance shares, are required to be retained as KeySpan stock.

## Conclusion

We strive to ensure that each element of compensation delivered to the named executive officers is reasonable and appropriate as compared to the type and levels of compensation and benefits provided to executives in the marketplace. We also believe that such compensation should properly reflect the performance and results achieved by each individual. We have also established performance measures that ensure that each component of compensation is aligned with shareholders. Along with the Committee, we continually monitor trends in executive pay to ensure that recommendations and plan design reflect best practice.

**Summary Compensation Table**

| Name and Principal Position | Year | Salary ($) | Bonus ($) | Stock Awards ($) (1) | Option Awards ($) | Non-Equity Incentive Plan Compensation ($) | Change in Pension Value and Nonqualified Deferred Compensation Earnings ($) | All Other Compensation ($) | Total ($) |
|---|---|---|---|---|---|---|---|---|---|
| Robert B. Catell, Chairman & Principal Executive Officer | 2006 | 1,140,000 | 0 | 3,514,017 | 0 | 2,223,900 | 721,242 (2) | 336,830 (3) | 7,935,989 |
| Gerald Luterman, Executive Vice President & Principal Financial Officer | 2006 | 486,250 | 0 | 274,115 | 0 | 590,218 | 129,804 (2) | 87,893 (4) | 1,568,280 |
| Robert J. Fani, President & Chief Operating Officer | 2006 | 814,500 | 0 | 581,225 | 0 | 1,104,827 | 997,503 (5) | 239,491 (6) | 3,737,546 |
| Wallace P. Parker Jr., President, KeySpan Energy Delivery and KeySpan Services | 2006 | 625,000 | 0 | 363,098 | 0 | 797,968 | 592,332 (5) | 212,007 (7) | 2,590,405 |
| Steven L. Zelkowitz, President, Energy Assets and Supply Group | 2006 | 625,000 | 0 | 410,426 | 0 | 784,407 | 477,570 (5) | 206,877 (8) | 2,504,280 |

(1) For a discussion of assumptions made in the valuation of restricted stock and performance shares, see "Note 1. Summary of Significant Accounting Policies" to our audited financial statements for the year ended December 31, 2006.

(2) Includes change in pension values (Mr. Catell: $709,752; Mr. Luterman: $128,210) as well as the earnings on deferred compensation under the Deferred Compensation Plan that is above market and calculated based upon the difference between the Federal Reserve Prime Rate and 120% of the Federal Long-Term Rate (Mr. Catell: $11,490; Mr. Luterman: $1,594).

(3) Includes the cost of life insurance of $12,848; the 20% match of $140,000 contributed by us on amounts payable under our Corporate Plan but deferred to the Officers' Deferred Stock Unit Plan; $161,309 as the total expense incurred to provide a car and driver used for business and security purposes, with income imputed for personal commutation; and $22,673 in certain other compensation and perquisites, including a leased vehicle, club membership, physical exam and 401(k) employer match, each of which are valued at less than $10,000.

(4) Includes the cost of life insurance of $29,603; the 20% match of $38,828 contributed by us on amounts payable under our Corporate Plan but deferred to the Officers' Deferred Stock Unit Plan; and $19,462 in certain other compensation and perquisites, including a leased vehicle, financial planning, health club membership, physical exam and 401(k) employer match, each of which are valued at less than $10,000.

(5) Reflects the change in pension value. These named executive officers do not participate in the nonqualified deferred compensation plan.

(6) Includes the 20% match of $37,059 contributed by us on amounts payable under our Corporate Plan but deferred to the Officers' Deferred Stock Unit Plan; $166,306 as the total expense incurred to provide a car and driver used for business and security purposes, with income imputed for personal commutation; $11,809 for a leased vehicle and $24,318 in certain other compensation and perquisites, including the cost of life insurance, financial planning, health club membership, club membership and 401(k) employer match, each of which are valued at less than $10,000.

(7) Includes the cost of life insurance of $13,082; the 20% match of $55,009 contributed by us on amounts payable under our Corporate Plan but deferred to the Officers' Deferred Stock Unit Plan; $118,355 as the total expense incurred to provide a car and driver used for business and security purposes, with income imputed for personal commutation; and $25,561 in certain other compensation and perquisites, including supplemental long term disability, a leased vehicle, financial planning, health club membership, physical exam, club membership and 401(k) employer match, each of which are valued at less than $10,000.

(8) Includes the cost of life insurance of $13,849; the 20% match of $51,313 contributed by us on amounts payable under our Corporate Plan but deferred to the Officers' Deferred Stock Unit Plan; $123,752 as the total expense incurred to provide a car and driver used for business and security purposes, with income imputed for personal commutation; $17,064 for a leased vehicle, health club membership and 401(k) employer match valued at less than $10,000.

**2006 Grants of Plan-Based Awards**

| Name | Grant Date | Estimated Future Payouts Under Non-Equity Incentive Plan Awards | | | Estimated Future Payouts Under Equity Incentive Plan Awards | | | All Other Stock Awards: Number of Shares of Stock or Units (#) | All Other Option Awards: Number of Securities Underlying Options (#) | Exercise or Base Price of Option Awards ($/Sh) | Grant Date Fair Value of Stock and Option Awards ($) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Threshold ($) | Target ($) | Maximum ($) | Threshold (#) | Target (#) | Maximum (#) | | | | |
| Robert B. Catell | 2/23/06 | 570,000 | 1,140,000 | 2,280,000 | 0 | 0 | 0 | 85,520 | 0 | N/A | 3,514,017 (1) |
| Gerald Luterman | 2/23/06 | 158,031 | 316,063 | 632,125 | 9,180 | 18,360 | 27,540 | 0 | 0 | N/A | 633,236 (2) |
| Robert J. Fani | 2/23/06 | 305,438 | 610,875 | 1,221,750 | 19,465 | 38,930 | 58,395 | 0 | 0 | N/A | 1,342,696 (2) |
| Wallace P. Parker Jr. | 2/23/06 | 218,750 | 437,500 | 875,000 | 12,160 | 24,320 | 36,480 | 0 | 0 | N/A | 838,797 (2) |
| Steven L. Zelkowitz | 2/23/06 | 218,750 | 437,500 | 875,000 | 13,745 | 27,490 | 41,235 | 0 | 0 | N/A | 948,130 (2) |

(1) Reflects the grant date fair value pursuant to the Statement of Financial Accounting Standards No. 123 (revised 2004) – Share-based Payment ("FAS 123R") of the restricted stock granted in 2006.
(2) Reflects the grant date fair value at threshold level pursuant to FAS 123R of performance shares granted in 2006.

## Salary

On February 23, 2006, upon recommendation of the Compensation and Management Development Committee, the Board of Directors approved base salary increases for 2006 for the named executive officers as follows:

**Approved Base Salary Increases for 2006**

| Name | Previous Base Salary | Base Salary Increased To | Effective Date of Increase |
|---|---|---|---|
| Mr. Catell | $1,075,000 | $1,140,000 | January 1, 2006 |
| Mr. Luterman | $467,000 | $488,000 | February 1, 2006 |
| Mr. Fani | $734,000 | $782,000, and then to $860,000 **(1)** | January 1, 2006<br>August 1, 2006 |
| Mr. Parker | $587,000 | $625,000 | January 1, 2006 |
| Mr. Zelkowitz | $545,000 | $625,000 **(2)** | January 1, 2006 |

(1) Mr. Fani received a second mid-year increase to reflect his planned succession to the Chief Executive Officer position. Consistent with this succession plan, upon recommendation of the Committee, on May 3, 2006, the Board of Directors approved a base salary increase for Mr. Fani from $782,000 to $860,000 effective August 1, 2006.

(2) The increase for Mr. Zelkowitz reflects both a merit increase and an adjustment to address internal equity considerations at the President level.

On February 21, 2007, upon recommendation of the Committee, the Board of Directors approved base salary increases for the named executive officers as follows:

**Approved Base Salary Increases for 2007**

| Name | Base Salary from | Base Salary to | Effective Date |
|---|---|---|---|
| Mr. Catell | $1,140,000 | $1,220,000 | January 1, 2007 |
| Mr. Luterman | $488,000 | $522,000 | February 1, 2007 |
| Mr. Fani | $860,000 | $919,000 | January 1, 2007 |
| Mr. Parker | $625,000 | $668,000 | January 1, 2007 |
| Mr. Zelkowitz | $625,000 | $668,000 | January 1, 2007 |

These increases were based on the individual executive's performance appraisal rating and accomplishments for the 2005 and 2006 calendar years, respectively, which took into account performance results achieved in 2005 and 2006, as well as competencies such as leadership, teamwork, strategic thinking, urgency for results, enterprise-wide commitment, developing organizational talent and integrity.

The amounts shown in the Non-Equity Incentive Plan Compensation column of the Summary Compensation Committee include any amounts deferred to the ODSUP. The ODSUP is described more fully in the narrative following the Non-Qualified Deferred Compensation table.

Stock Awards

On February 23, 2006, the Committee approved a grant to Mr. Catell of 85,520 shares of restricted stock pursuant to the Incentive Plan. The restrictions on the restricted stock will lapse after two years on February 23, 2008. The Committee has the discretion to lapse restrictions after one year on February 23, 2007 based on the success of the senior executive transition. On February 20, 2007, the Committee elected not to accelerate the lapse on these restricted shares. In the event of retirement or upon a change of control, the restrictions on the shares granted shall fully lapse. Restricted shares constitute issued and outstanding shares of common stock, and therefore, Mr. Catell has the right to vote such restricted shares. Dividends paid on the restricted stock are reinvested and are subject to all of the same restrictions as the restricted stock granted to him.

Also on February 23, 2006, the Committee approved performance share grants to the named executive officers (other than Mr. Catell). The estimated future payout of performance shares at threshold, target and maximum is provided in the 2006 Grants of Plan-Based Awards table under the Equity Incentive Plan Awards columns. Performance shares were granted at the target level 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 target level of shares granted and will be linked to the following two performance measures, using a matrix approach that encompasses both measures:

- the percentage improvement in Return on Invested Capital (“ROIC”), and
- KeySpan’s cumulative three-year TSR relative to the cumulative three-year TSR for the Standard and Poor’s Utilities Group.

The payout matrix is as follows:

| Three year % Improvement in ROIC | | Three - Year Cumulative TSR Relative to S&P Utility Group | | | |
|---|---|---|---|---|---|
| | | | Threshold | Target | Maximum |
| | | < 35th Percentile | 35th Percentile | 50th Percentile | 90th Percentile |
| | **< 1%** | **0%** | **0%** | **0%** | **0%** |
| Threshold | **1%** | **25%** | **50%** | **75%** | **100%** |
| Target | **3%** | **50%** | **75%** | **100%** | **125%** |
| Maximum | **5%** | **75%** | **100%** | **125%** | **150%** |

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. In the event of an officer’s retirement, performance shares shall be distributed based upon results achieved at the end of the performance period and pro-rated through the date of retirement. Upon a change of control, performance shares shall be distributed based upon the greater of the number of performance shares originally awarded at target level or the number of shares earned based on actual performance through the change of control date.

The dual performance measures were introduced in 2006 based upon an analysis of accounting considerations under the Statement of Financial Accounting Standards No. 123 (revised 2004) – Share-based Payment (“FAS 123R”). In this regard, the use of TSR as well as ROIC as an internal performance measure, with ROIC as the trigger, allows for more favorable accounting treatment in the event of forfeitures. If the TSR goal is the sole measure, the FAS 123R accounting rules will not allow for the reversal of expense in the event shares are forfeited. Using ROIC as the trigger allows for the reversal of expense in the event shares are forfeited.

The FAS 123R value expensed in 2006 for the restricted shares granted to Mr. Catell and for the performance shares granted to the other named executive officers is reported in the Stock Awards column of the Summary Compensation Table.

The grant date fair value pursuant to FAS 123R with respect to the entire 2006 restricted share grant to Mr. Catell is reported in the last column of the Grants of Plan Based Awards table. The amounts reported in this table for the other named executive officers reflects the grant date fair value at threshold for the 2006 performance share awards pursuant to FAS 123R.

There were no grants of stock options to the named executive officers during 2006. Outstanding options from previous grants are reflected in the Outstanding Equity Awards at Fiscal Year-End table.

Non-Equity Incentive Plan Compensation

The Non-Equity Incentive Plan Compensation column of the Summary Compensation Table reflects amounts earned pursuant to the Corporate Plan. These amounts will be paid in March of 2007 and are based upon performance results achieved during the twelve-month period from January 1, 2006 to December 31, 2006. The awards earned under the Corporate Plan are paid as cash (with the option to defer between 10% and 50% of the award to the ODSUP, as discussed in the narrative following the Nonqualified Deferred Compensation table) based upon annual performance results. The amounts reported in the Non-Equity Incentive Plan Compensation column include any amounts deferred pursuant to the ODSUP. Incentive awards for 2006 performance were determined based upon our performance, strategic business group performance and individual performance results, and were calculated as a percentage of cumulative base salary paid during 2006. The incentive award ranges for 2006 were zero for below threshold performance, and at threshold, target and maximum as a percentage of cumulative base salary paid as follows:

| | Threshold | Target | Maximum |
|---|---|---|---|
| Mr. Catell | 50.0% | 100% | 200% |
| Mr. Fani | 37.5% | 75% | 150% |
| Mr. Parker | 35.0% | 70% | 140% |
| Mr. Zelkowitz | 35.0% | 70% | 140% |
| Mr. Luterman | 32.5% | 65% | 130% |

Threshold, target and maximum annual incentive awards for 2006 are shown in the Grants of Plan-Based Awards table. The actual awards paid in 2007 based on 2006 performance were modified to reflect individual performance appraisal ratings by the following percentages: Mr. Catell: 15%; Mr. Luterman: 10%; Mr. Fani: 10%; Mr. Parker: 10%; and Mr. Zelkowitz: 10%.

Change in Pension Value and Nonqualified Deferred Compensation Earnings

With respect to Mr. Catell and Mr. Luterman, the amounts shown in the Change in Pension Value and Nonqualified Deferred Compensation Earnings column of the Summary Compensation Table includes change in pension values (Catell: $709,751; Luterman: $151,109) as well as earnings on deferred compensation under the Deferred Compensation Plan that is above market and calculated based upon the difference between the Federal Reserve Prime Rate and 120% of the Federal Long-Term Rate (Catell: $11,490; Luterman: $1,594). The change in pension value is calculated using the accrued pension benefit as of December 31, 2005, and compared to the accrued pension benefit as of December 31, 2006. These accrued amounts are then converted to a present value using the discount rate and mortality assumptions as used at year-end in the valuation of our pension plan. The change in value reflects the difference between these present value amounts. The accrued benefit amounts reflect the annuity amounts that are payable at age 65 or earlier if the executive is eligible for an unreduced retirement benefit at an earlier age. The Deferred Compensation Plan is more fully described in the narrative following the Non-Qualified Deferred Compensation table.

**2006 Outstanding Equity Awards at Fiscal Year-End**

| | Option Awards | | | | | Stock Awards | | | |
|---|---|---|---|---|---|---|---|---|---|
| Name | Number of Securities Underlying Unexercised Options (#) Exercisable | Number of Securities Underlying Unexercised Options (#) Unexercisable | Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#) | Option Exercise Price ($) | Option Expiration Date | Number of Shares or Units of Stock That Have Not Vested (#) | Market Value of Shares or Units of Stock That Have Not Vested ($) | Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#) | Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($) (1) |
| Robert B. Catell | 90,040 | 135,060 | N/A | 37.54 | 3/9/14(a) | 16,741 (2) | 689,394 | 40,350 (4) | 1,791,742 |
| | 125,280 | 83,520 | | 32.40 | 3/4/13(b) | | | | |
| | 297,600 | 74,400 | | 32.66 | 2/29/12(c) | | | | |
| | 267,000 | | | 39.50 | 2/12/11(d) | 88,490 (3) | 3,644,018 | | |
| | 525,000 | | | 22.50 | 1/19/10(e) | | | | |
| | 43,800 | | | 22.50 | 1/19/10(f) | | | | |
| | 186,667 | | | 27.0625 | 5/20/09(g) | | | | |
| | 111,000 | | | 29.375 | 12/15/08(h) | | | | |
| | 235,000 | | | 27.75 | 8/12/08(i) | | | | |
| | 23,334 | | | 27.75 | 8/12/08(j) | | | | |
| | 125,000 | | | 32.625 | 11/21/07(k) | | | | |
| Gerald Luterman | 10,960 | 43,840 | N/A | 39.25 | 2/23/15(l) | 3,689 (5) | 151,913 | 3,550 (7) | 548,476 |
| | 16,600 | 24,900 | | 37.54 | 3/9/14(a) | | | | |
| | 25,980 | 17,320 | | 32.40 | 3/4/13(b) | | | 9,180 (8) | |
| | 65,600 | 16,400 | | 32.66 | 2/29/12(c) | 5,431 (6) | 223,649 | | |
| | 60,000 | | | 39.50 | 2/12/11(d) | | | | |
| | 25,000 | | | 22.50 | 1/19/10(e) | | | | |
| | 6,800 | | | 22.50 | 1/19/10(f) | | | | |
| | 66,667 | | | 27.75 | 7/29/09(m) | | | | |
| Robert J. Fani | 25,160 | 100,640 | N/A | 39.25 | 2/23/15(l) | 5,383 (9) | 221,672 | 8,150 (10) | 1,190,623 |
| | 38,240 | 57,360 | | 37.54 | 3/9/14(a) | | | | |
| | 41,700 | 27,800 | | 32.40 | 3/4/13(b) | | | 19,465 (11) | |
| | 96,000 | 24,000 | | 32.66 | 2/29/12(c) | | | | |
| | 60,000 | | | 39.50 | 2/12/11(d) | | | | |
| | 18,200 | | | 36.59 | 7/1/11(n) | | | | |
| | 83,334 | | | 22.50 | 1/19/10(e) | | | | |
| | 30,000 | | | 27.0625 | 5/20/09(g) | | | | |
| | 17,000 | | | 27.75 | 8/12/08(j) | | | | |

| | Option Awards | | | | | Stock Awards | | | |
|---|---|---|---|---|---|---|---|---|---|
| Name | Number of Securities Underlying Unexercised Options (#) Exercisable | Number of Securities Underlying Unexercised Options (#) Unexercisable | Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#) | Option Exercise Price ($) | Option Expiration Date | Number of Shares or Units of Stock That Have Not Vested (#) | Market Value of Shares or Units of Stock That Have Not Vested ($) | Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#) | Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($) (1) |
| Wallace P. Parker Jr. | 17,720<br>29,880<br>41,700<br>96,000<br>60,000<br>18,200<br>68,334<br>4,400<br>15,000<br>59,000<br>5,667<br>17,000 | 70,880<br>44,820<br>27,800<br>24,000 | N/A | 39.25<br>37.54<br>32.40<br>32.66<br>39.50<br>36.59<br>22.50<br>22.50<br>27.0625<br>27.75<br>27.75<br>32.625 | 2/23/15(l)<br>3/9/14(a)<br>3/4/13(b)<br>2/29/12(c)<br>2/12/11(d)<br>7/1/11(n)<br>1/19/10(e)<br>1/19/10(f)<br>5/20/09(g)<br>8/12/08(i)<br>8/12/08(j)<br>11/21/07(k) | 5,383<br>(12) | 221,672 | 5,700<br>(13)<br><br>12,160<br>(14) | 770,821 |
| Steven L. Zelkowitz | 17,720<br>23,840<br>25,980<br>65,600<br>60,000<br>75,000 | 70,880<br>35,760<br>17,320<br>16,400 | N/A | 39.25<br>37.54<br>32.40<br>32.66<br>39.50<br>22.50 | 2/23/15(l)<br>3/9/14(a)<br>3/4/13(b)<br>2/29/12(c)<br>2/12/11(d)<br>1/19/10(e) | 3,689<br>(15) | 151,913 | 5,700<br>(16)<br><br>13,745<br>(17) | 838,302 |

<u>Option Awards footnotes follow</u>:

(a) The stock options were granted on March 10, 2004 and are subject to a three year vesting schedule if the total stockholder return performance goal is achieved, otherwise the stock options vest pro-rata over a five year vesting schedule with a 10 year exercise period.
(b) The stock options were granted on March 5, 2003 and are subject to a three year vesting schedule if the total stockholder return performance goal is achieved, otherwise the stock options vest pro-rata over a five year vesting schedule with a 10 year exercise period.
(c) The stock options were granted on March 1, 2002 and are subject to a three year vesting schedule if the total stockholder return performance goal is achieved, otherwise the stock options vest pro-rata over a five year vesting schedule with a 10 year exercise period.
(d) The stock options were granted on February 13, 2001 and were fully vested as of February 2006 with a 10 year exercise period.
(e) The stock options were granted on January 20, 2000 and were fully vested as of January 2003 with a 10 year exercise period.

(f) The stock options were granted on January 20, 2000 and were fully vested as of January 2001 with a 10 year exercise period.
(g) The stock options were granted on May 20, 1999 and were fully vested as of May 2002 with a 10 year exercise period.
(h) The stock options were granted on December 16, 1998 and were fully vested as of December 1999 with a 10 year exercise period.
(i) The stock options were granted on August 13, 1998 and were fully vested as of August 1999 with a 10 year exercise period.
(j) The stock options were granted on August 13, 1998 and were fully vested as of August 2001 with a 10 year exercise period.
(k) The stock options were granted November 21, 1997 and were fully vested as of November 2000 with a 10 year exercise period.
(l) The stock options were granted on February 24, 2005 and are subject to a three year vesting schedule if the total stockholder return performance goal is achieved, otherwise the stock options vest pro-rata over a five year vesting schedule with a 10 year exercise period.
(m) The stock options were granted on July 29, 1999 and were fully vested as of July 2002 with a 10 year exercise period.
(n) The stock options were granted on July 2, 2001 and were fully vested as of July 2006 with a 10 year exercise period.

Stock Awards footnotes follow:

(1) Reflects the fair value of all outstanding performance shares and accumulated dividends at the threshold award level.
(2) Includes 13,295 restricted shares granted on March 1, 2002 with reinvested dividends of 3,446 shares accrued through December 31, 2006. Such restricted shares are restricted for six years and fully vest on March 1, 2008.
(3) Includes 85,520 restricted shares granted on February 23, 2006 with reinvested dividends of 2,970 shares accrued through December 31, 2006. Such restricted shares are restricted for two years and fully vest on February 23, 2008.
(4) Reflects performance shares at threshold level granted on February 24, 2005.
(5) Includes 2,930 restricted shares granted on March 1, 2002 with reinvested dividends of 759 shares accrued through December 31, 2006. Such restricted shares are restricted for six years and fully vest on March 1, 2008.
(6) Includes 5,000 restricted shares granted on February 24, 2005 with reinvested dividends of 431 shares accrued through December 31, 2006. Such restricted shares are restricted for two years and fully vest on February 24, 2007.
(7) Reflects performance shares at threshold level granted on February 24, 2005.
(8) Reflects performance shares at threshold level granted on February 23, 2006.
(9) Includes 4,275 restricted shares granted on March 1, 2002 with reinvested dividends of 1,108 shares accrued through December 31, 2006. Such restricted shares are restricted for six years and fully vest on March 1, 2008.
(10) Reflects performance shares at threshold level granted on February 24, 2005.
(11) Reflects performance shares at threshold level granted on February 23, 2006.
(12) Includes 4,275 restricted shares granted on March 1, 2002 with reinvested dividends of 1,108 shares accrued through December 31, 2006. Such restricted shares are restricted for six years and fully vest on March 1, 2008.
(13) Reflects performance shares at threshold level granted on February 24, 2005.
(14) Reflects performance shares at threshold level granted on February 23, 2006.
(15) Includes 2,930 restricted shares granted on March 1, 2002 with reinvested dividends of 759 shares accrued through December 31, 2006. Such restricted shares are restricted for six years and fully vest on March 1, 2008.
(16) Reflects performance shares at threshold level granted on February 24, 2005.
(17) Reflects performance shares at threshold level granted on February 23, 2006.

The Outstanding Equity Awards at Fiscal Year-End table reflects holdings of equity-based interests that relate to compensation or are potential sources of future compensation. The table represents equity-based interests that were awarded in 2006 and all prior years, as well as equity-based interests that are "at risk" of forfeiture or expiration prior to exercise.

The Option Awards section of the above table reflects all outstanding vested and unvested options. In the event of termination or retirement, the named executives may forfeit all or a portion of the unexercisable options depending on whether or not they are retirement eligible. At retirement or termination of employment due to death or disability, an adjustment to the vesting schedule is made to the options that include a 5 year pro-rata vesting schedule to reflect a 36 month vesting schedule. As a result, the options shall become vested and the shares may be exercised based upon a 36 month pro-rata vesting schedule with such options vesting monthly based on the number of full months that have lapsed between the grant date and the date of retirement. All outstanding KeySpan stock options will immediately vest on consummation of a change of control and will remain exercisable until the close of business on the expiration date.

The stock option award process included a performance goal feature in the stock option vesting schedule for officers which directly links three-year TSR for KeySpan common stock to the options granted since 2001. The TSR goal measures the total return to shareholders of KeySpan common stock, including price appreciation and dividends. KeySpan's performance will be measured against the S&P Utility Group over a three-year performance period, with the goal for KeySpan's TSR to be at or above the median of those comprising the group. Options were granted with a five-year pro-rata vesting schedule. If KeySpan achieves its TSR goal at the end of the three-year performance period, then those options that are not yet vested will vest immediately. If the TSR goal is not achieved in year three, the remaining unvested options will continue to vest on the five-year schedule. Stock options granted in 2001 and 2002 are fully vested. For stock options granted in 2003 and 2004, the required TSR performance target that would accelerate vesting was not achieved and the stock options granted in these years continue to vest over the five year period.

The Stock Awards section of the table reflects outstanding restricted stock and performance shares. Restricted stock outstanding is reflected in the Number of Shares or Units of Stock That Have Not Vested column and includes restricted stock granted including reinvested dividends.

In 2002, restricted stock was granted to each named executive officer. The restrictions on the restricted stock granted in 2002 will lapse on March 1, 2008. In the event of retirement, the restriction period shall be adjusted to reflect the number of full months that have lapsed between the date of the award and the date of retirement using a 48 month restriction period. In the event of retirement after the 48 month period, all restrictions would lapse on such shares and reinvested dividends. In the event of termination of employment due to death or disability, all restrictions would lapse on such shares and reinvested dividends.

In 2005, Mr. Luterman was granted 5,000 shares of restricted stock. The restrictions on this grant of restricted stock will lapse on February 24, 2007. For both Mr. Luterman's 2005 grant and Mr. Catell's 2006 grant of restricted stock described above, in the event of termination of employment due to death, disability or retirement, all restrictions would lapse on such shares and reinvested dividends. For all restricted stock grants to date, in the event of change of control, the restrictions on all such outstanding shares and reinvested dividends will fully lapse on the date of the change of control.

Performance shares outstanding are reflected at threshold, or 50% of target grant level, in the Equity Incentive Plan Awards columns of the 2006 Outstanding Equity Awards at Fiscal Year-End table. The awards are reflected at the threshold level due to the forfeiture of the 2004 performance shares.

Performance shares granted in 2005 have a three-year performance period (January 1, 2005 through December 31, 2007). The performance goal to be measured will compare KeySpan's cumulative TSR for a three year period, as compared to the S&P Utilities Group cumulative shareholder return for the same three-year measurement period. The performance shares issued will vary based upon a sliding scale from 50% to 150% of the number of performance shares awarded at the target level based upon the level of achievement of the performance goal. If the threshold level of the performance goal is not achieved, the right to performance shares will be forfeited without payment. The 2005 performance shares granted will be earned on a pro-rata basis based upon the degree of achievement of the performance goal established by the Committee and the shares will be issued and fully transferable, in accordance with the following schedule:

| KeySpan Cumulative Return Compared to S&P Utility Group | Percent of Target Performance Shares Earned |
|---|---|
| 0 to 34th percentile | 0 % |
| 35th percentile | 50% |
| 50th percentile | 100% |
| 90th percentile or over | 150% |

For information related to the performance measures related to the 2006 grant of performance shares, see the narrative following the Summary Compensation Table and Grants of Plan Based Awards table.

For both the 2005 and 2006 performance share awards, in the event of termination of employment due to retirement or disability, performance shares and accumulated dividends shall be distributed to the named executive officers based upon the degree of achievement of the performance goal at the end of the three year performance period, with an adjustment to the total shares calculated on a pro-rata basis, utilizing the number of full months from the beginning of the performance period to the date of retirement or disability, divided by 36 months.

In the event of termination of employment due to death, the target award amount will be calculated and distributed on a pro-rata basis utilizing the number of full months from the beginning of the performance period to the date of death, divided by 36 months regardless of performance results.

In the event of change of control, the performance shares including accumulated dividends will be calculated and distributed at the change of control date based upon the greater of the number of shares originally awarded at target level and the number of shares earned based upon actual performance through the change of control date.

The Merger Agreement provides that each outstanding share of our common stock (other than shares of our common stock owned by us as treasury stock or by a subsidiary of us, or by National Grid or a subsidiary of National Grid) will be converted into the right to receive $42.00

per share in cash, without interest, or the "merger consideration." With respect to all outstanding options, upon consummation of the Merger all unvested options will immediately vest, and the holders of all options shall receive an amount in cash equal to the excess of the merger consideration over the exercise price per share applicable to all such outstanding stock options. With respect to shares of restricted stock and reinvested dividends, all restrictions on such stock will lapse upon consummation of the Merger. With respect to performance shares issued pursuant to our Incentive Plan, target performance levels will be assumed with respect to performance shares granted in 2005 and 2006 and, at such target performance, the target level of such shares and accumulated dividends will be paid. However, if actual performance levels through the date of change of control result in a greater number of shares than target, then such greater number of shares and accumulated dividends will be paid upon consummation of the change of control.

**2006 Option Exercises and Stock Vested**

| | Option Awards | | Stock Awards | |
|---|---|---|---|---|
| Name | Number of Shares Acquired on Exercise (#) | Value Realized on Exercise ($) | Number of Shares Acquired on Vesting (#) | Value Realized on Vesting ($) |
| Robert B. Catell | 100,000 | 1,050,000 | 0 | 0 |
| Gerald Luterman | 0 | 0 | 0 | 0 |
| Robert J. Fani | 0 | 0 | 0 | 0 |
| Wallace P. Parker Jr. | 17,000 | 169,524 | 0 | 0 |
| Steven L. Zelkowitz | 0 | 0 | 0 | 0 |

Options expire after a 10 year term if not otherwise exercised. None of the named executive officer options have expired prior to being exercised. As reflected in the above table, in 2006, Mr. Catell and Mr. Parker exercised options due to the approaching expiration date of those options.

**2006 Pension Benefits**

| Name | Plan Name | Number of Years Credited Service (#) | Present Value of Accumulated Benefit ($) | Payments During Last Fiscal Year ($) |
|---|---|---|---|---|
| Robert B. Catell | KeySpan Retirement Plan | 48 & 6/12 | 2,299,169 | 0 |
| | KeySpan Supplemental Pension Plan | 48 & 6/12 | 10,807,207 | |
| | Supplemental Executive Retirement Plan Agreement | N/A | 5,559,066 | |
| Gerald Luterman | KeySpan Retirement Plan | 7 & 2/12 | 241,490 | 0 |
| | KeySpan Supplemental Pension Plan | 7 & 2/12 | 554,906 | |
| | Supplemental Retirement Agreement | N/A | 220,708 | |
| Robert J. Fani | KeySpan Retirement Plan | 30 & 6/12 | 1,647,015 | 0 |
| | KeySpan Supplemental Pension Plan | 30 & 6/12 | 4,623,290 | |
| Wallace P. Parker Jr. | KeySpan Retirement Plan | 35 & 6/12 | 1,792,745 | 0 |
| | KeySpan Supplemental Pension Plan | 35 & 6/12 | 4,039,073 | |
| Steven L. Zelkowitz | KeySpan Retirement Plan | 8 | 244,702 | 0 |
| | KeySpan Supplemental Pension Plan | 8 | 709,496 | |
| | Supplemental Retirement Agreement | 8 | 954,198 | |

The table above provides the present value ("PV") of the accrued pension benefit payable at age 65, or earlier if the named executive officer is eligible to receive an unreduced benefit at an earlier age. The benefit amounts provided reflect the PV of the accrued benefit as of December 31, 2006. The PV of the accrued benefits is referred to as Accumulated Benefits in the table above.

All amounts above were calculated based upon the pension plan measurement date used for our audited financial statements and financial reporting purposes under generally accepted accounting principles. A 6% discount rate and the mortality assumptions used at year-end in the plans were used in these calculations.

Under all of our pension plans and supplemental agreements, the earliest age a named executive officer may retire without a reduction to their pension benefit for age is age 60. However, if the named executive's age plus service is equal to 80 or greater, the named executive officer may retire as early as age 52 with no reduction for age. In this regard, the calculations provided in the 2006 Pension Benefits table assume early retirement with no reduction for age for Mr. Fani (age 53) and Mr. Parker (age 57) as of December 31, 2006. Mr. Catell (age 69) and Mr. Luterman (age 62) are also eligible for unreduced benefits as of December 31, 2006. Mr. Zelkowitz who is age 57 as of December 31, 2006 will not be eligible for an unreduced benefit until age 60. His accrued benefit calculation assumes his pension commences at age 60.

The KeySpan Retirement Plan is a qualified pension plan under ERISA and provides retirement benefits to employees who are vested and meet the plan's retirement eligibility age. The benefit formula for the named executives in the plan is consistent with the formula provided to all other management employees participating in the plan. The accrued benefit amount under this plan is calculated using base salary and annual incentive awards in the calculation of compensation under the plan. The accrued benefit is based upon the average of the final five consecutive years of compensation multiplied by 1.5% and length of service. This accrued amount, which is payable only as an annual annuity under the plan, has been converted to the PV amount using the methodology described above. The form of annuity used in this calculation reflects a lifetime annuity with no beneficiary option. The normal form of annuity option under the plan is a 50% joint and survivor option.

The named executive officers also participate in the KeySpan Supplemental Pension Plan. This supplemental plan is maintained to provide retirement benefits using the same broad based plan formula under the qualified KeySpan Retirement Plan to provide for accrued benefits that are in excess of IRC Code Sections 415 and 401(a)(17) and can not be paid pursuant to the KeySpan Retirement Plan. The accrued amount under this supplemental plan is also only payable as an annual annuity. The annual annuity has been converted to PV amount in the table. The PV amount in the table has been calculated using the methodology described above. The form of annuity used in this calculation reflects a lifetime annuity with no beneficiary option. The normal form of annuity option under the plan is a 50% joint and survivor option.

Mr. Catell's supplemental pension benefit formula uses his base pay and annual incentive compensation in determining the pension benefit amount provided pursuant to his agreement. In this regard, Mr. Catell's cumulative base salary and highest annual bonus (as defined below) paid over any consecutive 36 month period is determined and then divided by three to determine an annual average amount. This annual average amount is then multiplied by 65%. The resulting amount is the gross annual pension benefit. The gross annual pension benefit is then reduced by several other pension amounts (i) 50% of Mr. Catell's primary social security amount; (ii) his KeySpan Retirement Plan benefit; and (iii) his KeySpan Supplemental Plan Benefit to determine his Agreement's supplemental retirement benefit. This benefit is identified as the Supplemental

Executive Retirement Plan Agreement benefit in the 2006 Pension Benefit Table. In the event his annual incentive target is decreased, Mr. Catell's supplemental pension benefit under the 2005 Agreement will be determined based upon the highest annual target level approved by our Board of Directors during his employment in the event his actual award in any year is less than his highest annual target. The normal form of benefit provided under the agreement is a 100% joint and survivor annuity with his spouse or the actuarial equivalent form of benefit including a single lump sum. Pursuant to the provision of the agreements, Mr. Catell has elected a lump sum option under both his 1998 and 2005 Agreements.

We have also entered into a Supplemental Retirement Agreement with Mr. Zelkowitz dated as of January 1, 2002. The agreement provides one added year of credited service for each year worked after completion of five years of service, up to a maximum of ten years in the calculation of his pension benefits. The maximum benefit would add 10 years of credited service providing an incremental benefit of 15% of his final five-year average earnings under the KeySpan Retirement and Supplemental plans. In addition, at retirement, Mr. Zelkowitz will receive medical and dental coverage at the same level of employee contribution in effect at retirement, with any amounts that may be subject to taxes grossed up for federal and state taxes. If Mr. Zelkowitz is terminated in connection with a change of control, based upon eight years of actual service through December 31, 2006, the agreement will provide additional credited service to the maximum of ten years.

We have also entered into a Supplemental Retirement Agreement with Mr. Luterman dated as of July 1, 2002. The agreement provides that Mr. Luterman will receive an annual supplemental retirement amount determined by multiplying Mr. Luterman's age 62 accrued benefit from the KeySpan Retirement Plan and the KeySpan Supplemental Pension Plan by 35%. Mr. Luterman vested in this benefit in June 2005. In addition, at retirement, Mr. Luterman will receive medical and dental coverage at the same level of employee contribution in effect at retirement, with any amounts that may be subject to taxes grossed up for federal and state taxes.

## Employment Agreements Including Change of Control - Post Termination

In September 1998, we entered into an employment agreement with Mr. Catell relating to his service as Chairman and Chief Executive Officer, which was amended on February 24, 2000 and June 26, 2002 (the "1998 Agreement"). The agreement covered the period beginning July 31, 1998 and ending July 31, 2005. Effective January 1, 2005, we entered into a new agreement (the "2005 Agreement"), which supersedes the 1998 Agreement. The 2005 Agreement provided for Mr. Catell's continued employment until July 31, 2006. The 2005 Agreement also provides that the term of the agreement would be extended in the event of a change of control (as defined in the 2005 Agreement). Pursuant to the agreement, and as a result of the pending acquisition of KeySpan by National Grid, the term of the agreement has been extended until two years following the closing of the transaction.

Mr. Catell's employment agreement also provides for severance benefits to be paid to him in the event his employment is terminated by KeySpan without cause or if Mr. Catell terminates his employment for good reason. The severance benefits to be provided during the Severance Period (as defined below) include: (a) payment to Mr. Catell in a single lump sum of (i) all accrued obligations (the accrued obligations include any base salary, annual or long-term incentive compensation actually earned but not yet paid through the date of termination, accrued but unpaid vacation pay, and any compensation previously deferred, inclusive of any accrued interest), and (ii) the aggregate amount of salary and annual incentive compensation that he would have received had he remained employed through the end of the employment period; (b) continued accrual of Supplemental Executive Retirement Plan benefits (as provided in the agreement) to the end of the term of the agreement; (c) continuation of all other employee benefits; and (d) acceleration of vesting of all equity awards, as if he had remained employed by KeySpan during the term of the agreement. If Mr. Catell voluntarily terminates his employment, other than for good reason, we will pay the accrued obligations to Mr. Catell and he shall be entitled to retire and receive all the pension benefits as provided under the various pension plans, as well as retiree medical and dental coverage provided under the group health plan. In addition, he is eligible for the benefits under the Executive Group Replacement Life Insurance Policy as described in the above Compensation Discussion and Analysis. If Mr. Catell is terminated without cause or resigns for good reason during the Protection Period, Mr. Catell will be provided with severance at a multiple of two times base salary and highest annual bonus, continued benefits and additional supplemental pension benefits accrual for the two year period following his termination. The highest annual bonus under the agreement is calculated based upon the higher of the average of the three most recent years of bonus received prior to the change of control and the most recently received annual bonus.

The protection period under his agreement begins on the date that we enter into a definitive agreement that would constitute a change of control transaction (as defined in the Change of Control Plan) and ends on the second anniversary of the date following consummation of such change of control.

Mr. Catell may resign for any reason in the thirteenth month following a change of control with all severance benefits. In the event that any payments or other severance benefits Mr. Catell receives from us or otherwise are subject to a parachute excise tax, then Mr. Catell will be entitled to a gross-up payment in order to put him in the same after-tax position he would have been in without the imposition of the excise tax.

In March 2006, we entered into a letter agreement with Mr. Luterman relating to his service as Executive Vice President and Chief Financial Officer. The letter agreement provides that in the event of his termination of employment as a result of the change of control of KeySpan, he would be entitled to separation benefits under the Change of Control Plan without regard to his age as of any date of termination or mandatory retirement age. Under the qualified pension plan, age 65 is the mandatory retirement age. The Change of Control Plan would have otherwise capped his separation benefit at this age.

## Senior Executive Change of Control Severance Plan

On October 29, 2003, after a competitive market analysis and a due diligence review by an outside consultant, our Board of Directors authorized a five year extension of the Change of Control Plan. The Change of Control Plan expires October 30, 2008, unless extended for an additional period by our Board of Directors; provided that, following a change of control, the Change of Control Plan shall continue until after all the executives who become entitled to any payments or benefits thereunder shall have received such payments in full.

With the exception of Mr. Catell, all other named executive officers participate in the Change of Control Plan. The Change of Control Plan provides for the payment of severance and other benefits upon certain qualifying terminations of such executives within two (2) years of a "change of control" (as defined in the Change of Control Plan). The protection period under the Change of Control Plan commences upon the date that we enter into a definitive agreement contemplating a change of control and will continue for a period of two years after the effective date of the actual change of control. Upon the signing of the definitive Merger Agreement with National Grid, the protection period went into effect on February 25, 2006. The benefits payable under the Change of Control Plan provide for:

(i) the payment of the executive's base salary and compensation previously deferred by the executive, earned through the date of termination;

(ii) the payment of an amount equal to three times an executive's base salary and highest annual bonus (as defined in footnote 1 following the table below) for any President, any Executive Vice President and any Senior Vice President and two times an executive's base salary and highest annual bonus for Vice Presidents;

(iii) the payment of amounts under retirement plan formulas, including the applicable two to three year period as added service and compensation under the plans; and

(iv) the continuation of medical, dental and life insurance benefits for a period of two to three years depending on the executive's position with us.

In addition to severance benefits provided under the Change of Control Plan, the occurrence of a change of control will also result in the acceleration of vesting of all equity based awards under the provisions of the Incentive Plan.

**Estimated Change of Control/Severance Payments**

The following table shows the amount of potential severance benefits including potential gross-up amounts for excise taxes for the named executive officers pursuant to the Change of Control Plan, or in the case of Mr. Catell, his 2005 Agreement, and in the case of Mr. Luterman, his 2006 agreement, assuming a change of control took place in 2006 and the named executive officers were terminated on December 31, 2006. The table also shows the estimated present value of continuing coverage for the benefits provided under our group health, dental, executive life insurance and all retirement plans. The amounts indicated are applicable only in the event the named executive officers are not retained upon a change of control or they resign for good reason under the terms of the plan. Upon termination of employment, each named executive officer is eligible for outplacement benefits not to exceed $30,000.

Mr. Catell has agreed to serve as Deputy Chairman of National Grid and Executive Chairman of National Grid US8 for a two-year period following the change of control date. Assuming he serves in such capacities for such period, he will not be entitled to receive the severance benefits listed in the table below. Likewise, in the event the other named executive officers continue their employment beyond a two-year protection period, they also will not be entitled to receive the payments listed in the table below. However, pursuant to the Change of Control Plan, an excise tax and gross-up payment of $2,146,137 and $1,195,864, regardless of their continued employment, will be made to Mr. Catell and Mr. Fani, respectively, as a result of the acceleration of vesting upon change of control associated with unvested options, restricted stock and performance shares.

| **Executive Officers** | **Potential Cash Severance Payment (1)** | **Estimated Value of Welfare Benefits (2)** | **Estimated Present Value of Retirement Benefits (3)** | **Estimated Excise Tax and Gross-up Payments (4)** |
|---|---|---|---|---|
| Robert B. Catell **(5)** | $ 6,480,000 | $ 45,000 | $ 2,600,768 | $7,069,925 |
| Gerald Luterman | $ 3,017,125 | $ 117,300 | $ 605,298 | $2,299,900 |
| Robert J. Fani | $ 5,544,700 | $ 54,900 | $ 3,783,892 | $6,256,851 |
| Wallace P. Parker Jr. | $ 4,075,361 | $ 69,300 | $ 2,151,370 | $4,053,558 |
| Steven L. Zelkowitz | $ 3,927,516 | $ 72,900 | $ 2,135,649 | $3,977,279 |

(1) Cash severance benefit is a lump sum payment based on the annual base salary prior to termination plus the highest annual bonus times the severance multiple. Highest annual bonus is defined as the greater of the bonus most recently paid prior to the change of control or the average of the three prior years ("Highest Annual Bonus"). The lump sum also includes an amount which represents the Highest Annual Bonus prorated from January 1 to the date of termination divided by 365. The severance multiple for Mr. Catell pursuant to his employment agreement is two times while all other named executive officers listed above have a multiple of three times.

(2) Includes the cost of continuation of employee coverage for medical, dental and life insurance during the two year period for Mr. Catell and the three year period for all other named executive officers.

(3) Represents the present value of the increase in the annual lifetime pension annuity attributed to the added service and compensation associated with the two year period for Mr. Catell and the three year period for all other named executive officers.

(4) The executive officers are entitled to receive a gross-up payment to eliminate the effect on any "golden parachute" excise taxes that may be imposed on the executives under Sections 280G and 4999 of the Internal Revenue Code. This is a tax imposed on the executive above and beyond ordinary income taxes. The amount of such gross-up payment has been calculated taking into consideration the value of the all cash severance payments, the value of all benefits and the acceleration of equity awards attributed to change of control. This payment amount is provided to pay the excise taxes that may be imposed on the executive as well as any taxes on this gross-up check. All other federal, state and local income taxes that are attributed to the cash severance payments, benefits and equity awards will be paid by the executive.

(5) Mr. Catell's severance benefits are provided pursuant to his employment agreement dated January 1, 2005. Mr. Catell is not a participant in the Change of Control Plan.

The following table provides a summary of the value of unvested stock options, restricted stock and performance shares that vest upon a change of control.

## Accelerated Vesting of Equity Awards Attributed to Change of Control

| | Unvested Stock Options ($) (1) | Unvested Restricted Stock ($) (2) | Unvested Performance Shares ($) (3) |
|---|---|---|---|
| Robert B. Catell | 1,858,813 | 4,333,412 | 5,074,658 |
| Gerald Luterman | 467,046 | 375,562 | 1,371,813 |
| Robert J. Fani | 851,591 | 221,672 | 3,014,580 |
| Wallace P. Parker Jr. | 748,510 | 221,672 | 2,036,389 |
| Steven L. Zelkowitz | 558,765 | 151,913 | 2,071,571 |

(1) The value of all unvested options reflects the difference between the exercise price of each unvested option and the closing price of our stock at the fiscal year end ($41.18 per share).

(2) The value of all unvested restricted shares reflects the closing price of our stock at fiscal year end ($41.18 per share) including reinvested dividends, with all restrictions assumed to be lapsed on December 31, 2006.

(3) The value of all unvested performance shares reflects shares granted in 2004, 2005 and 2006, and assumes that the shares and accumulated dividends vested at the target grant level at the closing price of our stock at fiscal year end ($41.18 per share). While the 2004 grant of performance shares would have vested under an assumed change of control on December 31, 2006, in actuality these shares and accumulated dividends thereon have been forfeited because the performance result required to vest this award as of December 31, 2006 was not achieved. The amounts forfeited by each named executive officer are as follows: Mr. Catell: $1,491,174; Mr. Luterman: $274,860; Mr. Fani: $633,334; Mr. Parker: $494,749; and Mr. Zelkowitz: $394,967.

**2006 Nonqualified Deferred Compensation**

| Name | Executive Contributions in Last FY ($) (1) | Registrant Contributions in Last FY ($) (2) | Aggregate Earnings in Last FY ($) (3) | Aggregate Withdrawals/ Distributions ($) | Aggregate Balance at Last FYE ($) (4) |
|---|---|---|---|---|---|
| Robert B. Catell | 700,000 | 140,000 | 191,220 (5) | 0 | 4,167,494 |
| Gerald Luterman | 194,141 | 38,828 | 33,759 (5) | 0 | 772,696 |
| Robert J. Fani | 185,294 | 37,058 | 57,189 | 0 | 1,359,983 |
| Wallace P. Parker Jr. | 275,045 | 55,009 | 56,410 | 0 | 1,369,767 |
| Steven L. Zelkowitz | 256,565 | 51,312 | 48,834 | 0 | 1,191,472 |

(1) Reflects amounts deferred by each named executive officer to the ODSUP from the amount earned under the Corporate Plan for the purchase of our stock units. The amounts deferred would have been paid to each of the named executives in 2006 attributable to performance in 2005.
(2) Represents the 20% match on the amount deferred into the ODSUP.
(3) Includes dividends paid on shares held in the ODSUP. Dividends paid in the ODSUP are equal to dividends paid to all KeySpan stockholders and therefore, no amount is preferential or above the market rate. Since dividends paid in the ODSUP are not above the market rate, earnings on the ODSUP are not included in the Summary Compensation Table, but rather, are included in this column in its entirety.
(4) Aggregate balance of deferred compensation represents amounts previously deferred by the named executive officers and any earnings thereon. The ODSUP shares have been valued at the full market value closing price of our stock per share at fiscal year end ($41.18 per share).
(5) Also includes earnings on amounts deferred pursuant to the Deferred Compensation Plan.

## Officers' Deferred Stock Unit Plan

Pursuant to the ODSUP and consistent with our desire to encourage increased officer stock ownership to further align the interests of our executives and stockholders, the named executive officers and certain other executives may elect to defer between 10% and 50% of their annual cash award earned under the Corporate Plan to deferred stock units held within the ODSUP. The deferred stock units track the performance of our common stock but do not possess voting rights. The deferred stock units receive dividends which accumulate during the deferral period.

Executives also receive a 20% match from us on the amounts deferred in each year, which amounts are reported in the All Other Compensation column of the Summary Compensation Table. The match component and dividends on the deferral will track the performance of our common stock and will generally be payable in cash upon retirement. Amounts held within the ODSUP must be deferred until retirement or resignation and are payable in common stock for the amounts deferred by the executive, and either in stock or cash for the match component and dividends. In the event of the executive's resignation prior to retirement, the match and dividends are forfeited. Each of the named executive officers elected to defer the following amounts of their annual cash awards payable in 2006 (attributable to 2005 performance) and 2007 (attributable to 2006 performance), respectively:

| | 2006 | 2007 |
|---|---|---|
| Mr. Catell | 50% | 50% |
| Mr. Fani | 25% | 25% |
| Mr. Parker | 50% | 50% |
| Mr. Zelkowitz | 50% | 50% |
| Mr. Luterman | 50% | 40% |

Upon a change in control, all deferred stock units, the match and accumulated dividends will be converted to cash and distributed to the executives pursuant to the plan provisions as permitted under Internal Revenue Code section 409A.

Deferred Compensation Plan

Pursuant to the Deferred Compensation Plan, by December 31st of each year, each eligible executive and management employee may elect to defer receipt of between 1% and 10% of the following year's base pay. Deferred compensation for each participant shall be credited to an account on our books (the "Deferred Account"). Interest on amounts in a Deferred Account shall be credited and compounded monthly based on the average reference rate during such month (the "Prime Rate").

In the event of an executive's separation from service, the amounts in the executive's Deferred Account shall be distributed consistent with the distribution election made by the executive and as permitted under Internal Revenue Code section 409A.

Mr. Catell and Mr. Luterman maintain a balance in this plan while the other named executive officers do not participate in this plan.

**2006 Director Compensation**

| Name (1) | Fees Earned or Paid in Cash ($) | Stock Awards ($) (2) | Option Awards ($) | Non-Equity Incentive Plan Compensation ($) | Change in Pension Value and Nonqualified Deferred Compensation Earnings ($) | All Other Compensation ($) | Total ($) |
|---|---|---|---|---|---|---|---|
| A. S. Christensen | 73,500 | 64,000 | 0 | 0 | 0 | 0 | 137,500 |
| A. H. Fishman | 81,500 (3) | 64,000 | 0 | 0 | 0 | 0 | 145,500 |
| J. R. Jones | 70,500 (4) | 64,000 | 0 | 0 | 0 | 0 | 134,500 |
| J. L. Larocca | 75,500 (5) | 64,000 | 0 | 0 | 0 | 0 | 139,500 |
| G. C. Larson | 63,500 (6) | 64,000 | 0 | 0 | 0 | 0 | 127,500 |
| S. W. McKessy | 81,500 (7) | 64,000 | 0 | 0 | 0 | 0 | 145,500 |
| E. D. Miller | 70,500 (8) | 64,000 | 0 | 0 | 0 | 0 | 134,500 |
| V. L. Pryor | 69,500 (9) | 64,000 | 0 | 0 | 0 | 0 | 133,500 |

(1) Messrs. Catell and Fani are not listed in the above table because neither receives any additional compensation for serving on our board of directors or its committees.
(2) Stock awards are received as common stock equivalents pursuant to the Directors' Deferred Compensation Plan.
(3) Includes $48,900 elected by the director to be received as a stock equivalent and deferred pursuant to the Directors' Deferred Compensation Plan.
(4) Includes $35,250 elected by the director to be received as a stock equivalent and deferred pursuant to the Directors' Deferred Compensation Plan.
(5) Includes $18,875 elected by the director to be received as a stock equivalent and deferred pursuant to the Directors' Deferred Compensation Plan.
(6) Includes $63,500 elected by the director to be received as a stock equivalent and deferred pursuant to the Directors' Deferred Compensation Plan.
(7) Includes $40,750 elected by the director to be received as a stock equivalent and deferred pursuant to the Directors' Deferred Compensation Plan.
(8) Includes $70,500 elected by the director to be received as a stock equivalent and deferred pursuant to the Directors' Deferred Compensation Plan.
(9) Includes $69,500 elected by the director to be received as a stock equivalent and deferred pursuant to the Directors' Deferred Compensation Plan.

The directors' compensation as reflected in the table above includes the following amounts:

Non-employee directors:

$43,500 annual retainer;
$2,000 committee meeting fee;
$5,000 committee chairman retainer;
$10,000 audit committee chairman retainer;
$10,000 Lead Director retainer; and
$64,000 in common stock equivalents granted under the Directors' Deferred Compensation Plan.

The employee directors receive no additional compensation for serving on the Board or its committees.

The board of directors has adopted Directors' Deferred Compensation Plans (pre 2005 and post 2005 plans) to directly align the non-employee directors' financial interest with those of the shareholders. The Directors' Deferred Compensation Plans provide all non-employee directors with the opportunity to defer any portion of their cash compensation received as directors, in exchange for common stock equivalents or into a deferred cash account. Common stock equivalents are valued by utilizing the average of the high and low price per share of our common stock on the first trading day of the quarter following the quarter in which contributions are received. Dividends are paid on common stock equivalents in additional common stock equivalents in the same proportion as dividends paid on common stock. Compensation not deferred and exchanged for common stock equivalents may be deferred into a cash account bearing interest at the prime rate. Additionally, a director may elect to invest his or her compensation by participating in the KeySpan Investor Program (a dividend reinvestment plan). Upon retirement, death or termination of service as a director, all amounts in a director's common stock equivalent account and/or cash account shall, at the director's election, (i) be paid in a lump sum in cash; (ii) be deferred for up to five years; and/or (iii) be paid in the number of annual installments, up to ten, specified by the director. Our current non-employee directors are not entitled to benefits under any of our retirement plan.

With the exception of Ms. Christensen, each listed director elected to defer a portion or all of his or her cash earnings for 2006 into stock equivalents under the Directors' Deferred Compensation Plans. No director elected to defer any compensation into the deferred cash account under the Directors' Deferred Compensation Plans.

## Compensation Committee Interlocks and Insider Participation

Neither Ms. Larson nor Messrs. Jones, Larocca, McKessy and Miller, the current members of the Committee, is an officer or employee, or former officer or employee, of us or any of our subsidiaries. No interlocking relationship exists between the members of our Board of Directors or the Committee and the compensation committee, or board committee performing equivalent functions, of any other company, nor has any such interlocking relationship existed in the past.

## Compensation Committee Report

Under the rules of the New York Stock Exchange and the Sarbanes-Oxley Act of 2002, the Board of Directors must determine that each member of the Committee is independent under all applicable standards. Additionally, no director may serve unless he or she is a "Non-employee Director" for purposes of Rule 16b-3 under the Securities Exchange Act of 1934, as amended, and satisfies the requirements of an "outside director" for purposes of Section 162 (m) of the Internal Revenue Code. The members of the Committee are James R. Jones, James L. Larocca, Gloria C. Larson, Stephen W. McKessy and Edward D. Miller serving as chairperson. None of such members is or has been an officer or employee of KeySpan or any of its subsidiaries and they meet the required standards of independence. The Committee operates under a written charter adopted by the Board of Directors which is available on our internet site at http://www.keyspanenergy.com.

The Committee has reviewed and discussed the Company's Compensation Discussion and Analysis with management at meetings held on December 24, 2006, January 24, 2007 and February 20, 2007. Based on the review and discussions, the Committee recommended to the Board of Directors that the Compensation Discussion and Analysis be included in our annual report on Form 10-K.

**Compensation and Management Development Committee**

James R. Jones

James L. Larocca

Gloria C. Larson

Stephen W. McKessy

Edward D. Miller, Chairperson

## ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

### Security Ownership of Certain Beneficial Owners

As of February 20, 2007, there were no beneficial owners of more than 5% of our common stock.

### Security Ownership of Management

The following table sets forth information as of February 20, 2007, with respect to the number of shares of common stock beneficially owned (including vested stock options), common stock equivalents and/or deferred stock units and performance shares credited to each director, each named executive officer and all directors and executive officers as a group.

| | Name of Beneficial Owner | Amount and Nature of Beneficial Ownership of Common Stock (including Vested Stock Options)(1) | Common Stock Equivalents or Deferred Stock Units(2) | Performance Shares(3) | Percent of Outstanding Common Stock(4) |
|---|---|---|---|---|---|
| Named Executive Officers | R. B. Catell* | 2,358,448 | 89,151 | 80,700 | 1.4% |
| | G. Luterman | 302,737 | 17,146 | 25,460 | ** |
| | R. J. Fani* | 449,103 | 33,409 | 55,230 | ** |
| | W. P. Parker Jr. | 470,269 | 33,649 | 35,720 | ** |
| | S. L. Zelkowitz | 297,249 | 29,269 | 38,890 | ** |
| Directors | A. S. Christensen | 8,871 | 19,345 | 0 | ** |
| | A. H. Fishman | 13,061 | 27,584 | 0 | ** |
| | J. R. Jones | 11,227 | 15,829 | 0 | ** |
| | J. L. Larocca | 14,573 | 17,037 | 0 | ** |
| | G. C. Larson | 556 | 10,505 | 0 | ** |
| | S. W. McKessy | 10,615 | 23,579 | 0 | ** |
| | E. D. Miller | 21,318 | 34,318 | 0 | ** |
| | V. L. Pryor | 0 | 8,088 | 0 | ** |
| | All directors and executives as a group, including those named above, a total of 28 persons. | 5,490,385(4)(5)(6) | 479,917 | 420,070 | 3.6% |

* Messrs. Catell and Fani are also directors

** Less than 1%.

(1) Beneficial ownership of common stock includes holdings in KeySpan's 401(k) Plan, Employee Discount Stock Purchase Plan, Dividend Reinvestment Plan, and/or in other stock accounts, as well as issued and outstanding vested stock options. Such stock options give the holder the right to purchase underlying shares of common stock at the respective exercise price per share of the option. All such stock options were granted at an exercise price equal to the closing price of our common stock on the respective date of grant.

(2) Includes common stock equivalents or deferred stock units. The term "common stock equivalents" refers to units of

value which track the performance of common stock. Such units do not possess voting rights and have been issued pursuant to the Directors' Deferred Compensation Plans. The term "deferred stock units" also refers to units of value which track the performance of common stock. Such units do not possess voting rights and have been issued pursuant to the Officers' Deferred Stock Unit Plans.

(3) Performance shares have been granted with a three-year performance period with a threshold, target and maximum performance level. At threshold performance, 50% of the award shall be earned; at target, 100% of the award shall be earned; and at maximum, 150% of the award shall be earned. The number of shares set forth above assumes the target level of performance with a 100% payout.

(4) Calculated as the total of the three previous columns divided by 175,588,130 the number of shares outstanding on February 20, 2007.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, and DIRECTOR INDEPENDENCE

Please see Item 11. Executive Compensation for a description of our employment and change of control agreements and plans.

### Directors and Officers Liability Insurance and Indemnity

We have director and officer, or "D&O" liability insurance for the purpose of reimbursing us when we have indemnified our directors and officers. D&O liability insurance also provides direct payment to our directors and officers under certain circumstances when we have not previously provided indemnification. We also have liability insurance which provides fiduciary coverage for us, our directors, officers and employees for any alleged breach of fiduciary duty under the Employee Retirement Income Security Act. Our D&O liability insurance was purchased from Associated Electric & Gas Insurance Services, Energy Insurance Mutual, Zurich American, Hartford, Starr Excess, St. Paul Mercury Insurance Co. and Liberty Mutual for a one year period commencing on May 28, 2006 at a cost of $3,483,325. Fiduciary liability insurance from the American International Group, CHUBB, Zurich American and Energy Insurance Mutual for a one year period commencing on August 26, 2006 at a cost of $733,207. We plan to renew both programs upon expiration.

### Director Independence

Pursuant to our Corporate Governance Guidelines, which can be found on the Investor Relations section of our website at http://www.keyspanenergy.com or directly on our corporate governance website (http://governance.keyspanenergy.com), our board undertook a review of director independence. As a result of this review, our board affirmatively determined that all of the directors are independent under the standards set forth in the Corporate Governance Guidelines, and the relevant NYSE and SEC rules and regulations, with the exception of Robert B. Catell and Robert J. Fani. Mr. Catell cannot be deemed independent under the Corporate Governance Guidelines or applicable rules and regulations because he serves as Chief Executive Officer of the Corporation. Mr. Fani cannot be deemed independent under the Corporate Governance Guidelines or applicable rules and regulations because he serves as Chief Operating Officer and President of the Corporation.

The basis for our board's determination that the independent directors are indeed independent is set forth in our Corporate Governance Guidelines and is set forth, in relevant part, below:

> At all times, a majority of the directors shall be independent directors under the rules of the NYSE and the Sarbanes-Oxley Act of 2002 and the regulations promulgated thereunder. The following guidelines are established to assist our board in determining the independence of a director:
>
> a. A director will not be considered independent if, within the preceding three years: (i) the director was employed by KeySpan or one of its subsidiaries; (ii) an immediate family member of the director was employed by KeySpan as an officer; (iii) the director received more than $100,000 in direct compensation from KeySpan or its subsidiaries, other than for board service or pension or deferred compensation; (vi) an immediate family member of the director received more than $100,000 in direct compensation from KeySpan or its subsidiaries, other than for Board service or pension or deferred compensation; (v) the director was employed by or affiliated with KeySpan's independent auditor; (vi) an immediate family member of the director was employed by KeySpan's independent auditor; (vii) the director was employed as an executive officer of another company where any of KeySpan's officers serve on that company's compensation committee; or (viii) an immediate family member of the director was employed as an executive officer of another company where any of KeySpan's officers serve on that company's compensation committee;
>
> b. A director will not be considered independent if: (i) the director or an immediate family member of the director currently serves as an executive officer of another company that does business with KeySpan and the annual sales to, or purchases from, KeySpan in any of the preceding three years, exceeds the greater of $1 million or two percent of the annual consolidated gross revenues of the company; (ii) the director is an executive officer of another company which is indebted to KeySpan, or to which KeySpan is indebted, and the total amount of either company's indebtedness to the other is greater than one percent of the total consolidated assets of the company he or she serves as an executive officer; and (iii) if a director serves as an officer, director or trustee of a tax exempt organization, and KeySpan's charitable contributions to the organization are greater than $1 million or two percent of that organization's total consolidated gross revenues. The Board will annually review all commercial and charitable relationships of the directors.
>
> For relationships not covered by the guidelines in subsection (b) above, the determination of whether the relationship is material or not, and therefore whether the director would be independent or not, shall be made by the directors who satisfy the independence guidelines set forth in subsections (a) and (b) above. For example, if a director is the chief executive officer of a company that purchases products and services from KeySpan that are not more than two percent of that company's annual revenues, the independent directors could determine, after considering all of the relevant circumstances, whether

such a relationship was material or immaterial, and whether the director would therefore be considered independent.

KeySpan will not make any personal loans or extensions of credit to directors or officers.

Our directors complete and submit an annual director questionnaire to identify and assess relationships so that the entire Board can determine independence under these standards. The directors also complete and submit an annual statement that they are in compliance with our Corporate Policy Statement Concerning Ethical Business Conduct and our Corporate Policy Statement Concerning Affiliate Transactions. The directors also annually certify that they have, and continue to agree to comply with, the KeySpan Corporation Board Of Directors Code of Ethics which sets forth standards of diligence, loyalty, good faith and the avoidance of conflicts of interests for the directors.

## ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The following table provides information on the aggregate fees for services performed by Deloitte & Touche LLP ("Deloitte & Touche"), the member firms of Deloitte & Touche Tohmatsu, and their respective affiliates for the years ended December 31, 2006 and December 31, 2005:

| | 2006 | 2005 |
|---|---|---|
| Audit Fees (a) | $ 4,164,594 | $ 3,682,325 |
| Audit-Related Fees (b) | 96,200 | 88,000 |
| Tax Fees (c) | 318,419 | 385,522 |
| All Other Fees (d) | 132,010 | 50,121 |
| **Total** | **$ 4,711,223** | **$ 4,205,968** |

(a) In 2006, audit fees include base fees for the annual and statutory financial statement audits, audit of internal control over financial reporting, and quarterly reviews of $3,509,100 and fees for consultations on financial accounting standards as part of the audit of $655,494. In 2005, audit fees include base fees for the annual and statutory financial statement audits, audit of internal control over financial reporting, and quarterly reviews of $3,212,089; $185,498 for fees related to financings and fees for consultations on financial accounting standards as part of the audit of $284,738.

(b) Audit-related fees include benefit plan audits

(c) Fees for tax services billed in 2006 and 2005 consisted of tax compliance, tax consultation services and software licensing. Fees for tax compliance services totaled $192,928 and $313,738 in 2006 and 2005, respectively. Tax compliance services include services such as assistance with federal, state and local income tax returns. Fees for tax consultation services and software licensing totaled $125,491 and $71,784 in 2006 and 2005, respectively.

(d) Other fees include training.

In accordance with the Audit Committee Charter and the rules and regulations of the SEC, the Audit Committee reviews the scope of the audit and approves the nature and cost of all services provided by Deloitte & Touche. The Audit Committee has reviewed the nature and scope of the services provided by Deloitte & Touche and considers such to have been compatible with the maintenance of Deloitte & Touche's independence throughout its service to KeySpan.

The Audit Committee has also determined that the scope of services to be provided by Deloitte & Touche in 2007 will generally be limited to audit and audit related services and tax services. The Audit Committee will expressly approve the provision of any services by Deloitte & Touche outside the scope of the foregoing services. Although it is the intent of the Audit Committee to pre-approve all non-audit services to be provided by Deloitte & Touche, any inadvertent failure to do so will not be deemed a breach of the Audit Committee charter if: (i) the aggregate amount of all such non-audit services provided to the Corporation constitutes not more than five percent of the total amount of revenues paid by the Corporation to its auditor during the fiscal year in which the non-audit services are provided; (ii) such services were not recognized by the Corporation at the time of the engagement to be non-audit services; and (iii) such services are promptly brought to the attention of the Committee and approved prior to the completion of the audit by the Committee or its Chairman pursuant to delegated authority.

# PART IV

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a) Required Documents

1. Financial Statements

The following consolidated financial statements of KeySpan and its subsidiaries and Reports of the Independent Registered Public Accounting Firm are included in Item 8 and are filed as part of this Report:

- Consolidated Statement of Income for the year ended December 31, 2006, the year ended December 31, 2005, and the year ended December 31, 2004
- Consolidated Statement of Retained Earnings for the year ended December 31, 2006, the year ended December 31, 2005, and the year ended December 31, 2004
- Consolidated Balance Sheet at December 31, 2006 and December 31, 2005
- Consolidated Statement of Capitalization at December 31, 2006 and December 31, 2005
- Consolidated Statement of Cash Flows for the year ended December 31, 2006, the year ended December 31, 2005, and the year ended December 31, 2004
- Consolidated Statement of Comprehensive Income for the Year ended December 31, 2006, the year ended December 31, 2005 and the year ended December 31, 2004
- Notes to Consolidated Financial Statements
- Report of the Independent Registered Public Accounting Firm

2. Financial Statement Schedules

Consolidated Schedule of Valuation and Qualifying Accounts for the year ended December 31, 2006, the year ended December 31, 2005, and the year ended December 31, 2004.

## Schedule of Valuation and Qualifying Accounts

| Descriptions | Balance at Beginning of Period | Charged to costs and expenses | Net Deductions | Balance at End of Period |
|---|---|---|---|---|
| **Twelve Months Ended December 31, 2006** | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | $ 62,827 | $ 76,919 | $ 82,831 | $ 56,915 |
| Additions to liability accounts: | | | | |
| Reserve for injury and damages | $ 9,300 | $ - | $ 211 | $ 9,089 |
| Reserve for environmental expenditures | $ 424,248 | $ - | $ 51,229 | $ 372,437 |
| **Twelve Months Ended December 31, 2005** | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | $ 67,796 | $ 137,190 | $ 142,159 | $ 62,827 |
| Additions to liability accounts: | | | | |
| Reserve for injury and damages | $ 9,370 | $ 500 | $ 570 | $ 9,300 |
| Reserve for environmental expenditures | $ 256,789 | $ 211,178 | $ 43,719 | $ 424,248 |
| **Twelve Months Ended December 31, 2004** | | | | |
| Deducted from asset accounts: | | | | |
| Allowance for doubtful accounts | $ 75,671 | $ 74,089 | $ 81,964 | $ 67,796 |
| Additions to liability accounts: | | | | |
| Reserve for injury and damages | $ 9,370 | $ - | $ - | $ 9,370 |
| Reserve for environmental expenditures | $ 294,691 | $ - | $ 37,902 | $ 256,789 |

* Reflects adjustment for discontinued operations.

All other schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

(b) Exhibits

Exhibits listed below which have been filed with the SEC pursuant to the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, and which were filed as noted below, are hereby incorporated by reference and made a part of this report with the same effect as if filed herewith.

2.1 Agreement and Plan of Merger, dated as of February 25, 2006, by and among National Grid plc, National Grid US8 Inc. and KeySpan Corporation (filed as Exhibit 2.1 to KeySpan's Form 8-K dated March 1, 2006)

3.1 Certificate of Incorporation of KeySpan effective April 16, 1998, Amendment to Certificate of Incorporation of KeySpan effective May 26, 1998, Amendment to Certificate of Incorporation of KeySpan effective June 1, 1998, Amendment to the Certificate of Incorporation of KeySpan effective April 7, 1999 and Amendment to the Certificate of Incorporation of KeySpan effective May 20, 1999 (filed as Exhibit 3.1 to KeySpan's Form 10-Q for the quarterly period ended June 30, 1999)

3.2 By-Laws of KeySpan in effect as of June 25, 2003, as amended (filed as Exhibit 3.1 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2003)

4.1 Credit Agreement dated as of June 24, 2005 among KeySpan Corporation, the several lenders, The Royal Bank of Scotland PLC and Citibank, N.A., as Co-Syndication Agents, The Bank of New York and The Bank of Nova Scotia, as Co-Documentation Agents, and JPMorgan Chase Bank, N.A., as Administrative Agent (filed as Exhibit 4.1 to KeySpan's Form 8-K dated as of June 29, 2005)

4.2 Amended and Restated Credit Agreement dated as of June 24, 2005 among KeySpan Corporation, the several lenders, The Royal Bank of Scotland PLC and Citibank, N.A., as Co-Syndication Agents, The Bank of New York and The Bank of Nova Scotia, as Co-Documentation Agents, and JPMorgan Chase Bank, N.A., as Administrative Agent (filed as Exhibit 4.2 to KeySpan's Form 8-K dated as of June 29, 2005)

4.3 Indenture, dated as of November 1, 2000, between KeySpan Corporation and the Chase Manhattan Bank, as Trustee, with respect to the issuance of Debt Securities (filed as Exhibit 4-a to Amendment No. 1 to Form S-3 Registration Statement No. 333-43768 and filed as Exhibit 4-a to KeySpan's Form 8-K on November 20, 2000)

4.4 Form of Note issued in connection with the issuance of the KeySpan Corporation \$700 million of 7.625% Notes due 2010 issued on November 20, 2000 (filed as Exhibit 4-c to KeySpan's Form 8-K on November 20, 2000)

4.5 Form of Note issued in connection with the issuance of the KeySpan Corporation \$250 million of 8.0% Notes due 2030 issued on November 20, 2000 (filed as Exhibit 4-d to KeySpan's Form 8-K on November 20, 2000)

4.6 Form of Note issued in connection with the issuance of the KeySpan Corporation \$150 million of 4.65% Notes issued on April 1, 2003 (filed as Exhibit 4.1 to KeySpan's Form 8-K dated as of April 8, 2003)

4.7 Form of Note issued in connection with the issuance of the KeySpan Corporation \$150 million of 5.875% Notes issued on April 1, 2003 (filed as Exhibit 4.2 to KeySpan's Form 8-K dated as of April 8, 2003)

4.8 Form of Note issued in connection with the issuance of the KeySpan Corporation \$307.2 million of 5.803% Notes issued on March 29, 2005 (filed as Exhibit 4.1 to KeySpan's Form 8-K dated as of March 31, 2005)

4.9 Supplemental Remarketing Agreement dated as of March 21, 2005 among KeySpan Corporation, J.P. Morgan Securities Inc. and JPMorgan Chase Bank, N.A. in connection with the remarketing of the 4.9% Notes due 2008 (filed as Exhibit 99.1 to KeySpan's Form 8-K dated as of March 24, 2005)

4.10 Indenture, dated December 1, 1999, between KeySpan and KeySpan Gas East Corporation, the Registrants, and the Chase Manhattan Bank, as Trustee, with respect to the issuance of Medium-Term Notes, Series A, (filed as Exhibit 4-a to Amendment No. 1 to KeySpan's and KeySpan Gas East Corporation's Form S-3 Registration Statement No. 333-92003)

4.11 Form of Medium-Term Note issued in connection with the issuance of KeySpan Gas East Corporation 7 7/8% Notes issued on February 1, 2000 (filed as Exhibit 4 to KeySpan's Form 8-K on February 1, 2000)

4.12 Form of Medium-Term Note issued in connection with the issuance of KeySpan Gas East Corporation 6.9% Notes issued on January 19, 2001 (filed as Exhibit 4.3 to KeySpan's Form 10-K for the year ended December 31, 2000)

4.13 Participation Agreement, dated as of July 1, 1991, between New York State Energy Research and Development Authority ("NYSERDA") and The Brooklyn Union Gas Company relating to the Gas Facilities Revenue Bonds ("GFRBs") Series 1991A and 1991B (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1991)

4.14 Indenture of Trust, dated as of July 1, 1991, between NYSERDA and Manufacturers Hanover Trust Company, as Trustee, relating to the GFRBs Series 1991A and 1991B (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1991)

4.15 Participation Agreement, dated as of July 1, 1992, between NYSERDA and The Brooklyn Union Gas Company relating to the GFRBs Series 1993A and 1993B (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1992)

4.16 Indenture of Trust, dated as of July 1, 1992, between NYSERDA and Chemical Bank, as Trustee, relating to the GFRBs Series 1993A and 1993B (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company Form 10-K for the year ended September 30, 1992)

4.17 Participation Agreement dated as of July 1, 1991 between NYSERDA and The Brooklyn Union Gas Company relating to the GFRBs Series D (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1991)

4.18 First Supplemental Participation Agreement dated as of June 1, 1993 between NYSERDA and The Brooklyn Union Gas Company relating to GFRBs Series D (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1993)

4.19 Trust Indenture, dated as of July 1, 1991 between NYSERDA and Manufacturers Hanover Trust Company relating to the GFRBs Series D (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1991)

4.20 First Supplemental Trust Indenture, dated as of June 1, 1993 between NYSERDA and Chemical Bank (as successor to Manufacturers Hanover Trust Company) relating to the GFRBs Series D (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1993)

4.21 Participation Agreement, dated January 1, 1996, between NYSERDA and The Brooklyn Union Gas Company relating to GFRBs Series 1996 (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1996)

4.22 Indenture of Trust, dated January 1, 1996, between NYSERDA and Chemical Bank, as Trustee, relating to GFRBs Series 1996 (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1996)

4.23 Participation Agreement, dated as of January 1, 1997, between NYSERDA and The Brooklyn Union Gas Company relating to GFRBs 1997 Series A (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1997)

4.24 Indenture of Trust, dated January 1, 1997, between NYSERDA and Chase Manhattan Bank, as Trustee, relating to GFRBs 1997 Series A (The Brooklyn Union Gas Company Project) (filed as Exhibit 4 to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1997)

4.25 Supplemental Trust Indenture, dated as of January 1, 2000, by and between NYSERDA and The Chase Manhattan Bank, as Trustee, relating to the GFRBs 1997 Series A (The Brooklyn Union Gas Company Project) (filed as Exhibit 4.11 to KeySpan's Form 10-K for the year ended December 31, 1999)

4.26 Bond Purchase Agreement, dated as of October 26, 2005, among The Brooklyn Union Gas Company and NYSERDA and Morgan Stanley & Co. Incorporated, BNY Capital Markets, Inc., Sovereign Securities Corporation, LLC and The Williams Capital Group, L.P., as Series A Underwriters, for the issuance of $82 million aggregate principal amount of 4.7% GFRBs, 2005, Series A. (The

Brooklyn Union Gas Company Project) (filed as Exhibit 10.1 to KeySpan's Form 8-K dated November 1, 2005)

4.27 Indenture of Trust, dated as of November 1, 2005, between NYSERDA and Citibank, N.A., as Trustee, relating to the issuance of $82 million GFRBs, 2005 Series A, 4.7% due February 2024 (The Brooklyn Union Gas Company Project) (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.28 Participation Agreement, dated as of November 1, 2005, between NYSERDA and The Brooklyn Union Gas Company relating to the issuance of $82 million GFRBs, 2005 Series A, 4.7% due February 2024 (filed as Exhibit 10.2 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.29 Promissory Note, dated as of November 1, 2005, executed by the Brooklyn Union Gas Company for issuance of $82 million GFRBs, 2005 Series A, 4.7% due February 2024 (filed as Exhibit 10.3 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.30 Bond Purchase Agreement, dated as of October 26, 2005, among The Brooklyn Union Gas Company and NYSERDA and Goldman Sachs & Co., BNY Capital Markets, Inc., Sovereign Securities Corporation, LLC and The Williams Capital Group, L.P., as Series A Underwriters, for the issuance of $55 million aggregate principal amount of GFRBs, 2005, Series B (filed as Exhibit 10.2 to KeySpan's Form 8-K dated November 1, 2005)

4.31 Indenture of Trust, dated as of November 1, 2005, between NYSERDA and Citibank, N.A., as Trustee, relating to the issuance of $55 million GFRBs, 2005 Series B due June 2025 (filed as Exhibit 10.4 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.32 Participation Agreement, dated as of November 1, 2005, between NYSERDA and The Brooklyn Union Gas Company relating to the issuance of $55 million GFRBs, 2005 Series B, due February 2025 (filed as Exhibit 10.5 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.33 Promissory Note, dated as of November 1, 2005, executed by the Brooklyn Union Gas Company for the issuance of $55 million GFRBs, 2005 Series B, due June 2025 (filed as Exhibit 10.6 to KeySpan's Form 10-Q for the quarterly period ended September 30, 2005)

4.34 Letter of Credit and Reimbursement Agreement, dated December 9, 2003, by and between KeySpan Generation LLC and Royal Bank of Scotland Bank PLC (filed as Exhibit 4.34 to KeySpan's Form 10-K for the year ended December 31, 2003)

4.35 Participation Agreement dated as of December 1, 1997 by and between NYSERDA and Long Island Lighting Company relating to the 1997 Electric Facilities Revenue Bonds ("EFRBs"), Series A (KeySpan Generation LLC) (filed as Exhibit 10(a) to KeySpan's Form 10-Q for the quarterly period ended September 30, 1998)

4.36 Indenture of Trust, dated as of December 1, 1997, by and between NYSERDA and The Chase Manhattan Bank, as Trustee, relating to the 1997 EFRBs, Series A (KeySpan Generation LLC) (filed as Exhibit 10(a) to KeySpan's Form 10-Q for the quarterly period ended September 30, 1998)

4.37 Participation Agreement, dated as of October 1, 1999, by and between NYSERDA and KeySpan Generation LLC relating to the 1999 Pollution Control Refunding Revenue Bonds ("PCRB's"), Series A (filed as Exhibit 4.10 to KeySpan's Form 10-K for the year ended December 31, 1999)

4.38 Trust Indenture, dated as of October 1, 1999, by and between NYSERDA and The Chase Manhattan Bank, as Trustee, relating to the 1999 PCRBs, Series A (filed as Exhibit 4.10 to KeySpan's Form 10-K for the year ended December 31, 1999)

4.39 Indenture, dated as of December 1, 1989, between Boston Gas Company and The Bank of New York, as Trustee (filed as Exhibit 4.2 to Boston Gas Company's Form S-3 (File No. 33-31869))

4.40 Second Amended and Restated First Mortgage Indenture for Colonial Gas Company, dated as of June 1, 1992 (filed as Exhibit 4(b) to Colonial Gas Company's Form 10-Q for the quarter ended June 30, 1992)

4.41 First Supplemental Indenture for Colonial Gas Company dated as of June 15, 1992 (filed as Exhibit 4(c) to Colonial Gas Company's Form 10-Q for the quarter ended June 30, 1992)

4.42 Second Supplemental Indenture for Colonial Gas Company dated as of September 27, 1995 (filed as Exhibit 4(c) to Colonial Gas Company's Form 10-K for the fiscal year ended December 31, 1995)

4.43 Amendment to Second Supplemental Indenture for Colonial Gas Company dated as of October 12, 1995 (filed as Exhibit 4(d) to Colonial Gas Company's Form 10-K for the fiscal year ended December 31, 1995)

4.44 Third Supplemental Indenture for Colonial Gas Company dated as of December 15, 1995 (filed as Exhibit 4(f) to Colonial Gas Company's Form S-3 Registration Statement dated January 5, 1998)

4.45 Fourth Supplemental Indenture for Colonial Gas Company dated as of March 1, 1998 (filed as Exhibit 4(l) to Colonial Gas Company's Form 10-Q for the quarter ended March 31, 1998)

4.46 Trust Agreement, dated as of June 22, 1990, between Colonial Gas Company, as Trustor, and Shawmut Bank, N.A., as Trustee (filed as Exhibit 10(d) to Colonial Gas Company's Form 10-Q for the quarterly period ended June 30, 1990)

4.47 Lease Agreement, dated as of November 1, 2003, by and between the Suffolk County Industrial Development Agency and KeySpan-Port Jefferson Energy Center, LLC (filed as Exhibit 4.14-a to KeySpan's Form 10-K for the year ended December 31, 2003)

4.48 Company Lease Agreement, dated as of November 1, 2003, by and between KeySpan-Port Jefferson Energy Center, LLC and the Suffolk County Industrial Development Agency (filed as Exhibit 4.14-b to KeySpan's Form 10-K for the year ended December 31, 2003)

4.49 Guaranty, dated as of November 26, 2003, from KeySpan Corporation to the Suffolk County Industrial Development Agency (filed as Exhibit 4.14-c to KeySpan's Form 10-K for the year ended December 31, 2003)

4.50 Lease Agreement, dated as of November 1, 2003, by and between the Nassau County Industrial Development Agency and KeySpan-Glenwood Energy Center, LLC (filed as Exhibit 4.15-a to KeySpan's Form 10-K for the year ended December 31, 2003)

4.51 Company Lease Agreement, dated as of November 1, 2003, by and between KeySpan-Glenwood Energy Center, LLC and the Nassau County Industrial Development Agency (filed as Exhibit 4.15-b to KeySpan's Form 10-K for the year ended December 31, 2003)

4.52 Guaranty, dated as of November 26, 2003, from KeySpan Corporation to the Nassau County Industrial Development Agency (filed as Exhibit 4.14-c to KeySpan's Form 10-K for the year ended December 31, 2003)

4.53 Lease Agreement, dated June 9, 1999, between KeySpan-Ravenswood, LLC and LIC Funding, Limited Partnership (filed as Exhibit 10.2 to KeySpan's Form 10-Q for the quarterly period ended June 30, 1999)

4.54 First Amendment to the Lease Agreement between KeySpan-Ravenswood, LLC and LIC Funding, Limited Partnership, dated as of June 27, 2002 (filed as Exhibit 10.25 to KeySpan's Form 10-K for the year ended December 31, 2002)

| | |
|---|---|
| 4.55 | KeySpan Corporation Guaranty dated June 9, 1999, from KeySpan in favor of LIC Funding, Limited Partnership (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended June 30, 1999) |
| 4.56 | KeySpan Corporation Guaranty dated May 25, 2004, relating to the 250 MW Ravenswood Expansion (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2004) |
| 4.57 | Facility Lease Agreement, dated as of May 25, 2004, between SE Ravenswood Trust, a Delaware statutory trust, and KeySpan-Ravenswood, LLC relating to the 250 MW Ravenswood Expansion(filed as Exhibit 10.2 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2004) |
| 4.58 | Site Lease and Easement Agreement, dated as of May 25, 2004, between KeySpan-Ravenswood, LLC and SE Ravenswood Trust relating to the 250 MW Ravenswood Expansion (filed as Exhibit 10.3 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2004) |
| 4.59 | Site Sublease, dated as of May 25, 2004, between SE Ravenswood Trust and KeySpan-Ravenswood, LLC relating to the 250 MW Ravenswood Expansion (filed as Exhibit 10.4 to KeySpan's Form 10-Q for the quarterly period ended June 30, 2004) |
| 4.60 | Amendment, Assignment and Assumption Agreement, dated as of September 29, 1997, by and among The Brooklyn Union Gas Company, Long Island Lighting Company and KeySpan Energy Corporation (filed as Exhibit 2.5 to Schedule 13D by Long Island Lighting Company on October 24, 1997) |
| 10.1 | Agreement and Plan of Merger, dated as of June 26, 1997, by and among BL Holding Corp., Long Island Lighting Company, Long Island Power Authority and LIPA Acquisition Corp. (filed as Annex D to the Joint Registration Statement on Form S-4 of The Brooklyn Union Gas Company and Long Island Lighting Company, Registration No. 333-30353 on June 30, 1997) |
| 10.2 | Management Services Agreement between Long Island Power Authority and Long Island Lighting Company dated as of June 26, 1997 (filed as Annex D to the Joint Registration Statement on Form S-4 of The Brooklyn Union Gas Company and Long Island Lighting Company, Registration No. 333-30353 on June 30, 1997) |
| 10.3 | Amendment, dated as of March 29, 2002, to Management Services Agreement between Long Island Lighting Company d/b/a LIPA and KeySpan Electric Services LLC dated as of June 26, 1997 (filed as Exhibit 10.4-b to KeySpan's Form 10-K for the year ended December 31, 2002) |

10.4 Amended and Restated Management Services Agreement dated as of January 1, 2006 between the Long Island Lighting Company ("LILCO") d/b/a LIPA and KeySpan Electric Services LLC (filed as Exhibit 10.1 to KeySpan's Form 8-K filed on February 7, 2006)

10.5 Power Supply Agreement between Long Island Lighting Company and Long Island Power Authority dated as of June 26, 1997 (filed as Annex D to the Joint Registration Statement on Form S-4 of The Brooklyn Union Gas Company and Long Island Lighting Company, Registration No. 333-30353 on June 30, 1997)

10.6 Energy Management Agreement between Long Island Lighting Company and Long Island Power Authority dated as of June 26, 1997 (filed as Annex D to Registration Statement on Form S-4, No. 333-30353, on June 30, 1997)

10.7 Amendment, dated as of March 29, 2002, to Energy Management Agreement between Long Island Lighting Company d/b/a LIPA and KeySpan Energy Trading Services LLC dated as of June 26, 1997 (filed as Exhibit 10.6-b to KeySpan's Form 10-K for the year ended December 31, 2002)

10.8 Generation Purchase Rights Agreement between Long Island Lighting Company and Long Island Power Authority dated as of June 26, 1997 (filed as Exhibit 10.17 to KeySpan's Form 10-K for the year ended December 31, 2001)

10.9 Amendment, dated as of March 29, 2002, to Generation Purchase Rights Agreement by and between KeySpan Corporation, as Seller, and Long Island Lighting Company d/b/a LIPA, as Buyer, dated as of June 26, 1997 (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended March 31, 2002)

10.10 Generation Purchase Right Extension Agreement between KeySpan and the Long Island Power Authority dated as of March 28, 2005 (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended March 31, 2005)

10.11 Option and Purchase and Sale Agreement dated as of January 1, 2006 by and between LILCO d/b/a LIPA and KeySpan Electric Services LLC (filed as Exhibit 10.2 to KeySpan's Form 8-K filed on February 7, 2006)

10.12 Letter Amendment to the Option and Purchase and Sale Agreement between KeySpan Generation LLC and Long Island Lighting Company d/b/a LIPA, dated as of December 11, 2006 (filed as Exhibit 10.1 to KeySpan's Form 8-K dated December 19, 2006)

10.13 Settlement Agreement and Release dated as of January 1, 2006 by and among KeySpan, KeySpan Generation LLC, KeySpan Electric Services LLC, KeySpan Energy Trading Services LLC and LIPA (filed as Exhibit 10.3 to KeySpan's Form 8-K filed on February 7, 2006)

10.14 Agreement of Lease between Forest City Jay Street Associates and The Brooklyn Union Gas Company dated September 15, 1988 (filed as an Exhibit to The Brooklyn Union Gas Company's Form 10-K for the year ended September 30, 1996)

10.15 Second Amendment, dated as of March 24, 2005, to the Lease Agreement dated as of September 15, 1998 between The Brooklyn Union Gas Company and Forest City Jay Street Associates, L.P. (filed as Exhibit 10 to KeySpan's Form 8-K dated as of March 30, 2005)

10.16 ISDA Master Agreement, dated as of January 18, 2006, between KeySpan Corporation and Morgan Stanley Capital Group Inc. (filed as Exhibit 10.1 to KeySpan's Form 8-K dated January 24, 2006)

10.17 Restated Exploration Agreement between The Houston Exploration Company and KeySpan Exploration and Production, L.L.C. dated June 30, 2000 (filed as Exhibit 10.1 to The Houston Exploration Company's Form 10-Q for the quarter ended September 30, 2000, File No. 001-11899)

10.18 Distribution Agreement, dated June 2, 2004, by and among The Houston Exploration Company, Seneca-Upshur Petroleum, Inc., THEC Holdings Corp. and KeySpan Corporation (filed as Exhibit 99.2 to The Houston Exploration Company's Form 8-K dated as of June 3, 2004)

10.19 Asset Contribution Agreement, dated June 2, 2004, between The Houston Exploration Company and Seneca-Upshur Petroleum, Inc. (filed as Exhibit 99.3 to The Houston Exploration Company's Form 8-K dated as of June 3, 2004)

10.20 Tax Matters Agreement, dated June 2, 2004, by and among The Houston Exploration Company, Seneca-Upshur Petroleum, Inc., THEC Holdings Corp. and KeySpan Corporation (filed as Exhibit 99.4 to The Houston Exploration Company's Form 8-K dated as of June 3, 2004)

10.21 Share Sale and Purchase Agreement dated February 25, 2005 with BG Energy Holdings Limited and Premier Transmission Financing Public Limited Company (filed as Exhibit 10.37 to KeySpan's Form 10-K for the year ended December 31, 2004)

10.22 Purchase Agreement, dated January 28, 2005, among Robert B. Snyder, Frank J. Sullivan, Robert B. Snyder, Jr., Philip J. Andreoli, William J. McKean, Binsky & Snyder, LLC, Binsky & Snyder Service, LLC and KeySpan Business Solutions, LLC (filed as Exhibit 10.35 to KeySpan's Form 10-K for the year ended December 31, 2004)

10.23 Purchase Agreement, dated February 11, 2005, among WDF Holding Corp., WDF, Inc. and KeySpan Business Solutions, LLC (filed as Exhibit 10.36 to

KeySpan's Form 10-K for the year ended December 31, 2004)

10.24 Note Purchase Agreement, dated as of November 29, 2006, between KEDNY and certain investors for the issuance of $400 million of Senior Unsecured Notes, due November 29, 2016 (filed as Exhibit 10.1 to KeySpan's Form 8-K dated December 5, 2006)

10.25 Note Purchase Agreement, dated as of November 29, 2006, between KEDLI and certain investors for the issuance of $100 million of Senior Unsecured Notes, due November 29, 2016 (filed as Exhibit 10.2 to KeySpan's Form 8-K dated December 5, 2006)

10.26 KEDNY Form of 5.60% Senior Unsecured Note due November 29, 2016 (filed as Exhibit 10.2 to KeySpan's Form 8-K dated December 5, 2006)

10.27 KEDLI Form of 5.60% Senior Unsecured Note due November 29, 2016 (filed as Exhibit 10.2 to KeySpan's Form 8-K dated December 5, 2006)

10.28 ISDA Master Agreement between the Company and Morgan Stanley Capital Group Inc. dated as of January 18, 2006 (filed as Exhibit 10.1 to KeySpan's Form 8-K dated January 24, 2006)

**Compensation Agreements**

10.29* Cash Compensation for Non-Management Directors of KeySpan

10.30* Base Salaries of Named Executive Officers of KeySpan in effect as of February 20, 2007

10.31 Copy of the Amendment to the Employment Agreement dated January 1, 2005 between KeySpan Corporation and Anthony Sartor (filed as Exhibit 10.1 to KeySpan's Form 8-K dated September 8, 2006)

10.32 Agreement and Waiver of Rights and Claims between KeySpan and Lenore F. Puleo dated as of March 24, 2006 (filed as Exhibit 10.2 to KeySpan's Form 8-K dated March 30, 2006)

10.33 Letter Agreement between KeySpan and Gerald Luterman dated March 24, 2006 (filed as Exhibit 10.1 to KeySpan's Form 8-K dated March 30, 2006)

10.34 Employment Agreement, dated February 24, 2005, between KeySpan and Robert B. Catell (filed as Exhibit 10.10 to KeySpan's Form 10-K for the year ended December 31, 2004)

10.35 Employment Agreement, dated January 1, 2005, between KeySpan and Anthony Sartor (filed as Exhibit 10.01 to KeySpan's Form 8-K dated as of January 4, 2005)

10.36 Supplemental Retirement Agreement, dated January 1, 2005, between KeySpan and Anthony Sartor (filed as Exhibit 10.12 to Company's Form 8-K dated as of January 4, 2005)

10.37 Supplemental Retirement Agreement, dated July 1, 2002, between KeySpan and Steven L. Zelkowitz (filed as Exhibit 10.12 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002)

10.38 Supplemental Retirement Agreement, dated July 1, 2002, between KeySpan and Gerald Luterman (filed as Exhibit 10.11 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002)

10.39 Supplemental Retirement Agreement, dated July 1, 2002, between KeySpan and David J. Manning (filed as Exhibit 10.13 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002)

10.40 Supplemental Retirement Agreement, dated July 1, 2002, between KeySpan and Elaine Weinstein (filed as Exhibit 10.15 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002)

10.41 Directors' Deferred Compensation Plan effective April 2003 (filed as Exhibit 10.16 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2003)

10.42 Officers' Deferred Stock Unit Plan of KeySpan Corporation (filed as Exhibit 10.17 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002)

10.43 Officers' Deferred Stock Unit Plan of KeySpan Services, Inc. (filed as Exhibit 10.18 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2002)

10.44 Corporate Annual Incentive Compensation and Gainsharing Plan (filed as Exhibit 10.20 to KeySpan's Form 10-K for the year ended December 31, 2000)

10.45* Corporate Annual Incentive Compensation Plan Target Performance Award Level for Fiscal Year 2007

10.46 Senior Executive Change of Control Severance Plan effective as of October 29, 2003 (filed as Exhibit 10.20 to KeySpan's Form 10-K for the year ended December 31, 2003)

10.47 KeySpan's Amended Senior Executive Change of Control Severance Plan (filed as Exhibit 10.1 to KeySpan's Form 10-Q for the quarterly period ended March 31, 2006)

10.48 KeySpan's Amended Long-Term Performance Incentive Compensation Plan (filed as Exhibit A to KeySpan's 2001 Proxy Statement filed on March 23, 2001)

| | |
|---|---|
| 10.49* | KeySpan's Long-Term Performance Incentive Compensation Plan Performance Target Award Level for Fiscal Year 2007 |
| 14 | Code of Ethics (filed as Exhibit 14 to KeySpan's Annual Report on Form 10-K for the year ended December 31, 2003). |
| 21* | Subsidiaries of the Registrant |
| 23.1* | Consent of Deloitte & Touche LLP, Independent Registered Public Accounting Firm |
| 24.1* | Power of Attorney executed by Andrea S. Christensen on February 21, 2007 |
| 24.2* | Power of Attorney executed by Robert J. Fani on February 21, 2007 |
| 24.3* | Power of Attorney executed by Alan H. Fishman on February 21, 2007 |
| 24.4* | Power of Attorney executed by James R. Jones on February 21, 2007 |
| 24.5* | Power of Attorney executed by James L. Larocca on February 21, 2007 |
| 24.6* | Power of Attorney executed by Gloria C. Larson on February 21, 2007 |
| 24.7* | Power of Attorney executed by Stephen W. McKessy on February 21, 2007 |
| 24.8* | Power of Attorney executed by Edward D. Miller on February 21, 2007 |
| 24.9* | Power of Attorney executed by Vikki L. Pryor on February 21, 2007 |
| 31.1* | Certification of the Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2* | Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1* | Certification of the Chairman and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2* | Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* filed herewith

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KEYSPAN CORPORATION
(Registrant)

| **Signature:** | **Date:** |
|---|---|
| By: /s/Gerald Luterman<br>Gerald Luterman<br>Executive Vice President<br>and Chief Financial Officer | February 22, 2007 |

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| **Signatures:** | **Date:** |
|---|---|
| By: /s/Robert B. Catell<br>Robert B. Catell<br>Chairman of the Board of Directors<br>and Chief Executive Officer | February 22, 2007 |
| By: /s/Gerald Luterman<br>Gerald Luterman<br>Executive Vice President and<br>Chief Financial Officer | February 22, 2007 |
| By: /s/Theresa A. Balog<br>Theresa A. Balog<br>Vice President and<br>Chief Accounting Officer | February 22, 2007 |
| *<br>Andrea S. Christensen<br>Director | |

*

Robert J. Fani
President, Chief Operating Officer and Director

*

Alan H. Fishman
Director

*

James R. Jones
Director

*

James L. Larocca
Director

*

Gloria C. Larson
Director

*

Stephen W. McKessy
Lead Director

*

Edward D. Miller
Director

*

Vikki L. Pryor
Director

* Such signature has been affixed pursuant to a Power of Attorney filed as an exhibit hereto and incorporated herein by reference thereto

## CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement Nos. 333-119491, 333-104230, 333-82230, 333-92003 and 333-13429 on Form S-3 and Registration Statement Nos. 333-119474, 333-53765, 333-40472 and 333-79151 on Form S-8 of our reports dated February 22, 2007, relating to the financial statements and financial statement schedule of KeySpan Corporation (which report expressed an unqualified opinion and included an explanatory paragraph related to (i) the adoption of Statement of Financial Accounting Standards No. 158 *"Employers' Accounting for Defined Benefit Pensions and Other Postretirement Benefit Plans*" discussed in Notes 1 and 4 and (ii) the adoption of Financial Accounting Standards Board Interpretation No. 47, "*Accounting for Conditional Asset Retirement Obligations*" discussed in Notes 1 and 7) and management's report on the effectiveness of internal control over financial reporting, appearing in this Annual Report on Form 10-K of KeySpan Corporation for the year ended December 31, 2006.

/s/ DELOITTE & TOUCHE LLP

New York, New York
February 22, 2007

Exhibit 31.1

**CERTIFICATION OF THE
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Robert B. Catell, certify that:

1. I have reviewed this Report on Form 10-K for the year ended December 31, 2006 of KeySpan Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

    a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

    b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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 principals;

    c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

    d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter

(the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

    a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 22, 2007

/s/ Robert B. Catell
Robert B. Catell
Chairman of the Board of Directors
and Chief Executive Officer

Exhibit 31.2

**CERTIFICATION OF THE
EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER
PURSUANT TO SECTION 302
OF THE SARBANES-OXLEY ACT OF 2002**

I, Gerald Luterman, certify that:

1. I have reviewed this Report on Form 10-K for the year ended December 31, 2006 of KeySpan Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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 principals;

   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter

(the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

    a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 22, 2007

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President
and Chief Financial Officer

Exhibit 32.1

**CERTIFICATION OF THE**
**CHAIRMAN AND CHIEF EXECUTIVE OFFICER**
**PURSUANT TO SECTION 906**
**OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Report on Form 10-K for the year ended December 31, 2006 of KeySpan Corporation (the “Corporation”), as filed with the Securities and Exchange Commission on the date hereof (the “Report”), I, Robert B. Catell, Chairman and Chief Executive Officer of the Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

Date: February 22, 2007

/s/ Robert B. Catell
Robert B. Catell
Chairman of the Board of Directors
and Chief Executive Officer

Exhibit 32.2

**CERTIFICATION OF THE**
**EXECUTIVE VICE PRESIDENT AND CHIEF FINANCIAL OFFICER**
**PURSUANT TO SECTION 906**
**OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Report on Form 10-K for the year ended December 31, 2006 of KeySpan Corporation (the "Corporation"), as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Gerald Luterman, Executive Vice President and Chief Financial Officer of the Corporation, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

Date: February 22, 2007

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President
and Chief Financial Officer

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**

# FORM 10-Q

**ANNUAL REPORT**
**PURSUANT TO SECTION 13 OR 15(d)**
**OF THE SECURITIES EXCHANGE ACT OF 1934**

**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2006

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to _________

**Commission file number 1-14161**

**KEYSPAN CORPORATION**
(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| **NEW YORK** | **11-3431358** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| **One MetroTech Center, Brooklyn, New York** | **11201** |
| **175 East Old Country Road, Hicksville, New York** | **11801** |
| (Address of Principal Executive Offices) | (Zip Code) |

**(718) 403-1000 (Brooklyn)**
**(516) 755-6650 (Hicksville)**
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes**[X]** No**[ ]**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filler.

Large accelerated filer **[X]** Accelerated filer **[ ]** Non-accelerated filer **[ ]**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes**[X]** No**[ ]**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class of Common Stock | Outstanding at April 24, 2006 |
|---|---|
| $.01 par value | 174,960,377 |

KEYSPAN CORPORATION AND SUBSIDIARIES

INDEX

## CONSOLIDATED BALANCE SHEET
(Unaudited)

| *(In Millions of Dollars)* | **March 31, 2006** | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and temporary cash investments | **$ 313.1** | $ 124.5 |
| Restricted cash | **5.2** | 13.2 |
| Accounts receivable | **1,200.9** | 1,035.6 |
| Unbilled revenue | **479.7** | 685.6 |
| Allowance for uncollectible accounts | **(83.1)** | (62.8) |
| Gas in storage, at average cost | **491.4** | 766.9 |
| Material and supplies, at average cost | **132.4** | 140.5 |
| Derivative contracts | **22.3** | 142.8 |
| Other | **116.9** | 173.8 |
| | **2,678.8** | 3,020.1 |
| **Investments and Other** | **252.1** | 242.4 |
| **Property** | | |
| Gas | **7,352.5** | 7,275.9 |
| Electric | **2,518.3** | 2,492.3 |
| Other | **415.9** | 416.3 |
| Accumulated depreciation | **(2,979.7)** | (2,922.6) |
| Gas exploration and production, at cost | **184.7** | 184.2 |
| Accumulated depletion | **(110.2)** | (109.2) |
| | **7,381.5** | 7,336.9 |
| **Deferred Charges** | | |
| Regulatory assets: | | |
| Miscellaneous assets | **678.3** | 688.3 |
| Derivative contracts | **27.1** | 30.9 |
| Goodwill and other intangible assets | **1,666.3** | 1,666.3 |
| Derivative contracts | **34.0** | 75.2 |
| Other | **774.5** | 752.5 |
| | **3,180.2** | 3,213.2 |
| **Total Assets** | **$ 13,492.6** | $ 13,812.6 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED BALANCE SHEET
(Unaudited)

| *(In Millions of Dollars)* | **March 31, 2006** | December 31, 2005 |
|---|---|---|
| **LIABILITIES AND CAPITALIZATION** | | |
| **Current Liabilities** | | |
| Accounts payable and other liabilities | **$ 767.6** | $ 1,087.0 |
| Commercial paper | **496.8** | 657.6 |
| Current redemption of long-term debt | **13.5** | 13.0 |
| Taxes accrued | **329.9** | 176.3 |
| Dividends payable | **81.3** | 81.1 |
| Customer deposits | **37.9** | 39.1 |
| Interest accrued | **73.4** | 53.8 |
| Derivative contracts | **31.1** | 47.3 |
| | **1,831.5** | 2,155.2 |
| **Deferred Credits and Other Liabilities** | | |
| Regulatory liabilities: | | |
| Miscellaneous liabilities | **15.9** | 69.9 |
| Removal cost recovered | **529.7** | 516.4 |
| Derivative contracts | **31.0** | 175.4 |
| Asset retirement obligations | **48.1** | 47.4 |
| Deferred income tax | **1,144.0** | 1,157.9 |
| Postretirement benefits and other reserves | **1,192.4** | 1,118.4 |
| Derivative contracts | **23.1** | 44.3 |
| Other | **116.1** | 127.5 |
| | **3,100.3** | 3,257.2 |
| **Commitments and Contingencies (See Note 6)** | **-** | - |
| **Capitalization** | | |
| Common stock - 184,864 shares issued, 174,940 shares outstanding, stated at | **3,983.3** | 3,975.9 |
| Retained earnings | **993.7** | 866.9 |
| Other comprehensive (loss) | **(64.2)** | (74.8) |
| Treasury stock | **(287.3)** | (303.9) |
| Total common shareholders' equity | **4,625.5** | 4,464.1 |
| Long-term debt and capital leases | **3,920.0** | 3,920.8 |
| **Total Capitalization** | **8,545.5** | 8,384.9 |
| **Minority Interest in Subsidiary Companies** | **15.3** | 15.3 |
| **Total Liabilities and Capitalization** | **$ 13,492.6** | $ 13,812.6 |

See accompanying Notes to the Consolidated Financial Statements.

# CONSOLIDATED STATEMENT OF INCOME

(Unaudited)

| *(In Millions of Dollars, Except Per Share Amounts)* | **Three Months Ended March 31, 2006** | 2005 |
|---|---|---|
| **Revenues** | | |
| Gas Distribution | **$ 2,180.1** | $ 2,025.5 |
| Electric Services | **424.8** | 400.4 |
| Energy Services | **48.4** | 44.5 |
| Energy Investments | **7.8** | 10.1 |
| Total Revenues | **2,661.1** | 2,480.5 |
| **Operating Expenses** | | |
| Purchased gas for resale | **1,511.4** | 1,308.8 |
| Fuel and purchased power | **130.0** | 133.1 |
| Operations and maintenance | **406.0** | 387.2 |
| Depreciation, depletion and amortization | **110.3** | 106.1 |
| Operating taxes | **118.2** | 111.9 |
| Total Operating Expenses | **2,275.9** | 2,047.1 |
| Income from equity investments | **3.4** | 5.3 |
| Gain on sale of property | **0.5** | - |
| **Operating Income** | **389.1** | 438.7 |
| **Other Income and (Deductions)** | | |
| Interest charges | **(66.2)** | (60.0) |
| Gain on sale of investments | **-** | 4.1 |
| Cost of debt redemption | **-** | (20.9) |
| Other | **11.4** | 9.1 |
| Total Other Income and (Deductions) | **(54.8)** | (67.7) |
| **Income Taxes** | | |
| Current | **159.4** | 128.8 |
| Deferred | **(33.1)** | 6.5 |
| Total Income Taxes | **126.3** | 135.3 |
| Earnings from continuing operations | **208.0** | 235.7 |
| **Discontinued Operations** | | |
| Loss from discontinued operations, net of tax | **-** | (2.2) |
| Gain on disposal, net of tax | **-** | 2.2 |
| Loss from discontinued operations | **-** | - |
| **Net Income** | **208.0** | 235.7 |
| Preferred stock dividend requirements | **-** | 1.3 |
| **Earnings for Common Stock** | **$ 208.0** | $ 234.4 |
| **Basic Earnings Per Share:** | | |
| Continuing Operations, less preferred stock dividends | **$ 1.19** | $ 1.45 |
| Discontinued Operations | **-** | - |
| Basic Earnings Per Share | **$ 1.19** | $ 1.45 |
| **Diluted Earnings Per Share** | | |
| Continuing Operations, less preferred stock dividends | **1.18** | $ 1.44 |
| Discontinued Operations | **-** | - |
| Diluted Earnings Per Share | **$ 1.18** | $ 1.44 |
| **Average Common Shares Outstanding (000)** | **174,704** | 161,125 |
| **Average Common Shares Outstanding - Diluted (000)** | **176,953** | 162,245 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

| *(In Millions of Dollars)* | Three Months Ended March 31, **2006** | 2005 |
|---|---|---|
| ***Operating Activities*** | | |
| Net income | **$ 208.0** | $ 235.7 |
| **Adjustments to reconcile net income to net cash provided by (used in) operating activities** | | |
| Depreciation, depletion and amortization | **110.3** | 106.1 |
| Deferred income tax | **(33.1)** | 6.5 |
| Income from equity investments | **(3.4)** | (5.3) |
| Amortization of financing fees / interest rate swap | **2.1** | (11.7) |
| (Gain) on sale of investment | **-** | (4.1) |
| Amortization of property taxes | **33.4** | 28.3 |
| **Changes in assets and liabilities** | | |
| Accounts receivable | **12.3** | (262.3) |
| Materials and supplies, fuel oil and gas in storage | **283.5** | 297.8 |
| Accounts payable and other liabilities | **(308.1)** | (126.5) |
| Taxes accrued | **166.0** | 85.7 |
| Interest accrued | **19.6** | 15.0 |
| Environmental payments | **(10.0)** | (7.4) |
| Other | **63.3** | 25.6 |
| **Net Cash Provided by Operating Activities** | **543.9** | 383.4 |
| ***Investing Activities*** | | |
| Construction expenditures | **(122.2)** | (111.8) |
| Cost of removal | **(6.7)** | (4.8) |
| Net proceeds from sale of property and investments | **-** | 48.1 |
| **Net Cash Used in Investing Activities** | **(128.9)** | (68.5) |
| ***Financing Activities*** | | |
| Common/Treasury stock issued | **15.5** | 24.3 |
| Payment of commercial paper | **(160.8)** | (441.4) |
| Payment of long-term debt | **-** | (515.0) |
| Common stock dividends paid | **(81.1)** | (74.6) |
| Preferred stock dividends paid | - | (1.3) |
| Other | - | 9.1 |
| **Net Cash Used in Financing Activities** | **(226.4)** | (998.9) |
| Net Increase (Decrease) in Cash and Cash Equivalents | **188.6** | (684.0) |
| Cash Flow from Discontinued Operations - Operating | **-** | (4.4) |
| Cash Flow from Discontinued Operations - Investing | - | (10.6) |
| Cash and Cash Equivalents at Beginning of Period | **124.5** | 922.0 |
| Cash and Cash Equivalents at End of Period | **$ 313.1** | $ 223.0 |

Cash equivalents are short-term marketable securities purchased with maturities of three months or less that were carried at cost which approximates fair value.

See accompanying Notes to the Consolidated Financial Statements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

KeySpan Corporation (referred to in the Notes to the Financial Statements as "KeySpan," "we," "us" and "our") is a registered 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 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.)

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 of KeySpan (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 and the adoption of the Merger Agreement by the stockholders of KeySpan and the Parent. Assuming receipt of all required approvals, 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.

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 Federal Energy Regulatory Commission ("FERC") pursuant to PUHCA 2005. (For additional information on the Energy Act and PUHCA 2005 see KeySpan's Annual Report on

Form 10-K for the year ended December 31, 2005, Item 7. Management's Discussion and Analyses of Financial Condition and Results of Operations - "Regulation and Rate Matters.")

## 1. BASIS OF PRESENTATION

In our opinion, the accompanying unaudited Consolidated Financial Statements contain all adjustments necessary to present fairly KeySpan's financial position as of March 31, 2006, and the results of operations for the three months ended March 31, 2006 and March 31, 2005, as well as cash flows for the three months ended March 31, 2006 and March 31, 2005. The accompanying financial statements should be read in conjunction with the consolidated financial statements and notes included in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005. The December 31, 2005 financial statement information has been derived from the 2005 audited financial statements. Income from interim periods may not be indicative of future results. Certain reclassifications were made to conform prior period financial statements to the current period financial statement presentation.

Consolidated earnings are seasonal in nature primarily due to the significant contributions to earnings of the gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters.

Basic earnings per share ("EPS") is calculated by dividing earnings available 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 available 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 Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share" our basic and diluted EPS are as follows:

| *(In Millions of Dollars, Except Per Share Amounts)* | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Earnings for common stock | $ 208.0 | $ 234.4 |
| Weighted average shares outstanding (000) | 174,704 | 161,125 |
| Add dilutive securities: | | |
| Options | 2,249 | 1,120 |
| Total weighted average shares outstanding - assuming dilution | 176,953 | 162,245 |
| Basic earnings per share | $ 1.19 | $ 1.45 |
| Diluted earnings per share | $ 1.18 | $ 1.44 |

## 2. BUSINESS SEGMENTS

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

The Gas Distribution segment consists of six gas distribution subsidiaries. KeySpan Energy Delivery New York ("KEDNY") provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Queens and Staten Island. KeySpan Energy Delivery Long 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, Boston Gas Company, Colonial Gas Company, Essex Gas Company and EnergyNorth Natural Gas, Inc., collectively referred to as KeySpan Energy Delivery New England ("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 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 10, "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 New York Independent Systems Operator ("NYISO") energy markets. To finance the purchase and/or construction of the Ravenswood Generating Station, KeySpan entered into a leasing arrangement for each facility. The Electric Services segment also conducts retail marketing of electricity to commercial customers. (See Note 6 "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.

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 its 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. Houston Exploration, formerly a KeySpan subsidiary, was sold in 2004.

This 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, during the first quarter of 2006, KeySpan increased its interest in the Millennium Pipeline Company LLC to 26.25% from 21%. The Millennium Pipeline Company LLC is the developer of 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 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. 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 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.

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. At March 31, 2006, the total assets of each reportable segment have not changed materially from those levels reported at December 31, 2005. The reportable segment information is as follows:

| (In Millions of Dollars) | Gas Distribution | Electric Services | Energy Services | Energy Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|
| **Three Months Ended March 31, 2006** | | | | | | |
| Unaffiliated revenue | 2,180.1 | 424.8 | 48.4 | 7.8 | - | 2,661.1 |
| Intersegment revenue | - | - | 2.5 | 1.3 | (3.8) | - |
| Operating Income | 336.4 | 65.0 | (0.4) | 3.0 | (14.9) | 389.1 |
| **Three Months Ended March 31, 2005** | | | | | | |
| Unaffiliated revenue | 2,025.5 | 400.4 | 44.5 | 10.1 | - | 2,480.5 |
| Intersegment revenue | - | 4.6 | 2.6 | - | (7.2) | - |
| Operating Income | 391.9 | 51.0 | (2.8) | 6.4 | (7.8) | 438.7 |

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

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of $422.7 million and $371.0 million for the three months ended March 31, 2006 and 2005, respectively, represent approximately 16% and 15%, respectively of our consolidated revenues in both periods.

## 3. COMPREHENSIVE INCOME

The table below indicates the components of comprehensive income:

| (In Millions of Dollars) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Net Income | $ 208.0 | $ 235.7 |
| Other comprehensive income (loss), net of tax | | |
| Net (gains) on derivative instruments | (35.7) | (4.8) |
| Foreign currency translation adjustments | - | (5.0) |
| Unrealized gains (losses) on marketable securities | 0.4 | (1.8) |
| Unrealized gains (losses) on derivative financial instruments | 45.9 | (7.3) |
| Other comprehensive loss, net of tax | 10.6 | (18.9) |
| Comprehensive Income | $ 218.6 | $ 216.8 |
| Related tax (benefit) expense | | |
| Net (gains) on derivative instruments | (19.2) | (0.5) |
| Foreign currency translation adjustments | - | (2.7) |
| Unrealized gains (losses) on marketable securities | 0.2 | (1.0) |
| Unrealized gains (losses) on derivative financial instruments | 25.4 | (6.7) |
| Total Tax (Benefit) Expense | $ 6.4 | $ (10.9) |

## 4. HEDGING AND DERIVATIVE FINANCIAL INSTRUMENTS

*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 certain of these derivative instruments is subject to SFAS 71 "Accounting for the Effects of Certain Types of Regulation." 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, however, 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 rate for the highest consumption block otherwise applicable to our firm commercial customers. 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 2006. We use standard New York Mercantile Exchange ("NYMEX") futures prices to value the gas and heating oil positions. At March 31, 2006, the fair value of gas swap contracts was a liability of $1.4 million; the fair value of the oil swap contracts was a liability of $1.7 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 $3.1 million, or $2.0 million after-tax. The ineffective portion of these derivatives for the three months ended March 31, 2006 was immaterial.

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 March 31, 2006, Seneca-Upshur has hedge positions in place for approximately 85% of its estimated 2006 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 March 31, 2006 was a liability of $14.0 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 $5.2 million, or approximately $3.4 million after-tax. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial for the three months ended March 31, 2006.

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 employs OTC natural gas swaps to hedge the cash flow variability for a portion of forecasted purchases of natural gas. We use market quoted forward prices to value these swap positions. The maximum length of time over which we have hedged cash flow variability associated with forecasted purchases of natural gas is through December 2006. The fair value of these derivative instruments at March 31, 2006, was a liability of $0.1 million. 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 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 October 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 March 31, 2006 was $19.6 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 oil swap contracts. The fair value of these derivative instruments at March 31, 2006, was a liability of $3.9 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 March 31, 2006, was a liability of $0.2 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 $10.0 million. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial for the three months ended March 31, 2006.

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 three months ended March 31, 2006, 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 March 31, 2006 the fair value of these derivative instruments was a liability of $14.1 million and are reflected as a current asset of $2.7 million, a deferred asset of $7.0 million, and a regulatory asset of $20.1 million, with offsetting positions in current liabilities, regulatory liabilities and deferred credits of $18.8 million, $7.9 million and $3.2 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 March 31, 2006, these derivatives had a net fair value of $16.8 million and are reflected as a deferred asset of $25.7 million and a regulatory asset of $7.0 million with offsetting positions in regulatory liabilities and deferred credits of $23.1 million and $9.5 million, respectively on the Consolidated Balance Sheet.

Further, certain contracts for the physical purchase of natural gas associated with the Ravenswood facility are not exempt as normal purchases from the requirements of SFAS 133. At March 31, 2006, the fair value of these contracts was a liability of $0.9 million and was recorded through earnings.

*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 the first quarter, 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 2006 through October 2006 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 spikes in heating oil prices. These options do not qualify for hedge accounting treatment under SFAS 133. We recorded a $0.7 million benefit 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 first quarter of 2006.

Further, the Ravenswood facility has also employed a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133 associated with the purchase of fuel oil. We recorded a $0.7 million expense 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 first quarter of 2006.

On January 18, 2006, KeySpan 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”). The Agreement has a three year term beginning May 1, 2006. 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 (“NYISO”) 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 does not qualify for hedge accounting treatment under SFAS 133 and is subject to mark-to-market accounting treatment; although currently there is no observable market reference to value this derivative instrument.

The table below summarizes the fair value of all of the above outstanding derivative instruments at March 31, 2006 and December 31, 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)* | March 31, 2006 | December 31, 2005 |
|---|---|---|
| **Gas Contracts:** | | |
| Other current assets | $ 2.7 | $ 132.1 |
| Other deferred charges | 33.5 | 75.2 |
| Regulatory asset | 27.1 | 30.9 |
| Other current liability | (25.6) | (39.8) |
| Other deferred liabilities | (22.4) | (44.3) |
| Regulatory liability | (31.0) | (175.4) |
| **Oil Contracts:** | | |
| Other current assets | - | 0.5 |
| Other current liability | (5.6) | (6.8) |
| Other deferred liabilities | (0.7) | - |
| **Electric Contracts:** | | |
| Other current assets | 19.6 | 10.2 |
| Other deferred charges | 0.5 | - |
| Other current liability | - | (0.7) |
| | $ (1.9) | $ (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 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 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 first quarter of 2006 was approximately 8% warmer than normal in KeySpan's New England service territory; however for the entire primary winter heating season – November 2005 through March 2006 – weather 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. 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.

*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 March 31, 2006, KeySpan has received $5.2 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. At March 31, 2006, KeySpan has no outstanding margin calls to its counterparties.

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 the reported results of operations, financial position and cash flows and lowers overall business risk.

## 5. RECENT ACCOUNTING PRONOUNCEMENTS

On March 31,2006, the Financial Accounting Standards Board ("FASB") issued an Exposure Draft of proposed rules on employers' accounting for defined benefit pensions and other postretirement benefit plans that would require employers to fully recognize the plan's funded status on the balance sheet. If adopted as proposed, the new rules would be applied retroactively to prior financial statements presented and be effective for fiscal years ending after December 15, 2006. The new rules, if adopted as proposed, may significantly increase KeySpan's recorded pension and other postretirement liabilities and reduce its shareholders' equity. The comment period on this Exposure Draft ends on May 31, 2006. KeySpan is currently evaluating the Exposure Draft, and at this time cannot determine the full impact that the potential requirements of the Exposure Draft may have on its financial statements.

On July 14, 2005, the 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. KeySpan anticipates that implementation of this Exposure Draft in its proposed form will have minimal 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. Therefore implementation of this Statement 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.

## 6. FINANCIAL GUARANTEES AND CONTINGENCIES

*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, 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 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 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, KeySpan Ravenswood, LLC, under the Master Lease. Monthly lease payments substantially equal the monthly interest expense on such debt securities.

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 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 $318.9 million.

If our subsidiary that leases the Ravenswood Facility, 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 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."

*Asset Retirement Obligations*: KeySpan has various asset retirement obligations primarily associated with its gas distribution and electric generation activities. These obligations have remained substantially unchanged from December 31, 2005, except for accretion adjustments.

Generally, KeySpan's largest asset retirement obligations relate to: (i) legal requirements 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; (ii) cleaning and removal requirements associated with storage tanks containing waste oil and other waste contaminants; and (iii) legal requirements to remove asbestos upon major renovation or demolition of structures and facilities. At March 31, 2006, these obligations total $48.1 million. See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding these obligations.

Environmental Matters

*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 New York State Public Service Commission ("NYPSC") and the Department of Environmental Conservation ("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/or 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 continues to evaluate how to proceed with respect to participation in the BCP or alternative DEC remediation programs.

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 $64.8 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. Subject to the issues described above, 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 $53.7 million.

We presently estimate the remaining cost of our KEDNY and KEDLI MGP-related environmental remediation activities will be $349.6 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.

With respect to remediation costs, the KEDNY and KEDLI rate plans generally provide for the recovery from customers of investigation and remediation costs of certain sites. At March 31, 2006, we have reflected a regulatory asset of $385.3 million for our KEDNY/KEDLI MGP sites. In October 2003, KEDNY and KEDLI filed a joint petition with the NYPSC seeking rate treatment for additional environmental costs that may be incurred at all of our New York MGP sites. 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 $1.6 million, which amount has been accrued by us. Expenditures incurred to date total $3.4 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. 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 the Massachusetts KEDNE MGP-related environmental cleanup activities will be $12.2 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 these subsidiaries, with respect to these MGP-related activities total $31.3 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 in New Hampshire. 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.

We presently estimate the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $30.9 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 this subsidiary, with respect to these MGP-related activities total $17.6 million.

By rate orders, the Massachusetts Department of Telecommunications and Energy ("MADTE") and the New Hampshire Public Utility Commission ("NHPUC") provide for the recovery of site investigation and remediation costs and, accordingly, at March 31, 2006, we have reflected a regulatory asset of $64.6 million for the KEDNE MGP sites.

*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 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.

We presently estimate the remaining cost of our environmental cleanup activities for these three non-utility sites will be approximately $19.4 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 $13.4 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.

See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005 Note 7 to those Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for further information on environmental matters.

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, or in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, 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 us and our directors. The complaint, which was filed in the New York State Supreme Court for the County of Kings, relates to the execution of the merger agreement with National Grid plc and alleges that the merger consideration which our stockholders will receive in connection with the proposed merger transaction is inadequate and unfair because the transaction value of $42.00 for each share of our common stock does not provide our stockholders with a meaningful premium over the market price of the common stock. We believe the lawsuit is without merit and we intend to contest it vigorously.

***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 10 "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. 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 discussed in Note 10 "2006 LIA Settlement." Following the announcement of the proposed acquisition of KeySpan by National Grid, LIPA, National Grid 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.

As reported in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, KeySpan is currently in discussions with the Internal Revenue Service ("IRS") at the Appeals level with regard to the Long Island Lighting Company's ("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.

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 March 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:

| *Nature of Guarantee (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) | 71.7 | 2006 - 2008 |
| Commodity Guarantees and Other | (vi) | 52.9 | 2006 - 2009 |
| Letters of Credit | (vii) | 73.5 | 2006 - 2010 |
| | | $ 1,679.9 | |

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 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 of the lease has been extended to 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 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 March 31, 2006, the total cost to complete such remaining bonded projects is estimated to be approximately $33 million.

(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 March 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.

## 7. 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 this 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 March 31, 2006, after adjusting for forfeitures, there are approximately 2.8 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 three months ended March 31, 2005 would have decreased to the pro-forma amounts indicated below:

| (*In Millions of Dollars, Except Per Share Amounts)* | | March 31, 2005 |
|---|---|---|
| Earnings available for common stock: | | |
| As reported | $ | 234.4 |
| Add: recorded stock-based compensation expense, net of tax | | 2.9 |
| Deduct: total stock-based compensation expense, net of tax | | (3.4) |
| Pro-forma earnings | $ | 233.9 |
| Earnings per share: | | |
| Basic - as reported | $ | 1.45 |
| Basic - pro-forma | $ | 1.45 |
| | | |
| Diluted - as reported | $ | 1.44 |
| Diluted - pro-forma | $ | 1.44 |

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 three months ended March 31, 2006, KeySpan recorded an expense of $0.3 million for stock option awards previously accounted for under APB 25 and which have not 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.

| | Three Months Ended | | | |
|---|---|---|---|---|
| (*In Millions of Dollars, Except Per Share Amounts)* | | March 31, 2006 | | March 31, 2005 |
| Performance shares | $ | 2.3 | $ | 1.7 |
| Restricted stock | | 3.7 | | 0.2 |
| Stock options | | 1.5 | | 1.5 |
| EDSPP discount | | 1.5 | | 1.2 |
| Total stock-based compensation included in operations and maintenance expense | | 9.0 | | 4.6 |
| Income tax (benefit) | | (3.2) | | (1.7) |
| Total stock based compensation expense, net of tax | $ | 5.8 | $ | 2.9 |

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 three months ended March 31, 2006 and 2005, cash received from stock options exercised was $15.5 million and $24.3 million, respectively. The actual tax benefit realized for tax deductions from stock options exercised was $1.6 million and $2.6 million for the three months ended March 31, 2006 and 2005, respectively. The benefits received from these tax deductions were 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. Previously, these awards met the performance based criteria under SFAS 123. However, under SFAS 123(R), the goals associated with these awards are now viewed as market conditions, which prohibits the reversal of previously recognized expense should the attainment of the market condition not be met.

The 2006 performance share award was revised to reflect the new performance condition criteria under SFAS 123(R). In 2006, 314,560 performance shares were granted to officers. 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 originally awarded at target level or the number of shares earned based on actual performance through the change of control date. Under the performance based criteria associated with SFAS 123(R), the inability to achieve goals requires reversal of the previously recognized expense.

Performance share awards were priced at fair value. The unearned compensation as of March 31, 2006 associated with all of the performance share awards was $18.4 million. Upon a change of control, all performance share awards granted and outstanding will vest immediately.

*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 these awards is being amortized to compensation expense over the period in which the awards vest. 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 will be fully expensed by the end of this year and the 2006 award was expensed in the first quarter of 2006. Upon a change of control, all restricted stock awards will vest immediately. The unearned compensation as of March 31, 2006 associated with these awards was $0.4 million.

*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 538,551 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 grants issued in 2006. The following table presents the weighted average fair value, exercise price and assumptions used for the 2005 stock option grant:

| | 2005 |
|---|---|
| Fair value of grants issued | $ 5.47 |
| Dividend yield | 4.74% |
| Expected volatility | 23.48% |
| Risk free rate | 3.22% |
| Expected lives | 6.5 years |
| Exercise price | $ 37.54 |

A summary of the status of our fixed stock option plans and changes is presented below for the three months ended March 31, 2006:

| Fixed Options | Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value *(In Millions)* |
|---|---|---|---|
| Outstanding at beginning of period | 10,443,055 | $ 33.74 | |
| Granted during the year | - | $ - | |
| Exercised | (483,241) | $ 32.25 | |
| Forfeited | (7,656) | $ 38.52 | |
| Outstanding at end of period | 9,952,158 | $ 33.81 | $ 49.0 |
| Exercisable at end of period | 7,280,106 | $ 32.72 | $ 43.7 |

The total intrinsic value of the options exercised during the periods ending March 31, 2006 and 2005 was approximately $3.1 million and $4.5 million, respectively.

| Remaining Contractual Life | Options Outstanding at March 31, 2006 | Weighted Average Exercise Price | Range of Exercise Price | Options Exercisable at March 31, 2006 | Weighted Average Exercise Price | Range of Exercise Price |
|---|---|---|---|---|---|---|
| 1 years | 119,500 | $ 30.50 | 30.50 | 119,500 | $ 30.50 | 30.50 |
| 2 years | 186,410 | $ 32.52 | $ 19.15 - 32.63 | 186,410 | $ 32.52 | $ 19.15 - 32.63 |
| 3 years | 729,625 | $ 27.99 | $ 24.73 - 29.38 | 729,625 | $ 27.99 | $ 24.73 - 29.38 |
| 4 years | 382,181 | $ 26.97 | $ 21.99 - 27.06 | 382,181 | $ 26.97 | $ 21.99 - 27.06 |
| 5 years | 979,987 | $ 22.69 | $ 22.50 - 32.76 | 979,987 | $ 22.69 | $ 22.50 - 32.76 |
| 6 years | 1,582,578 | $ 39.50 | $39.50 | 1,582,578 | $ 39.50 | $39.50 |
| 7 years | 1,841,906 | $ 32.66 | $32.66 | 1,490,006 | $ 32.66 | $32.66 |
| 8 years | 1,231,531 | $ 32.40 | $32.40 | 807,931 | $ 32.40 | $32.40 |
| 9 years | 1,477,075 | $ 37.54 | $37.54 | 674,504 | $ 37.54 | $37.54 |
| 10 years | 1,421,365 | $ 39.25 | $39.25 | 327,384 | $ 39.25 | $39.25 |
| | 9,952,158 | | | 7,280,106 | | |

As of March 31, 2006, there are approximately 2.7 million options which have not yet vested. The unearned compensation cost related to these stock option awards is $7.8 million which is expected to be recognized over a weighted average period of 2.0 years.

## 8. POSTRETIREMENT BENEFITS

*Pension Plans:* The following information represents the consolidated net periodic pension cost for the three months ended March 31, 2006 and 2005 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 the 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:

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 |
| Service cost, benefits earned during the period | $ 16.1 | $ 15.0 |
| Interest cost on projected benefit obligation | 38.6 | 37.4 |
| Expected return on plan assets | (47.0) | (42.9) |
| Net amortization and deferral | 21.9 | 18.9 |
| Total pension cost | $ 29.6 | $ 28.4 |

*Other Postretirement Benefits:* The following information represents the consolidated net periodic other postretirement benefit cost for the three months ended March 31, 2006 and 2005 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:

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 |
| Service cost, benefits earned during the period | $ 6.9 | $ 6.3 |
| Interest cost on accumulated postretirement benefit obligation | 20.2 | 19.9 |
| Expected return on plan assets | (9.1) | (9.1) |
| Net amortization and deferral | 16.6 | 16.5 |
| Other postretirement cost | $ 34.6 | $ 33.6 |

During the first quarter of 2006, KeySpan contributed $4.0 million to its pension plans and $9.0 million to its other postretirement benefit plans. KeySpan anticipates contributing an additional $107 million to its pension and other postretirement benefit plans during the remainder of 2006.

These estimated contribution levels are subject to change based on future market returns, interest rates and certain other measurements. Actual contributions, therefore, may vary from these levels.

9. COMMERCIAL PAPER

At March 31, 2006, KeySpan had two credit facilities totaling $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 March 31, 2006, KeySpan's consolidated indebtedness was 48.9% 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 March 31, 2006, we had cash and temporary cash investments of $313.1 million. During the first quarter of 2006, we repaid $160.8 million of commercial paper and, at March 31, 2006, $496.8 million of commercial paper was outstanding at a weighted average annualized interest rate of 4.71%. At March 31, 2006, KeySpan had the ability to issue up to an additional $1 billion, under its commercial paper program.

## 10. 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 the Long Island Lighting Company's ("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 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. Following the announcement of the proposed acquisition of KeySpan by National Grid, LIPA, National Grid 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.

### *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 $91 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. 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. 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.

*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.

## 11. KEYSPAN GAS EAST CORPORATION SUMMARY FINANCIAL INFORMATION

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 the Long Island Lighting Company. KEDLI established a program for the issuance, from time to time, of up to $600 million aggregate principal amount of Medium-Term Notes, which are 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** | | | | | |
|---|---|---|---|---|---|
| | Three Months Ended March 31, 2006 | | | | |
| *(In Millions of Dollars)* | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
| **Revenues** | $ 0.2 | $ 543.7 | $ 2,117.4 | $ (0.2) | $ 2,661.1 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 364.9 | 1,146.5 | - | 1,511.4 |
| Fuel and purchased power | - | - | 130.0 | - | 130.0 |
| Operations and maintenance | 7.9 | 36.3 | 361.8 | - | 406.0 |
| Intercompany expense | - | 1.2 | (1.0) | (0.2) | - |
| Depreciation and amortization | - | 25.1 | 85.2 | - | 110.3 |
| Operating taxes | - | 17.7 | 100.5 | - | 118.2 |
| Total Operating Expenses | 7.9 | 445.2 | 1,823.0 | (0.2) | 2,275.9 |
| Income from equity investments | - | - | 3.4 | - | 3.4 |
| Gain on sale of property | - | - | 0.5 | - | 0.5 |
| **Operating Income (Loss)** | (7.7) | 98.5 | 298.3 | - | 389.1 |
| Interest charges | (39.8) | (14.1) | (53.0) | 40.7 | (66.2) |
| Other income and (deductions) | 249.2 | - | 19.4 | (257.2) | 11.4 |
| **Total Other Income and (Deductions)** | 209.4 | (14.1) | (33.6) | (216.5) | (54.8) |
| **Income Taxes (Benefit)** | (6.3) | 29.9 | 102.7 | - | 126.3 |
| **Net Income** | $ 208.0 | $ 54.5 | $ 162.0 | $ (216.5) | $ 208.0 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Three Months Ended March 31, 2005 | | | | |
| **Revenues** | $ 0.2 | $ 503.6 | $ 1,976.9 | $ (0.2) | $ 2,480.5 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 314.1 | 994.7 | - | 1,308.8 |
| Fuel and purchased power | - | - | 133.1 | - | 133.1 |
| Operations and maintenance | 6.3 | 32.5 | 348.4 | - | 387.2 |
| Intercompany expense | - | 1.3 | (1.3) | | - |
| Depreciation and amortization | - | 26.5 | 79.6 | - | 106.1 |
| Operating taxes | - | 17.0 | 94.9 | - | 111.9 |
| Total Operating Expenses | 6.3 | 391.4 | 1,649.4 | - | 2,047.1 |
| Income from equity investments | - | - | 5.3 | - | 5.3 |
| **Operating Income (Loss)** | (6.1) | 112.2 | 332.8 | (0.2) | 438.7 |
| Interest charges | (29.7) | (14.8) | (63.3) | 47.8 | (60.0) |
| Other income and (deductions) | 261.7 | 0.1 | 13.4 | (282.9) | (7.7) |
| **Total Other Income and (Deductions)** | 232.0 | (14.7) | (49.9) | (235.1) | (67.7) |
| **Income Taxes (Benefit)** | (9.8) | 34.1 | 111.0 | - | 135.3 |
| **Net Income** | $ 235.7 | $ 63.4 | $ 171.9 | $ (235.3) | $ 235.7 |

**Balance Sheet**

| (In Millions of Dollars) | Guarantor | KEDLI | March 31, 2006<br>Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & temporary cash investments | $ 276.2 | $ 3.6 | $ 33.3 | $ - | $ 313.1 |
| Accounts receivable, net | 0.7 | 226.1 | 891.0 | - | 1,117.8 |
| Other current assets | 3.0 | 202.9 | 1,042.0 | - | 1,247.9 |
| | 279.9 | 432.6 | 1,966.3 | - | 2,678.8 |
| **Equity Investments** | 4,791.3 | - | 134.9 | (4,674.1) | 252.1 |
| **Property** | | | | | |
| Gas | - | 2,128.7 | 5,223.8 | - | 7,352.5 |
| Other | - | 1.7 | 2,932.5 | - | 2,934.2 |
| Accumulated depreciation and depletion | - | (409.7) | (2,495.5) | - | (2,905.2) |
| | - | 1,720.7 | 5,660.8 | - | 7,381.5 |
| **Intercompany Accounts Receivable** | 2,607.0 | 582.1 | 786.9 | (3,976.0) | - |
| **Deferred Charges** | 481.4 | 300.9 | 2,397.9 | - | 3,180.2 |
| **Total Assets** | $ 8,159.6 | $ 3,036.3 | $ 10,946.8 | $ (8,650.1) | $ 13,492.6 |
| **LIABILITIES AND CAPITALIZATION** | | | | | |
| **Current Liabilities** | | | | | |
| Accounts payable | $ 46.9 | $ 91.6 | $ 629.1 | $ - | $ 767.6 |
| Commercial paper | 496.8 | - | - | - | 496.8 |
| Other current liabilities | 349.2 | 43.7 | 174.2 | - | 567.1 |
| | 892.9 | 135.3 | 803.3 | - | 1,831.5 |
| **Intercompany Accounts Payable** | 45.0 | 803.2 | 1,599.0 | (2,447.2) | - |
| **Deferred Credits and Other Liabilities** | | | | | |
| Deferred income tax | 25.4 | 335.2 | 783.4 | - | 1,144.0 |
| Other deferred credits and liabilities | 694.6 | 160.2 | 1,101.5 | - | 1,956.3 |
| | 720.0 | 495.4 | 1,884.9 | - | 3,100.3 |
| **Capitalization** | | | | | |
| Common shareholders' equity | 4,639.3 | 951.5 | 3,708.8 | (4,674.1) | 4,625.5 |
| Long-term debt | 1,862.4 | 650.9 | 2,935.5 | (1,528.8) | 3,920.0 |
| **Total Capitalization** | 6,501.7 | 1,602.4 | 6,644.3 | (6,202.9) | 8,545.5 |
| **Minority Interest in Subsidiary Companies** | - | - | 15.3 | - | 15.3 |
| **Total Liabilities & Capitalization** | $ 8,159.6 | $ 3,036.3 | $ 10,946.8 | $ (8,650.1) | $ 13,492.6 |

**Balance Sheet**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | | | December 31, 2005 | | |
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & 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 | - | 2,111.3 | 5,164.6 | - | 7,275.9 |
| Other | - | - | 3,092.8 | - | 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 Subsidiary Companies** | - | - | 15.3 | - | 15.3 |
| **Total Liabilities & Capitalization** | $ 7,951.3 | $ 2,594.4 | $ 10,678.2 | $ (7,411.3) | $ 13,812.6 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Three Months Ended March 31, 2006 Guarantor | KEDLI | Other Subsidiaries | Consolidated |
|---|---|---|---|---|
| **Operating Activities** | | | | |
| Net Cash Provided by Operating Activities | $ 32.7 | $ 142.1 | $ 369.1 | $ 543.9 |
| **Investing Activities** | | | | |
| Capital expenditures | - | (20.8) | (101.4) | (122.2) |
| Cost of removal | - | (0.6) | (6.1) | (6.7) |
| Net Cash Provided by (Used in) Investing Activities | - | (21.4) | (107.5) | (128.9) |
| **Financing Activities** | | | | |
| Treasury stock issued | 15.5 | - | - | 15.5 |
| Payment of debt, net | (160.8) | - | - | (160.8) |
| Common and preferred stock dividends paid | (81.1) | - | - | (81.1) |
| Net intercompany accounts | 390.3 | (120.6) | (269.7) | - |
| Net Cash Provided by (Used in) Financing Activities | 163.9 | (120.6) | (269.7) | (226.4) |
| Net Increase (Decrease) in Cash and Cash Equivalents | $ 196.6 | $ 0.1 | $ (8.1) | $ 188.6 |
| Cash and Cash Equivalents at Beginning of Period | 79.6 | 3.5 | 41.4 | 124.5 |
| Cash and Cash Equivalents at End of Period | $ 276.2 | $ 3.6 | $ 33.3 | $ 313.1 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Three Months Ended March 31, 2005 Guarantor | KEDLI | Other Subsidiaries | Consolidated |
|---|---|---|---|---|
| **Operating Activities** | | | | |
| Net Cash Provided by (Used in) Operating Activities | $ 33.4 | $ 81.6 | $ 268.4 | $ 383.4 |
| **Investing Activities** | | | | |
| Capital expenditures | - | (17.0) | (94.8) | (111.8) |
| Cost of removal | - | (0.3) | (4.5) | (4.8) |
| Proceeds from sale of property | - | - | 48.1 | 48.1 |
| Net Cash Used in Investing Activities | - | (17.3) | (51.2) | (68.5) |
| **Financing Activities** | | | | |
| Treasury stock issued | 24.3 | - | - | 24.3 |
| Payment of debt, net | (941.4) | - | (15.0) | (956.4) |
| Common and preferred stock dividends paid | (75.9) | - | - | (75.9) |
| Other | 9.1 | - | - | 9.1 |
| Intercompany dividend payment | 265.0 | | (265.0) | - |
| Net intercompany accounts | 187.5 | (68.6) | (118.9) | - |
| Net Cash Provided by (Used in) Financing Activities | (531.4) | (68.6) | (398.9) | (998.9) |
| Net Increase (Decrease) in Cash and Cash Equivalents | $ (498.0) | $ (4.3) | $ (181.7) | $ (684.0) |
| Net Cash Flow from Discontinued Operations | - | - | (15.0) | (15.0) |
| Cash and Cash Equivalents at Beginning of Period | 580.7 | (0.9) | 342.2 | 922.0 |
| Cash and Cash Equivalents at End of Period | $ 82.7 | $ (5.2) | $ 145.5 | $ 223.0 |

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Consolidated Review of Results**

The following is a summary of transactions affecting comparative earnings for the three months ended March 31, 2006, compared to the three months ended March 31, 2005. Capitalized terms used in the following discussion, but not otherwise defined, have the same meaning as when used in the Notes to the Consolidated Financial Statements included under Item 1. References to "KeySpan," "we," "us," and "our" mean KeySpan Corporation, together with its consolidated subsidiaries.

Operating income by segment, as well as consolidated earnings for common stock is set forth in the following table for the periods indicated.

*(In Millions of Dollars, Except per Share)*

| Quarter Ended March 31, | 2006 | 2005 |
|---|---|---|
| Gas Distribution | $ 336.4 | $ 391.9 |
| Electric Services | 65.0 | 51.0 |
| Energy Services | (0.4) | (2.8) |
| Energy Investments | 3.0 | 6.4 |
| Eliminations and other | (14.9) | (7.8) |
| **Operating Income** | 389.1 | 438.7 |
| Other income and (deductions) | | |
| Interest charges | (66.2) | (60.0) |
| Gain on sale of investments | - | 4.1 |
| Cost of debt redemption | - | (20.9) |
| Other income and (deductions) | 11.4 | 9.1 |
| | (54.8) | (67.7) |
| Income taxes | 126.3 | 135.3 |
| **Earnings from continuing operations** | 208.0 | 235.7 |
| Discontinued operations | - | - |
| **Net Income** | 208.0 | 235.7 |
| Preferred stock dividend requirements | - | 1.3 |
| **Earnings for Common Stock** | $ 208.0 | $ 234.4 |
| **Basic Earnings per Share** | $ 1.19 | $ 1.45 |

KeySpan's earnings for common stock for the three months ended March 31, 2006, were $208.0 million, or $1.19 per share, compared to $234.4 million or $1.45 per share realized during the corresponding period last year, a decrease of $26.4 million, or $0.26 per share.

As indicated in the above table, operating income decreased $49.6 million, or 11% for the quarter ended March 31, 2006, compared to the corresponding period last year. The comparative operating income primarily reflects lower earnings from the Gas Distribution segment of $55.5 million, partially offset by higher earnings from KeySpan's electric operations of $14.0 million. Operating income from the Gas Distribution segment was adversely impacted by the warm weather during the first quarter of 2006 which resulted in a decrease to comparative net gas revenues (revenues less the cost of gas and associated revenue taxes). The Electric Services segment results were favorably impacted by an increase in electric revenues from KeySpan's merchant electric generating facilities. (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 a subsidiary stock transaction and other miscellaneous items. For the three months ended March 31, 2006, other income and (deductions) reflects a net expense of $54.8 million compared to a net expense of $67.7 million for the three months ended March 31, 2005. The favorable variation of $12.9 million is primarily due to debt redemption costs incurred in 2005. In 2005, KeySpan redeemed $500 million 6.15% Series Notes due 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.

In addition, other income and (deductions) for the first quarter of 2005 reflects 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 resulted in a pre-tax gain of $4.1 million reflecting the difference from earlier estimates.

Income tax expense for the first quarter of 2006 and 2005 generally reflects the level of pre-tax income.

As noted previously, KeySpan's earnings for common stock for the three months ended March 31, 2006 decreased $26.4 million, or $0.26 per share, compared to same period of 2005 primarily reflecting the items noted - specifically lower earnings from KeySpan's gas distribution operations, partially offset by higher earnings from electric services operations. In addition, earnings per share for the first quarter of 2006 reflects a higher level of outstanding common stock compared to last year. In May 2005, KeySpan issued 12.1 million shares of common stock upon the conversion of previously held MEDs Equity Units. The dilutive effect of this issuance, in addition to KeySpan's employee stock purchase plans, on earnings per share for the first quarter of 2006 was approximately $0.10 per share. (See KeySpan's Annual Report of Form 10-K for the year ended December 31, 2005, Note 6 to the Consolidated Financial Statements "Long-term Debt and Commercial Paper" for additional details on 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.

In light of the pending Merger between KeySpan and National Grid and the widespread integration efforts being undertaken by both companies, KeySpan believes that it is no longer relevant to comment on guidance.

**Review of Operating Segments**

KeySpan reports its segment results 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, and 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 gas distribution companies - Boston Gas Company, Colonial Gas Company, Essex 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)* | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Revenues | $ 2,180.1 | $ 2,025.5 |
| Cost of gas | 1,512.6 | 1,313.4 |
| Revenue taxes | 26.2 | 24.8 |
| Net Revenues | 641.3 | 687.3 |
| Operating Expenses | | |
| Operations and maintenance | 190.4 | 181.8 |
| Depreciation and amortization | 75.9 | 76.8 |
| Operating taxes | 38.6 | 36.8 |
| Total Operating Expenses | 304.9 | 295.4 |
| Operating Income | $ 336.4 | $ 391.9 |
| Firm gas sales and transportation (MDTH) | 126,904 | 150,626 |
| Transportation - Electric Generation (MDTH) | 6,471 | 2,840 |
| Other Sales (MDTH) | 52,332 | 56,547 |
| Warmer (Colder) than Normal - New York | 13.0% | (2.7)% |
| Warmer (Colder) than Normal - New England | 7.7% | (6.6)% |

A MDTH is 10,000 therms (British Thermal Units) 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 decreased $55.5 million for the three months ended March 31, 2006 compared to the same period last year, primarily due to a decrease in net gas revenues (revenues less the cost of gas and associated revenue taxes) of $46.0 million, primarily resulting from the warm first quarter weather. Further, operating expenses increased $9.5 million due, in part to, to an increase of $4.7 million in the provision for uncollectible accounts receivable as a result of higher gas costs, as well as to higher employee benefit related expenses.

*Net Revenues*

Net gas revenues from our gas distribution operations decreased $46.0 million, or 7%, in the first quarter of 2006 compared to the same quarter 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 first quarter of 2006. As measured in heating degree days, weather for the first quarter of 2006 in our New York and New England service territories was approximately 13% and 8% warmer than normal, respectively, and was approximately 15% warmer than last year across KeySpan’s service territories.

Net revenues from firm gas customers (residential, commercial and industrial customers) decreased by $48.7 million in the first quarter of 2006 compared to the same period last year. The favorable impact to net gas revenues from load growth additions was more than offset by the adverse impact of conservation measures adopted by firm gas sales customers and by the warm weather. Load growth additions from oil-to-gas conversions, primarily for space heating purposes, as well as from new construction in 2005, resulted in a benefit to net gas revenues of $7.5 million in the first quarter of 2006. However, these load growth additions were offset by declining usage per customer due to the extremely warm first quarter weather, the use of more efficient gas heating equipment and higher gas costs that, in the aggregate, resulted in an adverse impact to net gas revenues of $56.2 million, net of the benefits from the weather normalization adjustments and weather derivatives discussed below.

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 $25 million during the first quarter of 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 winter heating season. These financial derivatives afforded KeySpan some protection against warmer than normal weather. As noted, weather for the first quarter of 2006 was approximately 8% warmer than normal in KeySpan's New England service territory; however for the entire primary winter heating season –November 2005 through March 2006 – weather was slightly colder than normal. Therefore, there was no earnings impact associated with these weather derivatives for the first quarter of 2006. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" 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 $2.7 million during the first quarter of 2006 compared to the same period last year reflecting higher pricing.

*Firm Sales, Transportation and Other Quantities*

Firm gas sales and transportation quantities for the quarter ended March 31, 2006, decreased 16% compared to the same period in 2005 due primarily to the warmer weather this year compared to last year. Customer additions and oil-to-gas conversions offset the full impact of the warmer weather. 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. The decrease in these sales quantities for the three months ended March 31, 2006, compared to the same period of 2005 reflects the warm weather experienced. We have a management contract with Merrill Lynch Trading, under which Merrill Lynch Trading provides portfolio management services to KeySpan's Massachusetts gas distribution subsidiaries. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

*Purchased Gas for Resale*

The increase in gas costs for the first quarter of 2006 compared to the first quarter of 2005 of $199.2 million, or 15%, reflects an increase of 32% in the price per dekatherm of gas purchased for firm gas sales customers, offset by a 16% decrease in the quantity of gas purchased due to the warm first quarter weather. 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 during the first quarter of 2006 compared to the same quarter last year increased $9.5 million, or 3%. Operations and maintenance expense increased $8.6 million, or 5%, in 2006 compared to 2005 primarily due to an increase of $4.7 million in the provision for uncollectible accounts as a result of increasing gas costs, as well as from an increase in employee benefit costs, including postretirement costs.

Comparative operating taxes increased $1.8 million due to the expiration of a five-year property tax assessment agreement with New York City. Higher depreciation charges of $1.5 million reflecting the continued expansion of the gas distribution system were offset by lower regulatory amortization charges of $2.4 million.

*Gas Supply and Pricing*

KeySpan had adequate gas supply available to meet its gas load demand in its service territories for the 2005/2006 winter heating season as KeySpan's gas storage was 100% full at the start of the winter heating season. The current gas rate structure of each of our gas distribution utilities includes 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, management is concerned with the rising natural gas prices and the related impact on customers' gas bills and recovery of customer accounts receivable. As noted, KeySpan has already experienced an increase in bad debt expense and an increase in collection lag. Further, the high gas prices has led to an increase in price elasticity resulting in 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 should help to mitigate the increase in bad debt expense.

With our strategy of having KeySpan's storage facilities 100% full at the start of the heating season and our use of financial derivatives, KeySpan effectively hedged the price of approximately two-thirds of the gas supply that was needed to serve its customers during the 2005/2006 winter. This helped mitigate the impact from rising 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, which we supported the expansion of through the Energy Policy Act of 2005. Management believes that these measures helped mitigate the impact of rising 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 rising 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 our market segments, through the expansion of our gas distribution system for new 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 where natural gas is already in the home for other uses 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 Duke Energy Corporation formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Once in service, the pipeline is expected to transport up to 260,000 DTH of natural gas to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. In addition, KeySpan has a 26.25% interest 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 150,000 DTH of natural gas per day of transportation capacity from the Millennium Pipeline system, increasing to 200,000 DTH in the third 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 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; (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". (For a further discussion on these LIPA agreements see Note 10 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) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Revenues | $ 424.8 | $ 405.0 |
| Purchased fuel | 130.0 | 133.0 |
| Net Revenues | 294.8 | 272.0 |
| Operating Expenses | | |
| Operations and maintenance | 155.3 | 153.6 |
| Depreciation | 27.1 | 22.8 |
| Operating taxes | 47.4 | 44.6 |
| Total Operating Expenses | 229.8 | 221.0 |
| Operating Income | $ 65.0 | $ 51.0 |
| Electric sales (MWH)* | 806,677 | 1,001,408 |
| Capacity(MW)* | 2,450 | 2,450 |
| Cooling degree days | N/A | N/A |

*Reflects the operations of the Ravenswood Generating Station only.

*Executive Summary*

Operating income increased $14.0 million, or 27%, for the three months ended March 31, 2006, compared to the same period last year, due primarily to an increase in net revenues from the Ravenswood Generating Station of $23.9 million as a result of improved pricing and gains from the settlement of derivative financial instruments. The hedging strategies that were in place during the first quarter of 2006 were consistent with past KeySpan policy to hedge the cash flow variability associated with a portion of forecasted electric energy sales from the Ravenswood Generating Station. This benefit to operating income was partially offset by an increase in operating expenses of $8.8 million primarily as a result of higher depreciation charges and property taxes.

*Net Revenues*

Total electric net revenues realized during the first quarter of 2006 were $22.8 million, or 8% higher than such revenues realized during the corresponding period last year.

Net revenues from the Ravenswood Generating Station increased $23.9 million, or 35% for the three months ended March 31, 2006, compared to the same period last year reflecting increased energy margins of $38.0 million. Capacity revenues, however, decreased $14.1 million reflecting lower volume sales as a result of new installed capacity additions in New York City.

The increase in energy margins for the first quarter of 2006 primarily reflects the settlement of derivative financial instruments. 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 Generating Station. 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 Generating Station. These derivative instruments resulted in hedging gains, which are reflected in net electric margins, of $56.3 million for the first quarter of 2006 compared to hedging gains of $3.0 million for the first quarter of 2005. The benefits to energy margins from KeySpan's hedging strategy were partially offset by an 84% decrease in realized "spark-spreads" (the selling price of electricity less the cost of fuel, exclusive of hedging gains or losses). Further, the level of MWh sold into the New York Independent System Operator ("NYISO") energy market decreased 19%. Combined, these two items reduced energy margins by $15.3 million. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for further information on KeySpan's hedging strategy.)

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 "Market and Credit Risk Management Activities" for further details on these matters.

Net revenues for the first quarter of 2006 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, decreased approximately $2.0 million compared to the first quarter of 2005. This reflects a decrease $4.5 million in the level of incentives earned on these agreements, as well as lower revenues associated with KeySpan's Long Island based electric generating units of $1.0 million due to the warm winter weather. The lower level of incentives is, in part, timing in nature. Partially offsetting these adverse impacts to net electric revenues, was an increase in recoverable operations and maintenance costs from LIPA of $3.5 million. (For a description of the LIPA Agreements and power purchase agreements, see KeySpan's 2005 Annual Report on Form 10-K for the year ended December 31, 2005 Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "Electric Services – Revenue Mechanisms.")

Revenues associated with KeySpan's electric marketing activities during the first quarter of 2006 have remained consistent with such revenues realized during the same period last year.

*Operating Expenses*

Operating expenses increased $8.8 million, or 4%, for the first quarter of 2006 compared to the first quarter of 2005. Operations and maintenance expense posted a slight increase compared to last year - $1.7 million or 1% - reflecting a $3.5 million increase in recoverable operations and maintenance costs from LIPA as noted above, offset by a decrease in overhaul costs at the Ravenswood Generating Station . The decrease in overhaul costs are primarily timing related, since we anticipate incurring the same level of overhaul expenses at the Ravenswood Generating Station in 2006 as we incurred in 2005. The increase in depreciation expense is associated with KeySpan's Long Island based electric generating units. The higher operating taxes primarily reflect an increase in property taxes, also related to KeySpan's Long Island based electric generating units.

*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 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 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. We have begun discussions with LIPA regarding this proposal. At March 31, 2006, total capitalized costs associated with the siting, permitting and procurement of equipment for the Melville facility were $61.8 million.

As part of our growth strategy, we continually evaluate the possible acquisition and development of additional generating facilities in the Northeast, as well as other assets to complement our core operations. 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.

On February 6, 2006, the NYISO's New York City local reliability rules that required that 80% of the electric capacity needs of New York City be provided by "in-City" generators was increased to 83%. However, in March 2006, the NYISO Operating Committee reversed its decision and returned the local reliability rules to 80%. See the discussion under the caption "Market and Credit Risk Management Activities – Regulatory Issues and the Competitive Environment" for further information regarding this matter.

**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.

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 |
| Revenues | $ 50.9 | $ 47.1 |
| Operating expenses | 51.3 | 49.9 |
| Operating (Loss) | $ (0.4) | $ (2.8) |

The Energy Services segment incurred a seasonal operating loss of $0.4 million for the first quarter of 2006 compared to an operating loss of $2.8 million incurred in the first quarter of 2005. The improved performance reflects higher gross profit margins on engineering and service contracts, as well as a reduction in general and administrative expenses.

**Energy Investments**

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 its 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 primarily engaged in a joint venture with The Houston Exploration Company, an independent natural gas and oil exploration company that was a former KeySpan subsidiary.

This segment is also engaged in pipeline development activities. KeySpan and 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, during the first quarter of 2006, KeySpan increased its interest in the Millennium Pipeline Company LLC to 26.25% from 21%. The Millennium Pipeline Company LLC is the developer of 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 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. KeySpan has filed a petition for judicial review of a FERC decision that denied KeySpan LNG's application for FERC authorization to expand the facility to accept marine deliveries and triple vaporization capacity.

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. On March 18, 2005, the sale was completed and generated cash proceeds of $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 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.

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

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 |
| Revenues | $ 9.1 | $ 10.1 |
| Less: Operation and maintenance expense | 6.6 | 6.5 |
| Other operating expenses | 3.1 | 2.5 |
| Add: Equity earnings | 3.4 | 5.3 |
| Gain on sale of property | 0.2 | - |
| Operating Income | $ 3.0 | $ 6.4 |

As indicated in the above table, operating income for the Energy Investments segment decreased $3.4 million in the first quarter of 2006 compared to the corresponding period of 2005 due, in part, to lower equity earnings as a result of the sale Premier. Further, a KeySpan subsidiary engaged in the transportation of liquefied natural gas realized lower earnings due to the warm first quarter weather.

*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 Secretary of Commerce 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 and a decision from that court is pending. 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 Policy Act of 2005 (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. The appeal was argued in January 2006. Further, oral arguments on the constitutional and jurisdictional issues were held in April 2006. Various options for the financing of this pipeline construction are being evaluated. As of March 31, 2006, KeySpan's total capitalized costs associated with the siting and permitting of the Islander East pipeline were approximately $25.6 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., a unit of NiSource Incorporated and DTE Energy. 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, Consolidated Edison Company of New York Inc. ("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 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, it is anticipated that the Millennium Pipeline will be in service in either 2007 or 2008. As of March 31, 2006, KeySpan's investment in the Millennium Pipeline project was $13.6 million.

In 2005, KeySpan LNG entered into a development agreement with BG, LNG Services, a subsidiary of British Gas, to upgrade the KeySpan LNG's liquefied natural gas 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 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.

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. As of March 31, 2006, our investment in this project was $15.8 million, a portion of which may be subject to reimbursement from BG LNG pursuant to the terms of the development 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 corporate advertising.

**Liquidity**

Cash flow from operations increased $160.5 million in the first quarter of 2006 compared to the same period last year primarily reflecting favorable working capital requirements and the timing of income tax payments.

At March 31, 2006, we had cash and temporary cash investments of $313.1 million. During the first quarter of 2006, we repaid $160.8 million of commercial paper and, at March 31, 2006, $496.8 million of commercial paper was outstanding at a weighted-average annualized interest rate of 4.71%. We had the ability to borrow up to an additional $1 billion at March 31, 2006, under the terms of our credit facility.

KeySpan has two credit facilities which total $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 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 March 31, 2006, KeySpan's consolidated indebtedness was 48.9% 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 Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement" 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) | Three Months Ended March 31, 2006 | 2005 |
|---|---|---|
| Gas Distribution | $ 85.8 | $ 71.6 |
| Electric Services | 28.9 | 31.1 |
| Energy Investments | 5.4 | 6.6 |
| Energy Services and other | 2.1 | 2.5 |
| | $ 122.2 | $ 111.8 |

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. The increase in capital expenditures for the three months ended March 31, 2006 compared to the same period last year of $10.4 million reflects an increase in the Gas Distribution segment mainly due to the timing of capital main and service work. KeySpan anticipates incurring approximately the same amount of construction expenditures in 2006 as it incurred in 2005.

*Financing*

KeySpan did not engage in any financing activities in the first quarter of 2006, other than commercial paper repayments as noted earlier. However, KeySpan anticipates refinancing two tax exempt bonds at KEDNY in the summer of 2006 - $153.5 million 5.5% due January 1, 2021 and $100 million 6.95% due July 1, 2026.

The following table represents the ratings of our long-term debt at March 31, 2006. In 2004 Standard & Poor's reaffirmed its ratings on KeySpan's and its subsidiaries' long-term debt and removed its negative outlook. Further in 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 March 31, 2006. 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 $71.7 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 $52.9 million; and (iii) $73.5 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 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees.)

**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. These obligations have remained substantially unchanged since December 31, 2005. (For additional details regarding these obligations see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as Note 6 "Long-Term Debt" and Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" to those Consolidated Financial Statements.)

**Discussions 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.

Below is a discussion of KeySpan's critical accounting policies and assumptions at March 31, 2006. For a more detailed discussion of these policies and assumptions see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations "Discussion of Critical Accounting Policies and Assumptions."

*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 annual operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set annual budgetary guidelines. At March 31, 2006, KeySpan has $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.

*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 orders issued by the MADTE relating to the Eastern Enterprise acquisition in 2000, 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.

As is further discussed under the caption "Regulation and Rate Matters," 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*

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.

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At March 31, 2006, we had a funding credit balance in excess of the ERISA minimum funding requirements. Although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Therefore,
for 2006, KeySpan expects to contribute a total of $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. (In addition to Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, see also Note 4 of those Consolidated Financial Statements, "Postretirement Benefits.")

**Regulation and Rate Matters**

*Gas Matters*

The rate agreements for KEDNY and KEDLI have expired. Under the terms of the KEDNY and KEDLI rate agreements, gas distribution rates and all other provisions 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 the KEDNY and KEDLI rate plans, including but not limited to, proposing new rate plans.

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 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's 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'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 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 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 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. Boston Gas also plans to request full recovery, as an exogenous cost, the 2005 gas cost component of bad debt write-offs from Boston Gas ratepayers beginning November 1, 2006.

For an additional discussion of our current gas distribution rate agreements, see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Regulation and Rate Matters."

*Electric 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% 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.

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. (For a further discussion on the LIPA agreements see Note 10 to the Consolidated Financial Statements "2006

LIPA Settlement," as well as KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Electric Services – LIPA 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. 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.

**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.

We estimate that the remaining cost of our MGP related environmental cleanup activities, including costs associated with the Ravenswood Generating Station, will be approximately $394.3 million and we have recorded a related liability for such amount. We have also recorded an additional $19.4 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of March 31, 2006, we have expended a total of $184.2 million on environmental investigation and remediation activities. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies.")

**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. The most significant contingency involves the evolution of the gas distribution and electric industries towards more competitive and deregulated environments. The risks associated with KeySpan's gas distribution activities have not changed substantially since December 31, 2005. For additional information regarding these risks see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Market and Credit Risk Management Activities." The following is an update to certain matters related KeySpan's electric operations.

*The Ravenswood Generating Station and KeySpan's 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 rerunning 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%.

## Item 3. 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 Generating Station uses 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 Generating Station also hedges the cash flow variability associated with a portion of electric energy sales using OTC electricity swaps.

KeySpan uses market quoted forward prices to value OTC swap contracts.

*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 the first quarter, 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 2006 through October 2006 and further complement our hedging strategy noted above regarding sales to certain large-volume customers. Further, the Ravenswood facility has also employed a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133 associated with the purchase of fuel oil. Additionally, KeySpan entered into an International SWAP Dealers Association Master Agreement for a fixed for float unforced capacity financial swap with Morgan Stanley Capital Group Inc.

The following tables set forth selected financial data associated with these derivative financial instruments noted above that were outstanding at March 31, 2006.

| **Type of Contract** | **Year of Maturity** | **Volumes mmcf** | **Fixed Price $** | **Current Price $** | **Fair Value (In $ Millions)** |
|---|---|---|---|---|---|
| **Gas** | | | | | |
| Swaps/Futures - Long Natural Gas | 2006 | 4,468 | 7.67 - 8.50 | 7.69 - 8.27 | (1.7) |
| OTC Swaps - Short Natural Gas | 2006 | 1,389 | 6.17 - 6.29 | 7.52 - 10.50 | (3.0) |
| | 2007 | 1,702 | 5.86 - 5.97 | 9.27 - 11.16 | (6.9) |
| | 2008 | 1,552 | 6.77 - 6.85 | 8.59 - 11.19 | (4.1) |
| | | 9,111 | | | (15.7) |

| **Type of Contract** | **Year of Maturity** | **Volumes Barrels** | **Fixed Price $** | **Current Price $** | **Fair Value (In $ Millions)** |
|---|---|---|---|---|---|
| **Oil** | | | | | |
| Swaps - Long Fuel Oil | 2006 | 952,625 | 57.00 - 66.80 | 53.49 - 58.10 | (4.6) |
| | 2007 | 2,875 | 59.20 - 62.14 | 62.51 | - |
| Swaps - Short Heating Oil | 2006 | 406,004 | 73.50 - 79.38 | 78.12 - 82.74 | (1.7) |
| | | 1,361,504 | | | (6.3) |

| Type of Contract | Year of Maturity | MWh | Fixed Margin/ Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Electricity** | | | | | |
| Swaps - Energy | 2006 | 898 | 73.50 - 156.25 | 69.96 - 118.90 | 20.1 |
| | | 898 | | | 20.1 |

| *Change in Fair Value of Derivative Instruments* | **2006 (In $ Millions)** |
|---|---|
| Fair value of contracts at January 1, | (18.1) |
| Net (gains) on contracts realized | (54.9) |
| Increase in fair value of all open contracts | 71.1 |
| Fair value of contracts outstanding at March 31, | (1.9) |

| *(In Millions of Dollars)* | **Fair Value of Contracts** | | |
|---|---|---|---|
| Sources of Fair Value | **Mature Within 12 Months** | **Thereafter** | **Total Fair Value** |
| Prices actively quoted | $ (6.4) | $ (8.8) | $ (15.2) |
| Local published indicies | 13.3 | - | 13.3 |
| | $ 6.9 | $ (8.8) | $ (1.9) |

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 March 31, 2006 a 10% increase/decrease in natural gas prices would decrease/increase the value of derivative instruments maturing in one year by $1.7 million. Further, a 10% increase/decrease in electricity and fuel prices would decrease/increase the value of derivative instruments maturing in one year by $3.6 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 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 March 31, 2006.

| Type of Contract | Year of Maturity | Volumes mmcf | Floor ($) | Ceiling ($) | Fixed Price ($) | Current Price ($) | Fair Value (In $ Millions) |
|---|---|---|---|---|---|---|---|
| Options | 2006 | 2,096 | 5.50 | 10.00 | - | 7.21 - 10.07 | 1.7 |
| Swaps | 2006 | 27,470 | - | - | 7.35 - 11.63 | 7.21 - 10.07 | (18.8) |
| | 2007 | 35,130 | - | - | 6.81 - 11.99 | 8.90 - 10.72 | 3.0 |
| | | 64,696 | | | | | (14.1) |

See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for a further description of all our derivative instruments.

## Item 4. Controls and Procedures

We maintain disclosure controls and procedures (as defined under Exchange Act Rule 13a-15(e) and 15d-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 March 31, 2006. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our 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.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

See Note 6 to the Consolidated Financial Statements "Financial Guarantees and Contingencies".

### Item 1A. Risk Factors

Certain statements contained in this Quarterly Report on Form 10-Q concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are other than statements of historical facts, are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Without limiting the foregoing, all statements under the captions "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk" relating to our future outlook, anticipated capital expenditures, future cash flows and borrowings, pursuit of potential future acquisition opportunities and sources of funding, are forward-looking statements. Such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties and actual results may differ materially from those discussed in such statements.

Among the factors that could cause actual results to differ materially are:

- occurrence or impact of the potential merger with National Grid plc;

- volatility of energy prices 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 manage our cost structure and operate efficiently;

- our ability to successfully contract for natural gas supplies required to meet the needs of our customers;

- implementation of new accounting standards or changes in accounting standards or GAAP which may require adjustments to financial statements;

- inflationary trends and interest rates;

- the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of such acquisitions;

- available sources and cost of fuel;

- creditworthiness of counterparties to derivative instruments and commodity contracts;

- the resolution of certain disputes with LIPA concerning each party's rights and obligations under various agreements;

- retention of key personnel;

- federal and state regulatory initiatives that threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses and conduct operations;

- the impact of federal, state and local utility regulatory policies, legislation 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 facing our unregulated Energy Services businesses;

- the degree to which we develop unregulated business ventures, as well as federal, state and local regulatory policies affecting our ability to retain and operate such business ventures profitably;

- a change in the fair value of our investments that could cause a significant change in the carrying value of such investments or the carrying value of related goodwill;

- timely receipts of payments from our two largest customers LIPA and the NYISO;

- changes in the UCAP pricing structure;

- timing of approval of the 2006 LIPA Agreements and;

- other risks detailed from time to time in other reports and other documents filed by KeySpan with the SEC.

For any of these statements, KeySpan claims the protection of the safe harbor for forward-looking information contained in the Private Securities Litigation Reform Act of 1995, as amended. For additional discussion on these risks, uncertainties and assumptions, see "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk."

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

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.

**Item 5. Other Information**

The following disclosure would otherwise have been filed on Form 8-K under the heading "Item 1.01 - Entry into a Material Definitive Agreement".

On May 3, 2006, KeySpan’s Board of Directors increased the annual base salary of Robert J. Fani, President and Chief Operating Officer from $782,000 to $860.000 effective August 1, 2006.

**Item 6. Exhibits**

31.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

10.1* KeySpan’s Amended Senior Executive Change of Control Severance Plan

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*Filed Herewith

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on behalf of the undersigned there unto duly authorized.

**KEYSPAN CORPORATION**

(Registrant)

By: /s/Gerald Luterman
Name: Gerald Luterman
Title: Executive Vice President and
Chief Financial Officer

Date: May 4, 2006

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President and
Chief Financial Officer

Date: May 4, 2006

/s/ Theresa A. Balog
Theresa A. Balog
Vice President and
Chief Accounting Officer

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**ANNUAL REPORT**
**PURSUANT TO SECTION 13 OR 15(d)**
**OF THE SECURITIES EXCHANGE ACT OF 1934**

**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2006

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to _________

**Commission file number 1-14161**

**KEYSPAN CORPORATION**
(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| **NEW YORK** | **11-3431358** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| **One MetroTech Center, Brooklyn, New York** | **11201** |
| **175 East Old Country Road, Hicksville, New York** | **11801** |
| (Address of Principal Executive Offices) | (Zip Code) |

**(718) 403-1000 (Brooklyn)**
**(516) 755-6650 (Hicksville)**
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes**[X]** No**[ ]**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

Large accelerated filer **[X]** Accelerated filer **[ ]** Non-accelerated filer **[ ]**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes**[X]** No**[ ]**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class of Common Stock | Outstanding at July 18, 2006 |
|---|---|
| $.01 par value | 175,022,851 |

KEYSPAN CORPORATION AND SUBSIDIARIES

INDEX

## CONSOLIDATED BALANCE SHEET
(Unaudited)

| *(In Millions of Dollars)* | **June 30, 2006** | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and temporary cash investments | **$ 40.1** | $ 124.5 |
| Restricted cash | **6.3** | 13.2 |
| Accounts receivable | **934.5** | 1,035.6 |
| Unbilled revenue | **236.6** | 685.6 |
| Allowance for uncollectible accounts | **(77.4)** | (62.8) |
| Gas in storage, at average cost | **690.7** | 766.9 |
| Material and supplies, at average cost | **127.0** | 140.5 |
| Derivative contracts | **24.9** | 142.8 |
| Other | **126.0** | 173.8 |
| | **2,108.7** | 3,020.1 |
| **Investments and Other** | **251.3** | 242.4 |
| **Property** | | |
| Gas | **7,444.9** | 7,275.9 |
| Electric | **2,533.4** | 2,492.3 |
| Other | **423.0** | 416.3 |
| Accumulated depreciation | **(3,035.5)** | (2,922.6) |
| Gas exploration and production, at cost | **185.3** | 184.2 |
| Accumulated depletion | **(119.8)** | (109.2) |
| | **7,431.3** | 7,336.9 |
| **Deferred Charges** | | |
| Regulatory assets: | | |
| Miscellaneous assets | **710.9** | 688.3 |
| Derivative contracts | **50.8** | 30.9 |
| Goodwill and other intangible assets | **1,666.3** | 1,666.3 |
| Derivative contracts | **69.9** | 75.2 |
| Other | **771.0** | 752.5 |
| | **3,268.9** | 3,213.2 |
| **Total Assets** | **$ 13,060.2** | $ 13,812.6 |

See accompanying Notes to the Consolidated Financial Statements.

# CONSOLIDATED BALANCE SHEET
(Unaudited)

| *(In Millions of Dollars)* | **June 30, 2006** | December 31, 2005 |
|---|---|---|
| **LIABILITIES AND CAPITALIZATION** | | |
| **Current Liabilities** | | |
| Accounts payable and other liabilities | **$ 683.2** | $ 1,087.0 |
| Commercial paper | **190.0** | 657.6 |
| Current redemption of long-term debt | **13.4** | 13.0 |
| Taxes accrued | **161.3** | 176.3 |
| Dividends payable | **81.4** | 81.1 |
| Customer deposits | **36.5** | 39.1 |
| Interest accrued | **55.9** | 53.8 |
| Derivative contracts | **68.4** | 47.3 |
| | **1,290.1** | 2,155.2 |
| **Deferred Credits and Other Liabilities** | | |
| Regulatory liabilities: | | |
| Miscellaneous liabilities | **56.2** | 69.9 |
| Removal cost recovered | **538.0** | 516.4 |
| Derivative contracts | **53.0** | 175.4 |
| Asset retirement obligations | **48.8** | 47.4 |
| Deferred income tax | **1,178.5** | 1,157.9 |
| Postretirement benefits and other reserves | **1,216.2** | 1,118.4 |
| Derivative contracts | **36.9** | 44.3 |
| Other | **120.0** | 127.5 |
| | **3,247.6** | 3,257.2 |
| **Commitments and Contingencies (See Note 6)** | **-** | - |
| **Capitalization** | | |
| Common stock - 184,864 shares issued, 175,018 shares outstanding, par value $0.01 | **3,983.2** | 3,975.9 |
| Retained earnings | **961.6** | 866.9 |
| Other comprehensive (loss) | **(72.5)** | (74.8) |
| Treasury stock | **(285.0)** | (303.9) |
| Total common shareholders' equity | **4,587.3** | 4,464.1 |
| Long-term debt and capital leases | **3,919.8** | 3,920.8 |
| **Total Capitalization** | **8,507.1** | 8,384.9 |
| **Minority Interest in Subsidiary Companies** | **15.4** | 15.3 |
| **Total Liabilities and Capitalization** | **$ 13,060.2** | $ 13,812.6 |

See accompanying Notes to the Consolidated Financial Statements.

# CONSOLIDATED STATEMENT OF INCOME
(Unaudited)

| *(In Millions of Dollars, Except Per Share Amounts)* | Three Months Ended June 30, **2006** | 2005 | Six Months Ended June 30, **2006** | 2005 |
|---|---|---|---|---|
| **Revenues** | | | | |
| Gas Distribution | **$ 873.2** | $ 821.1 | **$ 3,053.3** | $ 2,846.5 |
| Electric Services | **444.2** | 468.5 | **869.0** | 869.1 |
| Energy Services | **50.4** | 44.2 | **98.7** | 88.6 |
| Energy Investments | **9.9** | 8.7 | **17.8** | 18.8 |
| Total Revenues | **1,377.7** | 1,342.5 | **4,038.8** | 3,823.0 |
| **Operating Expenses** | | | | |
| Purchased gas for resale | **539.8** | 501.6 | **2,051.2** | 1,810.5 |
| Fuel and purchased power | **115.7** | 159.2 | **245.7** | 292.3 |
| Operations and maintenance | **420.6** | 391.8 | **826.7** | 779.0 |
| Depreciation, depletion and amortization | **101.2** | 97.5 | **211.4** | 203.6 |
| Operating taxes | **95.8** | 94.0 | **214.0** | 205.8 |
| Total Operating Expenses | **1,273.1** | 1,244.1 | **3,549.0** | 3,291.2 |
| Income from equity investments | **2.9** | 4.7 | **6.3** | 10.0 |
| Sale of assets | **-** | 0.1 | **0.5** | 0.1 |
| **Operating Income** | **107.5** | 103.2 | **496.6** | 541.9 |
| **Other Income and (Deductions)** | | | | |
| Interest charges | **(59.4)** | (72.6) | **(125.6)** | (132.7) |
| Gain on sale of investments | **-** | - | **-** | 4.1 |
| Cost of debt redemption | **-** | - | **-** | (20.9) |
| Other | **6.2** | 4.1 | **17.6** | 13.2 |
| Total Other Income and (Deductions) | **(53.2)** | (68.5) | **(108.0)** | (136.3) |
| **Income Taxes** | | | | |
| Current | **(37.3)** | 16.0 | **122.2** | 144.8 |
| Deferred | **42.2** | (0.2) | **9.0** | 6.2 |
| Total Income Taxes | **4.9** | 15.8 | **131.2** | 151.0 |
| Earnings from continuing operations | **49.4** | 18.9 | **257.4** | 254.6 |
| **Discontinued Operations** | | | | |
| Income (loss) from discontinued operations, net of tax | **-** | (1.9) | **-** | (4.1) |
| Gain on disposal, net of tax | **-** | 0.1 | **-** | 2.3 |
| Loss from discontinued operations | **-** | (1.8) | **-** | (1.8) |
| **Net Income** | **49.4** | 17.1 | **257.4** | 252.8 |
| Preferred stock dividend requirements | **-** | 0.9 | **-** | 2.2 |
| **Earnings for Common Stock** | **$ 49.4** | $ 16.2 | **$ 257.4** | $ 250.6 |
| **Basic Earnings Per Share:** | | | | |
| Continuing Operations, less preferred stock dividends | **$ 0.28** | $ 0.11 | **$ 1.47** | $ 1.52 |
| Discontinued Operations | **-** | (0.01) | **-** | (0.01) |
| Basic Earnings Per Share | **$ 0.28** | $ 0.10 | **$ 1.47** | $ 1.51 |
| **Diluted Earnings Per Share** | | | | |
| Continuing Operations, less preferred stock dividends | **$ 0.28** | $ 0.10 | **$ 1.46** | $ 1.52 |
| Discontinued Operations | **-** | (0.01) | **-** | (0.01) |
| Diluted Earnings Per Share | **$ 0.28** | $ 0.09 | **$ 1.46** | $ 1.51 |
| **Average Common Shares Outstanding (000)** | **174,989** | 169,933 | **174,846** | 165,529 |
| **Average Common Shares Outstanding - Diluted (000)** | **176,121** | 170,878 | **175,848** | 166,507 |

See accompanying Notes to the Consolidated Financial Statements.

# CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

| | Six Months Ended June 30, | |
|---|---|---|
| *(In Millions of Dollars)* | **2006** | 2005 |
| ***Operating Activities*** | | |
| Net income | **$ 257.4** | $ 252.8 |
| **Adjustments to reconcile net income to net cash provided by (used in) operating activities** | | |
| Depreciation, depletion and amortization | **211.4** | 203.6 |
| Deferred income tax | **9.0** | 6.2 |
| Income from equity investments | **(6.3)** | (10.0) |
| Dividends from equity investments | **6.5** | 1.0 |
| Amortization of interest rate swap | **4.1** | (12.2) |
| (Gain) on sale of investment | - | (4.1) |
| Loss from discontinued operations | - | 1.8 |
| Amortization of property tax prepayments | **66.7** | 56.7 |
| Net pension and other postretirement expense / cash payment | **83.2** | (17.9) |
| **Changes in assets and liabilities** | | |
| Accounts receivable | **524.3** | 210.0 |
| Materials and supplies, fuel oil and gas in storage | **89.6** | 48.7 |
| Accounts payable and other liabilities | **(399.0)** | (219.6) |
| Taxes accrued | **(15.1)** | (14.4) |
| Interest accrued | **2.2** | 5.8 |
| Insurance recovery and regulatory settlements, net | - | 8.5 |
| Property tax prepayment | - | (24.9) |
| Other | **(44.5)** | (26.9) |
| **Net Cash Provided by Operating Activities** | **789.5** | 465.1 |
| ***Investing Activities*** | | |
| Construction expenditures | **(247.0)** | (231.0) |
| Cost of removal | **(15.7)** | (10.3) |
| Net proceeds from sale of property and investments | - | 48.1 |
| **Net Cash Used in Investing Activities** | **(262.7)** | (193.2) |
| ***Financing Activities*** | | |
| Treasury stock issued | **18.8** | 36.2 |
| MEDs equity conversion | - | 460.0 |
| Payment of long-term debt | - | (514.6) |
| Redemption of preferred stock | - | (75.0) |
| Payment of commercial paper | **(467.6)** | (628.3) |
| Common and preferred stock dividends paid | **(162.4)** | (149.8) |
| Other | - | 16.0 |
| **Net Cash Used in Financing Activities** | **(611.2)** | (855.5) |
| Net Decrease in Cash and Cash Equivalents | **(84.4)** | (583.6) |
| Cash Flow from Discontinued Operations - Operating | - | (3.8) |
| Cash Flow from Discontinued Operations - Investing | - | (10.6) |
| Cash and Cash Equivalents at Beginning of Period | **124.5** | 922.0 |
| Cash and Cash Equivalents at End of Period | **$ 40.1** | $ 324.0 |

Cash equivalents are short-term marketable securities purchased with maturities of three months or less that were carried at cost which approximates fair value.

See accompanying Notes to the Consolidated Financial Statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

INTRODUCTION TO THE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

KeySpan Corporation (referred to in the Notes to the Financial Statements 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 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.)

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 of KeySpan (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 adoption of the Merger Agreement by the stockholders of KeySpan and the Parent and the receipt of requisite regulatory approvals from certain United States federal and state public utility, antitrust and other regulatory authorities, many of which have been filed or obtained. Specifically, we filed our application for approval of the Merger pursuant to the Federal Power Act in May 2006. 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 and intend to seek approval from the New Hampshire Public Utility Commission and the State of New Jersey Board of Public Utilities within the next several weeks. In addition, approval of the Merger by our shareholders will be sought at our Annual Meeting scheduled for August 17, 2006**.** Shareholders of National Grid plc approved the transaction at a meeting held on July 31, 2006.

In addition to seeking approval of the Merger, the application filed with the NYPSC also contained a proposed ten-year rate plan for KEDNY and KEDLI, as well as proposals concerning corporate structure, affiliate rules and transactions and the rate treatment for contemplated synergy savings. Specifically, the rate plan proposal provides 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 clause would be increased to recover, on a prospective basis, 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 2.7% ($63.8 million) and 2.45% ($46.9 million), respectively in years 3, 5, 7 and 9 of the rate plan. The proposed rate plan also contemplates 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.

Assuming receipt of all required approvals, it is currently anticipated that the Merger will be consummated in 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

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 Federal Energy Regulatory Commission ("FERC") pursuant to PUHCA 2005. (For additional information on the Energy Act and PUHCA 2005 see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7. Management's Discussion and Analyses of Financial Condition and Results of Operations - "Regulation and Rate Matters.")

## 1. BASIS OF PRESENTATION

In our opinion, the accompanying unaudited Consolidated Financial Statements contain all adjustments necessary to present fairly KeySpan's financial position as of June 30, 2006, and the results of operations for the three and six months ended June 30, 2006 and June 30, 2005, as well as cash flows for the six months ended June 30, 2006 and June 30, 2005. The accompanying financial statements should be read in conjunction with the consolidated financial statements and notes included in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005. The December 31, 2005 financial statement information has been derived from the 2005 audited financial statements. Income from interim periods may not be indicative of future results. Certain reclassifications were made to conform prior period financial statements to the current period financial statement presentation.

Consolidated earnings are seasonal in nature primarily due to the significant contributions to earnings of the gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters.

Basic earnings per share ("EPS") is calculated by dividing earnings available 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 available 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 Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share" our basic and diluted EPS are as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | 2006 | 2005 | 2006 | 2005 |
| Earnings for common stock | $ 49.4 | $ 16.2 | $ 257.4 | $ 250.6 |
| Weighted average shares outstanding (000) | 174,989 | 169,933 | 174,846 | 165,529 |
| Add dilutive securities: | | | | |
| Options | 1,038 | 945 | 933 | 978 |
| Performance shares | 94 | - | 69 | - |
| Total weighted average shares outstanding - assuming dilution | 176,121 | 170,878 | 175,848 | 166,507 |
| Basic earnings per share | $ 0.28 | $ 0.10 | $ 1.47 | $ 1.51 |
| Diluted earnings per share | $ 0.28 | $ 0.09 | $ 1.46 | $ 1.51 |

## 2. BUSINESS SEGMENTS

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

The Gas Distribution segment consists of six gas distribution subsidiaries. KeySpan Energy Delivery New York ("KEDNY") provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Queens and Staten Island. KeySpan Energy Delivery Long 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, Boston Gas Company, Colonial Gas Company, Essex Gas Company and EnergyNorth Natural Gas, Inc., collectively referred to as KeySpan Energy Delivery New England ("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 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 10, "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 New York Independent Systems Operator ("NYISO") energy markets. To finance the purchase and/or construction of the Ravenswood Generating Station, KeySpan entered into a leasing arrangement for each facility. The Electric Services segment also conducts retail marketing of electricity to commercial customers. (See Note 6 "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.

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 its 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. Houston Exploration, formerly a KeySpan subsidiary, was sold in 2004.

This 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 26.3% interest in the Millennium Pipeline Company LLC, the developer of 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 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. 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 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.

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. At June 30, 2006, the total assets of each reportable segment have not changed materially from those levels reported at December 31, 2005. The reportable segment information is as follows:

| *(In Millions of Dollars)* | Gas Distribution | Electric Services | Energy Services | Energy Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|
| **Three Months Ended June 30, 2006** | | | | | | |
| Unaffiliated revenue | 873.2 | 444.2 | 50.4 | 9.9 | - | 1,377.7 |
| Intersegment revenue | - | - | 2.2 | 1.3 | (3.5) | - |
| Operating Income | 39.5 | 62.4 | 2.0 | 3.7 | (0.1) | 107.5 |
| **Three Months Ended June 30, 2005** | | | | | | |
| Unaffiliated revenue | 821.1 | 468.5 | 44.2 | 8.7 | - | 1,342.5 |
| Intersegment revenue | - | - | 3.7 | - | (3.7) | - |
| Operating Income | 30.4 | 65.7 | (2.8) | 5.5 | 4.4 | 103.2 |

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

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of $439.3 million and $440.6 million for the three months ended June 30, 2006 and 2005, respectively, represent approximately 32% and 33%, respectively of our consolidated revenues in these periods.

| *(In Millions of Dollars)* | Gas Distribution | Electric Services | Energy Services | Energy Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|
| **Six Months Ended June 30, 2006** | | | | | | |
| Unaffiliated revenue | 3,053.3 | 869.0 | 98.7 | 17.8 | - | 4,038.8 |
| Intersegment revenue | - | - | 4.7 | 2.6 | (7.3) | - |
| Operating Income | 376.0 | 127.3 | 1.6 | 6.7 | (15.0) | 496.6 |
| **Six Months Ended June 30, 2005** | | | | | | |
| Unaffiliated revenue | 2,846.5 | 869.1 | 88.6 | 18.8 | - | 3,823.0 |
| Intersegment revenue | - | 4.6 | 6.3 | - | (10.9) | - |
| Operating Income | 422.3 | 116.7 | (5.6) | 11.9 | (3.4) | 541.9 |

Eliminating items include the elimination of certain intercompany accounts, as well as activities of our corporate and administrative areas.

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of $862.0 million and $816.3 million for the six months ended June 30, 2006 and 2005, respectively, represent approximately 21%, of our consolidated revenues in both periods.

## 3. COMPREHENSIVE INCOME

The table below indicates the components of comprehensive income:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Net Income | $ 49.4 | $ 17.1 | $ 257.4 | $ 252.8 |
| Other comprehensive income (loss), net of tax | | | | |
| Reclassification of (gains) losses included in net income | (3.2) | 12.5 | (38.9) | 7.7 |
| Foreign currency translation adjustments | - | - | - | (5.0) |
| Unrealized gains (losses) on marketable securities | (0.1) | 0.3 | 0.3 | (1.5) |
| Unrealized (losses) gains on derivative financial instruments | (5.0) | (10.9) | 40.9 | (18.3) |
| Other comprehensive loss, net of tax | (8.3) | 1.9 | 2.3 | (17.1) |
| Comprehensive Income | $ 41.1 | $ 19.0 | $ 259.7 | $ 235.7 |
| Related tax (benefit) expense | | | | |
| Reclassification of (gains) losses included in net income | (1.7) | 5.2 | (20.9) | 4.7 |
| Foreign currency translation adjustments | - | - | - | (2.7) |
| Unrealized gains (losses) on marketable securities | (0.1) | 0.2 | 0.2 | (0.8) |
| Unrealized (losses) gains on derivative financial instruments | (2.4) | (4.5) | 22.9 | (11.2) |
| Total Tax (Benefit) Expense | $ (4.2) | $ 0.9 | $ 2.2 | $ (10.0) |

## 4. HEDGING AND DERIVATIVE FINANCIAL INSTRUMENTS

*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 Generating Station 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 certain of these derivative instruments is subject to SFAS 71 "Accounting for the Effects of Certain Types of Regulation." Therefore, the fair value of these derivatives are 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. 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, however, are not subject to SFAS 71 and thus are not subject to deferral accounting treatment. 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 rate for the highest consumption block otherwise applicable to our firm commercial customers. 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 natural gas swaps qualify for hedge accounting treatment, but the fuel oil swaps do not qualify for hedge accounting treatment and are discussed below under the caption "Financially-Settled Commodity Derivative Instruments that Do Not Qualify for Hedge Accounting."

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 2006. We use standard New York Mercantile Exchange ("NYMEX") futures prices to value the gas positions. At June 30, 2006, the fair value of gas swap contracts was a liability of $3.1 million; such amount is reported in accumulated other comprehensive income and is expected to be reclassified into earnings over the next twelve months. The ineffective portion of these derivatives for the six months ended June 30, 2006 was immaterial.

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 June 30, 2006, Seneca-Upshur has hedge positions in place for approximately 80% of its estimated 2006 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 June 30, 2006 was a liability of $11.2 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 $4.4 million. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial for the six months ended June 30, 2006.

The Ravenswood Generating Station hedges the cash flow variability associated with a portion of electric energy sales. Our strategy is to hedge up to 50% of the on-peak capability of the Ravenswood Generating Station. The maximum length of time over which we have hedged cash flow variability is through March 2007**.** 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 June 30, 2006 was $16.2 million, $15.8 million of which is reported in accumulated other comprehensive income and 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 June 30, 2006, was a liability of $1.2 million of which $1.0 million is reported in accumulated other comprehensive income and 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 June 30, 2006, was a liability of $13.1 million, of which $12.4 million 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 for the six months ended June 30, 2006.

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 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 Financial 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 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 are 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. At June 30, 2006 the fair value of these derivative instruments was a liability of $54.5 million.

*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 qualify for the normal purchases and sales exception. Certain contracts for the 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 71. At June 30, 2006, these derivatives had a net fair value of $62.7 million.

*Financially-Settled Commodity Derivative Instruments that Do Not Qualify for Hedge Accounting:* KeySpan subsidiaries also have employed financial derivatives that do not qualify for hedge accounting treatment under SFAS 133. In 2006, we purchased a series of call options on the spread between the price of heating oil and the price of natural gas. The remaining options cover the period July 2006 through October 2006 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 spikes in heating oil prices relative to the price of natural gas. These options do not qualify for hedge accounting treatment under SFAS 133. The fair value of these options at June 30, 2006 was $3.5 million and has been recorded as a deferred asset on the Consolidated Balance Sheet. Further, KeySpan recorded a $3.5 million benefit in other income and deductions on the Consolidated Statement of Income to reflect the change in the market value associated with these derivative instruments for the six months ended June 30, 2006.

As noted earlier, OTC fuel oil swaps associated with our hedging strategy regarding sales to large-volume customers do not qualify for hedge accounting treatment. The fair value of these derivative instruments at June 30, 2006 was a liability of $3.0 million and has been recorded as a current liability on the Consolidated Balance Sheet. During the six months ended June 30, 2006, $1.6 million was charged to expense on the Consolidated Statement of Income.

Further, the Ravenswood Generating Station has also employed a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133 that were originally executed to hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil that will be consumed during the generation of electricity. The fair value of these derivative instruments at June 30, 2006 was a liability of $3.7 million and has been recorded as a current liability on the Consolidated Balance Sheet. KeySpan recorded a $3.7 million charge to expense in the Consolidated Statement of Income to reflect the change in the market value associated with these derivative instruments for the six months ended June 30, 2006; $2.3 million of which was transferred from accumulated other comprehensive income since it is no longer probable that the forecasted transactions will occur.

KeySpan has employed a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133 to hedge the cash flow variability for a portion of forecasted purchases of fleet fuel. The fair value of these derivative instruments at June 30, 2006 was $0.6 million and has been recorded as a deferred asset on the Consolidated Balance Sheet.

On January 18, 2006, KeySpan 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"). The Agreement has a three year term that began on May 1, 2006. 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 occurs on a monthly 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 and is subject to fair value accounting treatment; although currently there is no observable market reference to value this derivative instrument. As noted, this is a financial derivative instrument and is unrelated to any physical production of electricity.

Additionally, KeySpan has a management contract with Merrill Lynch Trading, under which KeySpan and Merrill Lynch Trading will share the responsibilities for managing KeySpan's upstream gas distribution assets associated with its Massachusetts gas distribution subsidiaries, as well as providing city-gate delivered supply. This contract, which replaces the prior arrangement with Merrill Lynch Trading, allows for both KeySpan and Merrill Lynch Trading to employ derivative instruments to maximize the profitability of KeySpan's portfolio of gas distribution assets. Profits associated with these activities are shared between KeySpan, Merrill Lynch Trading and KeySpan's Massachusetts ratepayers. At June 30, 2006, KeySpan's proportionate share of the fair value associated with these derivative instruments amounted to $4.4 million and is reflected on the Consolidated Balance Sheet as a deferred asset of $4.4 million with an offsetting regulatory liability of $2.5 million and deferred liability of $1.1 million; the remaining amount was recorded as a benefit to revenues. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

The table below summarizes the fair value of all of the above outstanding derivative instruments at June 30, 2006 and December 31, 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)* | June 30, 2006 | December 31, 2005 |
|---|---|---|
| **Gas Contracts:** | | |
| Other current assets | $ 9.0 | $ 132.1 |
| Other deferred charges | 69.1 | 75.2 |
| Regulatory asset | 50.8 | 30.9 |
| Other current liability | (61.9) | (39.8) |
| Other deferred liabilities | (36.9) | (44.3) |
| Regulatory liability | (53.0) | (175.4) |
| **Oil Contracts:** | | |
| Other current assets | - | 0.5 |
| Other current liability | (6.5) | (6.8) |
| **Electric Contracts:** | | |
| Other current assets | 15.8 | 10.2 |
| Other deferred charges | 0.8 | - |
| Other current liability | - | (0.7) |
| | $ (12.8) | $ (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 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 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. 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.

*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 June 30, 2006, KeySpan has received $6.3 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 June 30, 2006, KeySpan has no outstanding margin calls to its counterparties.

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 the reported results of operations, financial position and cash flows and lowers overall business risk.

5. RECENT ACCOUNTING PRONOUNCEMENTS

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 requires application for fiscal years beginning after December 15, 2006. KeySpan anticipates that implementation of this Interpretation will have minimal impact on its results of operations, financial position or cash flows.

On March 31, 2006, the Financial Accounting Standards Board ("FASB") issued an Exposure Draft of proposed rules on employers' accounting for defined benefit pensions and other postretirement benefit plans that would require employers to fully recognize the plan's funded status on the balance sheet. If adopted as proposed, the new rules would be applied retroactively to prior financial statements presented and be effective for fiscal years ending after December 15, 2006. KeySpan is currently evaluating the Exposure Draft and believes that the new rules, if adopted as proposed, may significantly increase KeySpan's recorded pension and other postretirement liabilities and reduce its shareholders' equity. The comment period on this Exposure Draft ended on May 31, 2006.

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.

## 6. FINANCIAL GUARANTEES AND CONTINGENCIES

*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, 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 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 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, KeySpan Ravenswood, LLC, under the Master Lease. Monthly lease payments substantially equal the monthly interest expense on such debt securities.

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 $315.2 million.

If our subsidiary that leases the Ravenswood Facility, 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 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."

*Asset Retirement Obligations*: KeySpan has various asset retirement obligations primarily associated with its gas distribution and electric generation activities. These obligations have remained substantially unchanged from December 31, 2005, except for accretion adjustments. Generally, KeySpan's largest asset retirement obligations relate to: (i) legal requirements 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; or dispose of sections of gas main when removed from the pipeline system; (ii) cleaning and removal requirements associated with storage tanks containing waste oil and other waste contaminants; and (iii) legal requirements to remove asbestos upon major renovation or demolition of structures and facilities. At June 30, 2006, these obligations total $48.8 million. See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding these obligations.

Environmental Matters

*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 New York State Public Service Commission ("NYPSC") and the Department of Environmental Conservation ("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/or 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 United States Supreme Court's December 2004 decision in Cooper Industries v. Aviall Services, Inc. and the emerging case law in New York, KeySpan continues to evaluate how to proceed with respect to participation in the BCP or alternative DEC remediation programs.

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 $70.0 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. Subject to the issues described above, 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 $56.4 million.

We presently estimate the remaining cost of our KEDNY and KEDLI MGP-related environmental remediation activities will be $341.7 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, the KEDNY and KEDLI rate plans generally provide for the recovery from customers of investigation and remediation costs of certain sites. At June 30, 2006, we have reflected a regulatory asset of $381.8 million for our KEDNY/KEDLI MGP sites. In October 2003, KEDNY and KEDLI filed a joint petition with the NYPSC seeking rate treatment for additional environmental costs that may be incurred at all of our New York MGP sites. 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 $1.6 million, which amount has been accrued by us. Expenditures incurred to date total $3.4 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 the Massachusetts KEDNE MGP-related environmental cleanup activities will be $11.0 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 these subsidiaries, with respect to these MGP-related activities total $32.4 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 in New Hampshire. 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 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. The Nashua River Asbestos Site now has been fully remediated.

We presently estimate the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $28.0 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 this subsidiary, with respect to these MGP-related activities total $20.4 million.

By rate orders, the Massachusetts Department of Telecommunications and Energy ("MADTE") and the New Hampshire Public Utility Commission ("NHPUC") provide for the recovery of site investigation and remediation costs and, accordingly, at June 30, 2006, we have reflected a regulatory asset of $61.7 million for the KEDNE MGP sites.

*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. In 1989, 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 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 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.

We presently estimate the remaining cost of our environmental cleanup activities for these three non-utility sites will be approximately $16.6 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 $16.3 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 Settlements:* KeySpan has entered into confidential settlement agreements with certain of its insurance carriers for recovery of costs associated with the investigation and remediation of its MGP sites and the KeySpan New England LLC non-utility sites. Pursuant to these settlements, KeySpan recorded a benefit of $5.5 million in its Consolidated Statement of Income for the three and six months ended June 30, 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.

See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005 Note 7, to those Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for further information on environmental matters.

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, or in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, 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 us and our directors. The complaint, which was filed in the New York State Supreme Court for the County of Kings, relates to the execution of the merger agreement with National Grid plc and alleges that the merger consideration which our stockholders will receive in connection with the proposed merger transaction is inadequate and unfair because the transaction value of $42.00 for each share of our common stock does not provide our 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 can be granted. On May 26, 2006, the plaintiff served an amended complaint adding National Grid as a defendant. The amended complaint alleged that National Grid aided and abetted the alleged breach of fiduciary duties and added claims of inadequate disclosure with respect to KeySpan's preliminary proxy materials. On or about June 16, 2006, the parties agreed in principle to settle the case. The agreement is subject to negotiating and executing definitive settlement documentation, confirmatory discovery of the fairness of the settlement, and court approval of the settlement following notice to shareholders.

On July 12, 2006, a purported class action was filed alleging damages resulting from contamination associated with the historic operations of the former manufactured gas plant in Bay Shore, New York. We believe the lawsuit to be without merit and we intend to contest it vigorously.

***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 10 "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 10 "2006 LIPA Settlement." Following the announcement of the proposed acquisition of KeySpan by National Grid, LIPA, National Grid 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.

As reported in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, KeySpan is currently in discussions with the Internal Revenue Service ("IRS") at the Appeals level with regard to the Long Island Lighting Company's ("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. The primary issue relates to the valuation of the transferred assets in the KeySpan/LILCO combination. However, two issues were resolved in the second quarter of 2006. 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.

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 June 30, 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:

| *Nature of Guarantee (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) | | 72.1 | 2006 - 2008 |
| Commodity Guarantees and Other | (vi) | | 64.7 | 2006 - 2009 |
| Letters of Credit | (vii) | | 80.3 | 2006 - 2010 |
| | | $ | 1,698.9 | |

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 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 of the lease has been extended to 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 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 June 30, 2006, the total cost to complete such remaining bonded projects is estimated to be approximately $28 million.

(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 June 30, 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.

## 7. 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 this 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 June 30, 2006, after adjusting for forfeitures, there are approximately 3.1 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 three and six months ended June 30, 2005 would have decreased to the pro-forma amounts indicated below:

| (*In Millions of Dollars, Except Per Share Amounts*) | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2005 |
|---|---|---|
| Earnings available for common stock: | | |
| As reported | $ 16.2 | $ 250.6 |
| Add: recorded stock-based compensation expense, net of tax | 3.0 | 6.1 |
| Deduct: total stock-based compensation expense, net of tax | (3.5) | (7.0) |
| Pro-forma earnings | $ 15.7 | $ 249.7 |
| Earnings per share: | | |
| Basic - as reported | $ 0.10 | $ 1.51 |
| Basic - pro-forma | $ 0.09 | $ 1.51 |
| | | |
| Diluted - as reported | $ 0.09 | $ 1.51 |
| Diluted - pro-forma | $ 0.09 | $ 1.50 |

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 six months ended June 30, 2006, KeySpan recorded an expense of $0.7 million for stock option awards previously accounted for under APB 25 and which have not 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.

| | Six Months Ended | |
|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | June 30 2006 | June 30 2005 |
| Performance shares | $ 4.6 | $ 3.4 |
| Restricted stock | 3.8 | 0.5 |
| Stock options | 3.1 | 2.8 |
| EDSPP discount | 2.7 | 2.5 |
| Total stock-based compensation included in operations and maintenance expense | 14.2 | 9.2 |
| Income tax benefit | (5.0) | (3.2) |
| Total stock based compensation expense, net of tax | $ 9.2 | $ 6.0 |

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 six months ended June 30, 2006 and 2005, cash received from stock options exercised was $18.1 million and $37.6 million, respectively. The actual tax benefit realized for tax deductions from stock options exercised was $1.8 million and $4.6 million for the six months ended June 30, 2006 and 2005, respectively. The benefits received from these tax deductions were 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.

The 2006 performance share award reflects the new performance condition criteria under SFAS 123R. In 2006, 314,560 performance shares were granted to officers. 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 June 30, 2006 associated with all of the performance share awards was $16.1 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 these awards is being amortized to compensation expense over the period in which the awards vest. 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 will be fully expensed by the end of this year and the 2006 award was expensed in the first quarter of 2006. Upon a change of control, all restricted stock awards will vest immediately. The unearned compensation as of June 30, 2006 associated with these awards was $0.3 million.

*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 488,919 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 grants issued in 2006. The following table presents the weighted average fair value, exercise price and assumptions used for the 2005 stock option grant:

| | 2005 |
|---|---|
| Fair value of grants issued | $ 6.15 |
| Dividend yield | 4.64% |
| Expected volatility | 22.63% |
| Risk free rate | 4.10% |
| Expected lives | 6.4 years |
| Exercise price | $ 39.25 |

A summary of the status of our fixed stock option plans and changes is presented below for the six months ended June 30, 2006:

| Fixed Options | Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value *(In Millions)* |
|---|---|---|---|
| Outstanding at beginning of period | 10,443,055 | $ 33.74 | |
| Granted during the year | - | $ - | |
| Exercised | (561,224) | $ 32.39 | |
| Forfeited | (131,113) | $ 36.75 | |
| Outstanding at end of period | 9,750,718 | $ 33.78 | $ 64.5 |
| Exercisable at end of period | 7,200,707 | $ 32.71 | $ 55.3 |

The total intrinsic value of the options exercised during the six months ended June 30, 2006 and

2005 was approximately $4.5 million and $10.2 million, respectively.

| Remaining Contractual Life | Options Outstanding at June 30, 2006 | Weighted Average Exercise Price | Range of Exercise Price | Options Exercisable at June 30, 2006 | Weighted Average Exercise Price | Range of Exercise Price |
|---|---|---|---|---|---|---|
| 1 years | 119,500 | $ 30.50 | $30.50 | 119,500 | $ 30.50 | $30.50 |
| 2 years | 186,410 | $ 32.52 | $ 19.15 - 32.63 | 186,410 | $ 32.52 | $ 19.15 - 32.63 |
| 3 years | 724,625 | $ 27.99 | $ 24.73 - 29.38 | 724,625 | $ 27.99 | $ 24.73 - 29.38 |
| 4 years | 382,181 | $ 26.97 | $ 21.99 - 27.06 | 382,181 | $ 26.97 | $ 21.99 - 27.06 |
| 5 years | 975,437 | $ 22.69 | $ 22.50 - 32.76 | 975,437 | $ 22.69 | $ 22.50 - 32.76 |
| 6 years | 1,572,663 | $ 39.50 | $39.50 | 1,572,663 | $ 39.50 | $39.50 |
| 7 years | 1,795,711 | $ 32.66 | $32.66 | 1,462,611 | $ 32.66 | $32.66 |
| 8 years | 1,190,664 | $ 32.40 | $32.40 | 786,824 | $ 32.40 | $32.40 |
| 9 years | 1,433,927 | $ 37.54 | $37.54 | 665,732 | $ 37.54 | $37.54 |
| 10 years | 1,369,600 | $ 39.25 | $39.25 | 324,724 | $ 39.25 | $39.25 |
| | 9,750,718 | | | 7,200,707 | | |

As of June 30, 2006, there are approximately 2.6 million options which have not yet vested. The unearned compensation cost related to these stock option awards is $6.3 million which is expected to be recognized over a weighted average period of 2 years.

## 8. POSTRETIREMENT BENEFITS

*Pension Plans:* The following information represents the consolidated net periodic pension cost for the six months ended June 30, 2006 and 2005, 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 the 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:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Service cost, benefits earned during the period | 16.0 | 13.3 | $ 32.1 | $ 28.3 |
| Interest cost on projected benefit obligation | 38.6 | 36.9 | 77.2 | 74.3 |
| Expected return on plan assets | (47.0) | (43.7) | (94.0) | (86.6) |
| Net amortization and deferral | 21.9 | 18.1 | 43.8 | 37.0 |
| Total pension cost | 29.5 | 24.6 | $ 59.1 | $ 53.0 |

*Other Postretirement Benefits:* The following information represents the consolidated net periodic other postretirement benefit cost for the six months ended June 30, 2006 and 2005 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:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Service cost, benefits earned during the period | 7.0 | 5.9 | $ 13.9 | $ 12.2 |
| Interest cost on accumulated postretirement benefit obligation | 20.1 | 17.9 | 40.3 | 37.8 |
| Expected return on plan assets | (9.2) | (9.0) | (18.3) | (18.1) |
| Net amortization and deferral | 16.7 | 13.5 | 33.3 | 30.0 |
| Other postretirement cost | 34.6 | 28.3 | $ 69.2 | $ 61.9 |

During the first six months of 2006, KeySpan contributed $16.5 million to its pension plans and $9.0 million to its other postretirement benefit plans. KeySpan anticipates contributing an additional $94.5 million to its pension and other postretirement benefit plans during the remainder of 2006. Estimated contribution levels are subject to change based on future market returns, interest rates and certain other measurements. Actual contributions, therefore, may vary from these levels.

## 9. COMMERCIAL PAPER

At June 30, 2006, KeySpan had two credit facilities totaling $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 June 30, 2006, KeySpan's consolidated indebtedness was 47.3 % 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 June 30, 2006, we had cash and temporary cash investments of $40.1 million. During the first six months of 2006, we repaid $467.6 million of commercial paper and, at June 30, 2006, $190.0 million of commercial paper was outstanding at a weighted average annualized interest rate of 5.42%. At June 30, 2006, KeySpan had the ability to issue up to an additional $1.3 billion, under its commercial paper program.

10. 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 the Long Island Lighting Company's ("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 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. Following the announcement of the proposed acquisition of KeySpan by National Grid, LIPA, National Grid 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 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 $91 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. 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. 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.

*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.

11. INCOME TAXES

KeySpan's consolidated effective income tax rate, including city and state income taxes, was 33.8% for the six months ended June 30, 2006 compared to 37.2% for the corresponding period in 2005. During the second quarter of 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. In addition, KeySpan is currently in discussions with the IRS at the Appeals level with regard to the Long Island Lighting Company's ("LILCO") 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. The primary issue, relating to the valuation of certain assets transferred in the KeySpan/LILCO business combination of May 1998, remains open. However, two issues were resolved in the second quarter of 2006. As a result of settling the two issues with the IRS, as well as the New York City tax issue, KeySpan realized a tax benefit of $16.4 million during the three and six months ended June 30, 2006, thereby lowering the effective income tax rate.

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.

## 12. KEYSPAN GAS EAST CORPORATION SUMMARY FINANCIAL INFORMATION

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 the Long Island Lighting Company. KEDLI established a program for the issuance, from time to time, of up to $600 million aggregate principal amount of Medium-Term Notes, which are 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**

| | Three Months Ended June 30, 2006 | | | | |
|---|---|---|---|---|---|
| *(In Millions of Dollars)* | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
| **Revenues** | $ 0.2 | $ 245.9 | $ 1,131.8 | $ (0.2) | $ 1,377.7 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 153.8 | 386.0 | - | 539.8 |
| Fuel and purchased power | - | - | 115.7 | - | 115.7 |
| Operations and maintenance | 9.3 | 34.5 | 376.8 | - | 420.6 |
| Intercompany expense | - | 1.4 | (1.4) | | - |
| Depreciation and amortization | - | 18.7 | 82.5 | - | 101.2 |
| Operating taxes | - | 15.3 | 80.5 | - | 95.8 |
| Total Operating Expenses | 9.3 | 223.7 | 1,040.1 | - | 1,273.1 |
| Income from equity investments | - | - | 2.9 | - | 2.9 |
| **Operating Income (Loss)** | (9.1) | 22.2 | 94.6 | (0.2) | 107.5 |
| Interest charges | (39.9) | (13.2) | (14.3) | 8.0 | (59.4) |
| Other income and (deductions) | 75.8 | 0.9 | (13.4) | (57.1) | 6.2 |
| **Total Other Income and (Deductions)** | 35.9 | (12.3) | (27.7) | (49.1) | (53.2) |
| **Income Taxes (Benefit)** | (22.6) | 5.5 | 22.0 | - | 4.9 |
| **Net Income** | $ 49.4 | $ 4.4 | $ 44.9 | $ (49.3) | $ 49.4 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Three Months Ended June 30, 2005 | | | | |
| **Revenues** | $ 0.1 | $ 227.5 | $ 1,115.0 | $ (0.1) | $ 1,342.5 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 137.6 | 364.0 | - | 501.6 |
| Fuel and purchased power | - | - | 159.2 | - | 159.2 |
| Operations and maintenance | 1.1 | 31.3 | 359.4 | - | 391.8 |
| Intercompany expense | - | 1.2 | (1.2) | - | - |
| Depreciation and amortization | - | 18.4 | 79.1 | - | 97.5 |
| Operating taxes | - | 15.3 | 78.7 | - | 94.0 |
| Total Operating Expenses | 1.1 | 203.8 | 1,039.2 | - | 1,244.1 |
| Income from equity investments | - | - | 4.7 | - | 4.7 |
| Gain on Sale of Property | - | - | 0.1 | - | 0.1 |
| **Operating Income (Loss)** | (1.0) | 23.7 | 80.6 | (0.1) | 103.2 |
| Interest charges | (37.9) | (17.7) | (52.7) | 35.6 | (72.6) |
| Other income and (deductions) | 52.7 | 2.9 | 7.9 | (59.3) | 4.1 |
| **Total Other Income and (Deductions)** | 14.8 | (14.8) | (44.8) | (23.7) | (68.5) |
| **Income Taxes (Benefit)** | (3.2) | 4.1 | 14.9 | - | 15.8 |
| Earnings from Continuing Operations | 17.1 | 4.7 | 20.9 | (23.8) | 18.9 |
| **Discontinued Operations** | - | - | (1.8) | | (1.8) |
| **Net Income** | $ 17.1 | $ 4.7 | $ 19.1 | $ (23.8) | $ 17.1 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Six Months Ended June 30, 2006 | | | | |
| **Revenues** | $ 0.3 | $ 789.6 | $ 3,249.2 | $ (0.3) | $ 4,038.8 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 518.7 | 1,532.5 | - | 2,051.2 |
| Fuel and purchased power | - | - | 245.7 | - | 245.7 |
| Operations and maintenance | 17.3 | 70.9 | 738.5 | - | 826.7 |
| Intercompany expense | - | 2.6 | (2.6) | - | - |
| Depreciation and amortization | - | 43.8 | 167.6 | - | 211.4 |
| Operating taxes | - | 33.0 | 181.1 | - | 214.0 |
| Total Operating Expenses | 17.3 | 669.0 | 2,862.8 | - | 3,549.0 |
| Income from equity investments | - | - | 6.3 | - | 6.3 |
| Gain on sale of assets | - | 0.1 | 0.4 | - | 0.5 |
| **Operating Income (Loss)** | (17.0) | 120.7 | 393.2 | (0.3) | 496.6 |
| Interest charges | (79.7) | (27.4) | (31.0) | 12.4 | (125.6) |
| Other income and (deductions) | 325.2 | 1.0 | (30.6) | (278.0) | 17.6 |
| **Total Other Income and (Deductions)** | 245.5 | (26.4) | (61.6) | (265.6) | (108.0) |
| **Income Taxes (Benefit)** | (28.9) | 35.4 | 124.7 | - | 131.2 |
| **Net Income** | $ 257.4 | $ 59.0 | $ 206.9 | $ (265.9) | $ 257.4 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Six Months Ended June 30, 2005 | | | | |
| **Revenues** | $ 0.2 | $ 731.1 | $ 3,091.9 | $ (0.2) | $ 3,823.0 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 451.6 | 1,358.9 | - | 1,810.5 |
| Fuel and purchased power | - | - | 292.3 | - | 292.3 |
| Operations and maintenance | 7.3 | 63.8 | 707.9 | - | 779.0 |
| Intercompany expense | - | 2.5 | (2.5) | - | - |
| Depreciation and amortization | - | 44.9 | 158.7 | - | 203.6 |
| Operating taxes | - | 32.5 | 173.3 | - | 205.8 |
| Total Operating Expenses | 7.3 | 595.3 | 2,688.6 | - | 3,291.2 |
| Income from equity investments | - | - | 10.0 | - | 10.0 |
| Gain on Sale of Property | - | - | 0.1 | - | 0.1 |
| **Operating Income (Loss)** | (7.1) | 135.8 | 413.4 | (0.2) | 541.9 |
| Interest charges | (67.6) | (32.5) | (103.6) | 71.0 | (132.7) |
| Other income and (deductions) | 314.4 | 3.0 | 27.0 | (348.0) | (3.6) |
| **Total Other Income and (Deductions)** | 246.8 | (29.5) | (76.6) | (277.0) | (136.3) |
| **Income Taxes (Benefit)** | (13.1) | 38.2 | 125.9 | - | 151.0 |
| Earnings from Continuing Operations | 252.8 | 68.1 | 210.9 | (277.2) | 254.6 |
| **Discontinued Operations** | - | - | (1.8) | | (1.8) |
| **Net Income** | $ 252.8 | $ 68.1 | $ 209.1 | $ (277.2) | $ 252.8 |

**Balance Sheet**

| *(In Millions of Dollars)* | Guarantor | KEDLI | June 30, 2006<br>Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & temporary cash investments | $ 14.5 | $ 3.1 | $ 22.5 | $ - | $ 40.1 |
| Accounts receivable, net | 0.7 | 128.3 | 964.7 | - | 1,093.7 |
| Other current assets | 1.4 | 236.2 | 737.3 | - | 974.9 |
| | 16.6 | 367.6 | 1,724.5 | - | 2,108.7 |
| **Equity Investments** | 4,831.6 | - | 137.5 | (4,717.8) | 251.3 |
| **Property** | | | | | |
| Gas | - | 2,148.5 | 5,296.4 | - | 7,444.9 |
| Other | - | 1.6 | 3,140.1 | - | 3,141.7 |
| Accumulated depreciation and depletion | - | (416.9) | (2,738.4) | - | (3,155.3) |
| | - | 1,733.2 | 5,698.1 | - | 7,431.3 |
| **Intercompany Accounts Receivable** | 876.5 | 1,069.3 | 2,819.4 | (4,765.2) | - |
| **Deferred Charges** | 1,994.2 | 336.2 | 938.5 | - | 3,268.9 |
| **Total Assets** | $ 7,718.9 | $ 3,506.3 | $ 11,318.0 | $ (9,483.0) | $ 13,060.2 |
| **LIABILITIES AND CAPITALIZATION** | | | | | |
| **Current Liabilities** | | | | | |
| Accounts payable | $ 40.2 | $ 85.2 | $ 557.8 | $ - | $ 683.2 |
| Commercial paper | 190.0 | - | - | - | 190.0 |
| Other current liabilities | 201.4 | 48.7 | 166.8 | - | 416.9 |
| | 431.6 | 133.9 | 724.6 | - | 1,290.1 |
| **Intercompany Accounts Payable** | 49.1 | 1,237.4 | 1,964.9 | (3,251.4) | - |
| **Deferred Credits and Other Liabilities** | | | | | |
| Deferred income tax | 25.6 | 343.4 | 809.5 | - | 1,178.5 |
| Other deferred credits and liabilities | 740.1 | 184.8 | 1,144.2 | - | 2,069.1 |
| | 765.7 | 528.2 | 1,953.7 | - | 3,247.6 |
| **Capitalization** | | | | | |
| Common shareholders' equity | 4,610.3 | 955.9 | 3,738.9 | (4,717.8) | 4,587.3 |
| Long-term debt | 1,862.2 | 650.9 | 2,920.5 | (1,513.8) | 3,919.8 |
| **Total Capitalization** | 6,472.5 | 1,606.8 | 6,659.4 | (6,231.6) | 8,507.1 |
| **Minority Interest in Subsidiary Companies** | - | - | 15.4 | - | 15.4 |
| **Total Liabilities & Capitalization** | $ 7,718.9 | $ 3,506.3 | $ 11,318.0 | $ (9,483.0) | $ 13,060.2 |

**Balance Sheet**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | December 31, 2005 | | | | |
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & 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 | - | 2,111.3 | 5,164.6 | - | 7,275.9 |
| Other | - | - | 3,092.8 | - | 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 Subsidiary Companies** | - | - | 15.3 | - | 15.3 |
| **Total Liabilities & Capitalization** | $ 7,951.3 | $ 2,594.4 | $ 10,678.2 | $ (7,411.3) | $ 13,812.6 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Six Months Ended June 30, 2006 Guarantor | KEDLI | Other Subsidiaries | Consolidated |
|---|---|---|---|---|
| **Operating Activities** | | | | |
| Net Cash Provided by Operating Activities | $ (56.0) | $ 263.9 | $ 581.6 | $ 789.5 |
| **Investing Activities** | | | | |
| Capital expenditures | - | (41.2) | (205.8) | (247.0) |
| Cost of removal | - | (3.8) | (11.9) | (15.7) |
| Net Cash Provided by (Used in) Investing Activities | - | (45.0) | (217.7) | (262.7) |
| **Financing Activities** | | | | |
| Treasury stock issued | 18.8 | - | - | 18.8 |
| Payment of debt, net | (467.6) | - | - | (467.6) |
| Common and preferred stock dividends paid | (162.4) | - | - | (162.4) |
| Net intercompany accounts | 602.2 | (219.3) | (382.9) | - |
| Net Cash Provided by (Used in) Financing Activities | (9.0) | (219.3) | (382.9) | (611.2) |
| Net Increase (Decrease) in Cash and Cash Equivalents | $ (65.0) | $ (0.4) | $ (19.0) | $ (84.4) |
| Cash and Cash Equivalents at Beginning of Period | 79.5 | 3.5 | 41.5 | 124.5 |
| Cash and Cash Equivalents at End of Period | $ 14.5 | $ 3.1 | $ 22.5 | $ 40.1 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Six Months Ended June 30, 2005 Guarantor | KEDLI | Other Subsidiaries | Consolidated |
|---|---|---|---|---|
| **Operating Activities** | | | | |
| Net Cash Provided by (Used in )Operating Activities | $ (94.6) | $ 144.2 | $ 415.6 | $ 465.1 |
| **Investing Activities** | | | | |
| Capital expenditures | - | (43.2) | (187.8) | (231.0) |
| Cost of removal | | (2.5) | (7.8) | (10.3) |
| Proceeds from sale of investment | - | - | 48.1 | 48.1 |
| Net Cash Provided by (Used in) Investing Activities | - | (45.7) | (147.6) | (193.2) |
| **Financing Activities** | | | | |
| Treasury stock issued | 36.2 | - | - | 36.2 |
| Payment of debt, net | (1,128.2) | - | (14.7) | (1,142.9) |
| Redemption of preferred stock | (75.0) | - | - | (75.0) |
| Common and preferred stock dividends paid | (149.8) | - | - | (149.8) |
| MEDs equity conversion | 460.0 | - | - | 460.0 |
| Other | (2.4) | - | 18.4 | 16.0 |
| Intercompany dividend payments | 266.5 | | (266.5) | - |
| Net intercompany accounts | 289.2 | (94.0) | (195.2) | - |
| Net Cash Provided by (Used in) Financing Activities | (303.4) | (94.0) | (458.0) | (855.5) |
| Net Increase (Decrease) in Cash and Cash Equivalents | $ (398.0) | $ 4.4 | $ (190.0) | $ (583.6) |
| 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 | $ 182.7 | $ 3.5 | $ 137.8 | $ 324.0 |

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

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.

Consummation of the Merger is subject to various closing conditions and the adoption of the Merger Agreement by the stockholders of KeySpan and the Parent. Assuming receipt of all required approvals, it is currently anticipated that the Merger will be consummated in 2007. However, 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.

**<u>Consolidated Review of Results</u>**

The following is a summary of transactions affecting comparative earnings for the three and six months ended June 30, 2006, compared to the three and six months ended June 30, 2005. Capitalized terms used in the following discussion, but not otherwise defined, have the same meaning as when used in the Notes to the Consolidated Financial Statements included under Item 1. References to "KeySpan," "we," "us," and "our" mean KeySpan Corporation, together with its consolidated subsidiaries.

Operating income by segment, as well as consolidated earnings for common stock is set forth in the following table for the periods indicated.

| *(In Millions of Dollars, Except per Share)* | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|---|---|
| Gas Distribution | $ 39.5 | $ 30.4 | $ 376.0 | $ 422.3 |
| Electric Services | 62.4 | 65.7 | 127.3 | 116.7 |
| Energy Services | 2.0 | (2.8) | 1.6 | (5.6) |
| Energy Investments | 3.7 | 5.5 | 6.7 | 11.9 |
| Eliminations and other | (0.1) | 4.4 | (15.0) | (3.4) |
| **Operating Income** | 107.5 | 103.2 | 496.6 | 541.9 |
| **Other Income and (Deductions)** | | | | |
| Interest charges | (59.4) | (72.6) | (125.6) | (132.7) |
| Gain on sale of investments | - | - | - | 4.1 |
| Cost of debt redemption | - | - | - | (20.9) |
| Other income and (deductions) | 6.2 | 4.1 | 17.6 | 13.2 |
| Total Other Income and (Deductions) | (53.2) | (68.5) | (108.0) | (136.3) |
| Income taxes | 4.9 | 15.8 | 131.2 | 151.0 |
| **Earnings from continuing operations** | 49.4 | 18.9 | 257.4 | 254.6 |
| Discontinued operations | - | (1.8) | - | (1.8) |
| **Net Income** | 49.4 | 17.1 | 257.4 | 252.8 |
| Preferred stock dividend requirements | - | 0.9 | - | 2.2 |
| **Earnings for Common Stock** | $ 49.4 | $ 16.2 | $ 257.4 | $ 250.6 |
| Basic Earnings per Share | | | | |
| Continuing operations, less preferred stock dividends | $ 0.28 | $ 0.11 | $ 1.47 | $ 1.52 |
| Discontinued operations | - | (0.01) | - | (0.01) |
| | $ 0.28 | $ 0.10 | $ 1.47 | $ 1.51 |

**Results of Operations Quarter Ended June 30, 2006 vs 2005**

KeySpan’s earnings for common stock for the three months ended June 30, 2006, were $49.4 million, or $0.28 per share, compared to $16.2 million or $0.10 per share realized during the corresponding quarter last year, an increase of $33.2 million, or $0.18 per share. The favorable comparative operating results reflect: (i) an increase in operating income; (ii) lower interest expense; and (iii) a decrease in income tax expense due to the settlement of certain outstanding issues with the New York City Department of Taxation and Finance and the Internal Revenue Service (“IRS”).

As indicated in the above table, operating income increased $4.3 million, or 4% for the quarter ended June 30, 2006, compared to the corresponding quarter last year. The comparative operating income primarily reflects higher earnings from the Gas Distribution segment of $9.1 million, partially offset by lower earnings from KeySpan’s electric operations of $3.3 million. The favorable operating results from the Gas Distribution segment reflect a partial rebound in comparative net gas revenues (revenues less the cost of gas and associated revenue taxes). The Electric Services segment results were adversely impacted by an increase in operating expenses and a decrease in net electric revenues associated with the Ravenswood Generating Station, KeySpan's merchant electric generating facility. During the quarter, this segment also recognized a gain on a fixed for floating unforced capacity financial swap which is reflected in operating results of this segment. (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 second quarter of 2006, other income and (deductions) reflects a net expense of $53.2 million compared to a net expense of $68.5 million for the second quarter of 2005. The favorable variation of $15.3 million is primarily due to lower interest expense. During the second quarter of 2006, KeySpan resolved its dispute with the New York City Department of Taxation and Finance with respect to income taxes relating the operations of its merchant electric generating facility. As a result of the favorable settlement of this issue, KeySpan reversed a previously recorded $6 million interest reserve established in connection with this dispute. Further, interest expense in 2006 reflects lower carrying charges on regulatory deferrals.

KeySpan is currently in discussions with the IRS at the Appeals level with regard to the Long Island Lighting Company's ("LILCO") 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 ended September 30, 1997 through December 31, 1998. The primary issue, relating to the valuation of certain assets transferred in the KeySpan/LILCO business combination of May 1998, remains open. However, two issues were resolved in the second quarter of 2006. In addition, as noted above, KeySpan resolved its dispute with New York City Department of Taxation and Finance with respect to income taxes relating to its merchant electric generating facility. As a result of settling the two issues with the IRS, as well as the New York City issue, KeySpan realized a tax benefit of $16.4 million during the three months ended June 30, 2006.

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.

**Results of Operations Six Months Ended June 30, 2006 vs 2005**

KeySpan's earnings for common stock for the six months ended June 30, 2006, were $257.4 million, compared to $250.6 million realized during the same period last year, an increase of $6.8 million. The favorable comparative earnings reflect the impact of: (i) debt redemption costs incurred in 2005, but not repeated in 2006; (ii) lower interest expense; (iii) a decrease in income tax expense due to the settlement of certain outstanding issues with the New York City Department of Taxation and Finance and the IRS; offset by (iv) a decrease in operating income.

KeySpan's earnings per share for the six months ended June 30, 2006, were $1.47 per share, compared to $1.51 per share realized during the same period last year, a decrease of $0.04 per share. Earnings per share for the six months ended June 30, 2006 reflect a higher level of outstanding common stock compared to last year. 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 in 2006 from this issuance, in addition to KeySpan's employee stock purchase plans, was approximately $0.08 per share. (See KeySpan's Annual Report of Form 10-K for the year ended December 31, 2005, Note 6. to the Consolidated Financial Statements "Long-term Debt and Commercial Paper" for additional details on the MEDs Equity Units.)

Operating income decreased $45.3 million, or 8% for the six months ended June 30, 2006, compared to the corresponding period last year. Comparative operating income primarily reflects lower earnings from the Gas Distribution segment of $46.3 million, partially offset by higher earnings from KeySpan's electric operations of $10.6 million. Operating income from the Gas Distribution segment was adversely impacted by the warm weather experienced during the first quarter of 2006 (KeySpan's primary heating season) which resulted in a decrease to comparative net gas revenues. The decrease in net gas revenues resulting from the warm first quarter weather, was not fully recovered by an increase in net gas revenues realized during the second quarter of 2006, as noted previously. The Electric Services segment results were favorably affected by a gain recognized on a fixed for floating unforced capacity financial swap. 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 related to the anticipated KeySpan / National Grid merger including legal and consulting fees, as well as corporate advertising expenses. (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 six months ended June 30, 2006, other income and (deductions) reflects a net expense of $108.0 million compared to a net expense of $136.3 million for the same period of 2005. The favorable variation of $28.3 million is primarily due to debt redemption costs incurred in 2005. In 2005, KeySpan redeemed $500 million 6.15% Series Notes due 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. The remaining variation is due to lower interest expense of $7.1 million reflecting the reversal of a previously recorded $6 million reserve established in connection with the income tax dispute with the New York City Department of Taxation and Finance, as noted previously, and lower carrying charges on regulatory deferrals, offset by the benefits recorded in 2005 associated with the amortization of the interest rate swap.

In addition, other income and (deductions) for the six months ended June 30, 2005, reflects 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.

The decrease in income tax expense for the six months ended June 30, 2006, compared to same period of 2005 of $19.8 million reflects the settlement of certain outstanding issues with the New York City Department of Taxation and Finance and the IRS that resulted in a combined benefit to income tax expense of $16.4 million, as previously noted.

Additionally, it should be noted that KeySpan recorded a $1.8 million loss from discontinued operations for the three and six months ended June 30, 2005. In the fourth quarter of 2004, KeySpan's investment in its mechanical contracting subsidiaries was written-down to fair value. During the first six months of 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 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 three and six months ended June 30, 2005.

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.

In light of the pending merger between KeySpan and National Grid and the widespread integration efforts being undertaken by both companies, KeySpan believes that it is no longer relevant to comment on guidance.

## Review of Operating Segments

KeySpan reports its segment results 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, and 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 gas distribution companies - Boston Gas Company, Colonial Gas Company, Essex 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)* | Three Months Ended June 30, 2006 | 2005 | Six Months Ended June30, 2006 | 2005 |
|---|---|---|---|---|
| Revenues | $ 873.2 | $ 821.1 | $ 3,053.3 | $ 2,846.5 |
| Cost of gas | 541.1 | 501.6 | 2,053.7 | 1,815.1 |
| Revenue taxes | 10.0 | 10.5 | 36.2 | 35.2 |
| Net Revenues | 322.1 | 309.0 | 963.4 | 996.2 |
| Operating Expenses | | | | |
| Operations and maintenance | 176.5 | 175.2 | 366.9 | 356.9 |
| Depreciation and amortization | 69.2 | 67.1 | 145.1 | 143.9 |
| Operating taxes | 36.9 | 36.3 | 75.4 | 73.1 |
| Total Operating Expenses | 282.6 | 278.6 | 587.4 | 573.9 |
| Operating Income | $ 39.5 | $ 30.4 | $ 376.0 | $ 422.3 |
| Firm gas sales and transportation (MDTH) | 48,851 | 49,614 | 175,755 | 200,240 |
| Transportation - Electric Generation (MDTH) | 20,709 | 8,592 | 27,180 | 11,432 |
| Other Sales (MDTH) | 45,539 | 37,913 | 97,871 | 94,461 |
| Warmer (Colder) than Normal - New York | 18% | (2%) | 14% | (3%) |
| Warmer (Colder) than Normal - New England | (6%) | (29%) | 5% | (12%) |

A MDTH is 10,000 therms (British Thermal Units) 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 $9.1 million for the second quarter of 2006 compared to the same quarter of 2005, primarily due to an increase in net gas revenues (revenues less the cost of gas and associated revenue taxes) of $13.1 million. The beneficial impact of higher net gas revenues was partially offset by an increase of $4.0 million in operating expenses due primarily to higher postretirement expenses and depreciation charges.

For the six months ended June 30, 2006, operating income decreased $46.3 million compared to the same period last year, primarily due to a decrease in net gas revenues of $32.8 million, primarily resulting from the warm first quarter weather. Further, operating expenses increased $13.5 million due to an increase in postretirement expenses and in the provision for uncollectible accounts receivable as a result of higher gas costs.

*Net Revenues*

Net gas revenues from our gas distribution operations decreased $32.8 million, or 3%, in the first six months of 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 first six months of 2006.

As measured in heating degree days, weather for the first six months of 2006 in our New York and New England service territories was approximately 14% and 5% warmer than normal, respectively, and was approximately 15% warmer than last year across KeySpan's service territories.

Net revenues from firm gas customers (residential, commercial and industrial customers) decreased $39.3 million in the first six months of 2006 compared to the same period last year. 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 season, the use of more efficient gas heating equipment and higher gas costs. KeySpan estimates that the warm winter weather resulted in an adverse impact to net gas revenues of approximately $26 million, net of the benefits from the weather normalization adjustment and weather derivatives discussed below.

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 $25 million during the first six months of 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 winter heating season. Weather, during the first quarter of 2006 was significantly warmer than normal as noted earlier. However, during the entire primary winter heating season –November 2005 through March 2006 – weather was slightly colder than normal. Therefore, there was no earnings impact associated with these weather derivatives for the first six months of 2006. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" 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 $6.5 million during the first six months of 2006 compared to the same period last year reflecting higher pricing.

*Firm Sales, Transportation and Other Quantities*

Firm gas sales and transportation quantities for the six months ended June 30, 2006, decreased 12% compared to the same period in 2005 due primarily to the warmer weather this year compared to last year. Customer additions and oil-to-gas conversions offset the full impact of the warmer weather. 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 will share the responsibilities for managing KeySpan's upstream gas distribution 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 approved this contract in March 2006 to be effective April 1, 2006. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

*Purchased Gas for Resale*

The increase in gas costs for the six months ended June 30, 2006 compared to the same period of 2005 of $238.6 million, or 13%, reflects an increase of 25% in the price per dekatherm of gas purchased for firm gas sales customers, offset by a 13% decrease in the quantity of gas purchased due to the warm winter heating season weather. 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 during the second quarter of 2006 compared to the same quarter last year increased $4.0 million, or 1%. Operations and maintenance expense increased $1.3 million in 2006 compared to 2005 reflecting an increase of $7.7 million in postretirement costs, offset by lower repair and maintenance costs due, in part, to the beneficial impact from productivity initiatives implemented this year and the timing of these costs relative to last year.

Higher depreciation charges of $2.1 million reflect the continued expansion of the gas distribution system.

For the six months ended June 30, 2006, operating expenses increased $13.5 million, or 2% compared to the same period last year. Operations and maintenance expense increased $10.0 million, or 3%, in 2006 compared to 2005 primarily due to an increase of $11.1 million in employee benefit costs, including postretirement expenses and an increase in the provision for uncollectible accounts receivable of $2.5 million as a result of increasing gas costs, partially offset by lower repair and maintenance costs due, in part, to the beneficial impact from productivity initiatives implemented this year and the timing of these costs relative to last year.

Comparative operating taxes increased $2.3 million due to the expiration of a five-year property tax assessment agreement with New York City. Higher depreciation charges of $3.7 million reflecting the continued expansion of the gas distribution system were offset by lower regulatory amortization charges of $2.5 million.

*Gas Supply and Pricing*

KeySpan had adequate gas supply available to meet its gas load demand in its service territories for the 2005/2006 winter heating season as KeySpan's gas storage was 100% full at the start of the winter heating season. The current gas rate structure of each of our gas distribution utilities includes 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, management is concerned with the volatility of natural gas prices and the related impact on customers' gas bills and recovery of customer accounts receivable. As noted, KeySpan has already experienced an increase in bad debt expense and an increase in collection lag. Further, the high gas prices have led to an increase in price elasticity resulting in 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 should help to mitigate the increase in bad debt expense.

With our strategy of having KeySpan's storage facilities 100% full at the start of the heating season and our use of financial derivatives, KeySpan effectively hedged the price of approximately two-thirds of the gas supply that was needed to serve its customers during the 2005/2006 winter. 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, which we supported the expansion of through the Energy Policy Act of 2005. Management believes that these measures helped mitigate the impact of rising 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 rising 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 our market segments, through the expansion of our gas distribution system for new 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 where natural gas is already in the home for other uses 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 Duke Energy Corporation formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Once in service, the pipeline is expected to transport up to 260,000 DTH of natural gas to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. In addition, KeySpan has a 26.3% interest 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 150,000 DTH of natural gas per day of transportation capacity from the Millennium Pipeline system, increasing to 200,000 DTH in the third 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 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; (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." (For a further discussion on these LIPA agreements see Note 10 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) | Three Months Ended June 30, 2006 | Three Months Ended June 30, 2005 | Six Months Ended June 30, 2006 | Six Months Ended June 30, 2005 |
|---|---|---|---|---|
| Revenues from Operations | $ 426.5 | $ 468.5 | $ 851.3 | $ 873.7 |
| Purchased fuel | 115.5 | 159.0 | 245.5 | 292.0 |
| Net Revenues from Operations | 311.0 | 309.5 | 605.8 | 581.7 |
| Derivative Financial Instrument | 17.7 | - | 17.7 | - |
| Net Electric Revenues | 328.7 | 309.5 | 623.5 | 581.7 |
| Operating Expenses | | | | |
| Operations and maintenance | 195.2 | 176.6 | 350.5 | 330.2 |
| Depreciation | 25.1 | 23.1 | 52.2 | 46.0 |
| Operating taxes | 46.0 | 44.1 | 93.5 | 88.8 |
| Total Operating Expenses | 266.3 | 243.8 | 496.2 | 465.0 |
| Operating Income | $ 62.4 | $ 65.7 | $ 127.3 | $ 116.7 |
| Electric sales (MWH)* | 1,080,775 | 1,445,109 | 1,887,452 | 2,446,517 |
| Capacity(MW)* | 2,450 | 2,450 | 2,450 | 2,450 |
| Cooling degree days | 276 | 313 | 276 | 313 |

*Reflects the operations of the Ravenswood Generating Station only.

*Executive Summary*

Operating income decreased $3.3 million, or 5%, for the three months ended June 30, 2006, compared to the same quarter last year, due primarily to a decrease in net revenues from the Ravenswood Generating Station of $25.0 million as a result of lower energy margins and capacity revenues. KeySpan also recognized a gain of $17.7 million on a fixed for floating unforced capacity financial swap, as well as an increase of $4.2 in net revenues associated with KeySpan's electric marketing activities.

For the six months ended June 30, 2006, operating income increased $10.6 million, or 9%, compared to the same period last year, due primarily to the $17.7 million gain recognized on the fixed for floating unforced capacity financial swap.

*Net Revenues*

Total electric net revenues realized during the second quarter of 2006 were $19.2 million, or 6% higher than such revenues realized during the corresponding period last year.

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. This agreement has a three year term that began on May 1, 2006. For the three months ended June 30, 2006 KeySpan recognized a gain of $17.7 million from this derivative financial instrument. (See Note 4 to the Consolidated Financial Statements, "Hedging and Derivative Financial Instruments", for further information on this swap agreement.)

Net revenues for the second quarter of 2006 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $22.3 million compared to the second quarter of 2005. This increase reflects the recovery of operations and maintenance costs billed to LIPA, which increased by a similar amount. As a result, the increase in net revenues from the service agreements with LIPA had little or no impact on operating income. (For a description of the LIPA Agreements and power purchase agreements, see KeySpan's 2005 Annual Report on Form 10-K for the year ended December 31, 2005 Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "Electric Services – Revenue Mechanisms.")

Net revenues associated with KeySpan's electric marketing activities increased $4.2 million during the second quarter of 2006 compared to the same quarter of 2005.

Net revenues from the Ravenswood Generating Station, however, decreased $25.0 million, or 25% for the three months ended June 30, 2006, compared to the same quarter last year reflecting lower capacity revenues of $20.5 million and a decrease in energy margins of $4.5 million. The decrease in capacity revenues was due to recently installed capacity additions in New York City.

The decrease in energy margins for the second quarter of 2006 reflects, in part, a 38% decrease in realized "spark-spreads" (the selling price of electricity less the cost of fuel, exclusive of hedging gains or losses). Further, the level of MWh sold into the New York Independent System Operator ("NYISO") energy market decreased 25% due to increased competition. Combined, these two items reduced energy margins by $11.0 million. Partially offsetting these adverse impacts to energy margins were the benefits recognized from derivative financial instruments. 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 Generating Station. We have also 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 Generating Station. These derivative instruments resulted in hedging gains, which are reflected in net electric margins, of $7.1 million for the second quarter of 2006 compared to hedging gains of $0.6 million for the second quarter of 2005. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for further information on KeySpan's hedging strategy.)

Total electric net revenues realized during the six months ended June 30, 2006 were $41.8 million, or 7% higher than such revenues realized during the corresponding period last year. For the six months ended June 30, 2006, KeySpan recognized a gain of $17.7 million from the fixed for floating unforced capacity derivative financial instrument described previously.

Net revenues for the six months ended June 30, 2006 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $19.6 million compared to the same period of 2005, reflecting the recovery of approximately $28 million in operations and maintenance costs billed to LIPA and therefore had no impact on operating income. Partially offsetting this increase to net revenues, was a decrease in service fee revenues and the timing of performance incentives, that, on a combined basis, resulted in an adverse impact to comparative net revenues of approximately $8 million. KeySpan anticipates achieving approximately the same level of performance incentives in 2006 as was achieved in 2005.

Net revenues associated with KeySpan's electric marketing activities increased $5.7 million during the six months ended June 30, 2006 compared to the same period of 2005.

The Ravenswood Generating Station, however, recognized a decrease of $1.2 million in net revenues during the six months ended June 30, 2006, compared to the same period last year, reflecting lower capacity revenues of $34.7 million, partially offset by an increase in energy margins of $33.5 million. Recently installed capacity additions in New York City were the primary driver behind the decrease in capacity revenues.

The increase in energy margins for the six months ended June 30, 2006 reflects the settlement of derivative financial instruments. As noted previously, 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 Generating Station and to hedge the cash flow variability associated with a portion of forecasted electric energy sales. These derivative instruments resulted in hedging gains, which are reflected in net electric margins, of $62.8 million during the six months ended June 30, 2006 compared to hedging gains of $3.6 million during the same period of 2005. The benefits to energy margins from KeySpan's hedging strategy were partially offset by a 56% decrease in realized "spark-spreads." Further, the level of MWh sold into the NYISO energy market decreased 23%. Combined, these two items reduced the benefits on net revenues recognized from the hedging gains by $25.7 million.

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 "Market and Credit Risk Management Activities" for further details on these matters.

*Operating Expenses*

Operating expenses increased $22.5 million, or 9%, during the second quarter of 2006 compared to the second quarter of 2005 primarily reflecting a $21.7 million increase in recoverable costs from LIPA, as noted previously.

Operating expenses increased $31.2 million, or 7%, in the six months ended June 30, 2006 compared to the same period of 2005. Operations and maintenance expense posted a $20.3 million increase compared to last year reflecting higher costs associated with the service agreements with LIPA of $28 million, which, as mentioned earlier, are fully recoverable from LIPA, partially offset by a decrease in overhaul costs associated with the Ravenswood Generating Station and KeySpan's Long

Island based electric generating units of approximately $5 million and the timing of other operating costs associated with the service agreements with LIPA.

The increase in depreciation expense and operating taxes (primarily property taxes) are associated with KeySpan's Long Island based electric generating units and are generally recoverable from LIPA.

*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 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 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. We have begun discussions with LIPA regarding this proposal. At June 30, 2006, total capitalized costs associated with the siting, permitting and procurement of equipment for the Melville facility were $62.8 million.

On February 6, 2006, the NYISO's New York City local reliability rules that required that 80% of the electric capacity needs of New York City be provided by "in-City" generators was increased to 83%. However, in March 2006, the NYISO Operating Committee reversed its decision and returned the local reliability rules to 80%. See the discussion under the caption "Market and Credit Risk Management Activities – Regulatory Issues and the Competitive Environment" for further information regarding this matter.

**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.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Revenues | $ 52.6 | $ 47.9 | $ 103.4 | $ 94.9 |
| Operating expenses | 50.6 | 50.7 | 101.8 | 100.5 |
| Operating (Loss) | $ 2.0 | $ (2.8) | $ 1.6 | $ (5.6) |

The Energy Services segment posted operating profits of $2.0 million and $1.6 million for the quarter and six months ended June 30, 2006, respectively, compared to operating losses of $2.8 million and $5.6 million incurred for the quarter and six months ended June 30, 2005, respectively. The improved performance reflects higher gross profit and operating margins on engineering and service contracts, completion and favorable pricing on certain contracts, an increase in bandwidth sales and a reduction in general and administrative expenses as a result of cost containment measures implemented in 2005.

**Energy Investments**

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 its 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 primarily engaged in a joint venture with The Houston Exploration Company, an independent natural gas and oil exploration company that was a former KeySpan subsidiary.

This segment is also engaged in pipeline development activities. KeySpan and 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 26.3% interest in the Millennium Pipeline Company LLC, the developer of 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 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. KeySpan has filed a petition for judicial review of a FERC decision that denied KeySpan LNG's application for FERC authorization to expand the facility to accept marine deliveries and triple vaporization capacity.

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. On March 18, 2005, the sale was completed and generated cash proceeds of $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 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.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Revenues | $ 11.2 | $ 8.7 | $ 20.4 | $ 18.8 |
| Less: Operation and maintenance expense | 7.4 | 5.2 | 14.0 | 11.7 |
| Other operating expenses | 3.0 | 2.8 | 6.2 | 5.3 |
| Add: Equity earnings | 2.9 | 4.7 | 6.3 | 10.0 |
| Sale of assets | - | 0.1 | 0.2 | 0.1 |
| Operating Income | $ 3.7 | $ 5.5 | $ 6.7 | $ 11.9 |

As indicated in the above table, operating income for the Energy Investments segment decreased $1.8 million in the second quarter of 2006 compared to the second quarter of 2005, primarily reflecting lower earnings associated with KeySpan's investment in the Iroquois Gas Transmission System. Earnings from this investment have been adversely impacted by a decrease in pipeline transportation rates. Further, 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.

For the six months ended June 30, 2006, operating income decreased $5.2 million compared to the same period in 2005 due, in part, to lower earnings from KeySpan's investment in the Iroquois Gas Transmission System for the reasons noted above. Further, a KeySpan subsidiary engaged in the transportation of liquefied natural gas realized lower earnings due to the warm winter weather. Finally, equity earnings were adversely impacted by the sale of Premier in March 2005.

*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 Secretary of Commerce 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 and a decision from that court is pending. 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 Policy Act of 2005 (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. The appeal was argued in January 2006. Further, oral arguments on the constitutional and jurisdictional issues were held in April 2006. Onshore and offshore geotechnical work on this project was completed in the second quarter of 2006. Assuming a favorable outcome in the United States Court of Appeals, KeySpan anticipates that this pipeline will be in service in 2008. As of June 30, 2006, KeySpan's total capitalized costs associated with the siting and permitting of the Islander East pipeline were approximately $27.5 million.

As noted, KeySpan also owns a 26.3% 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., a unit of NiSource Incorporated and DTE Energy. 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, Consolidated Edison Company of New York Inc. ("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 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. It is anticipated that the Millennium Pipeline will be in service in 2008. In addition, the FERC issued a favorable draft supplemental environmental impact statement on June 9, 2006. As of June 30, 2006, KeySpan's investment in the Millennium Pipeline project was $17.7 million.

In 2005, KeySpan LNG entered into a development agreement with BG, LNG Services, a subsidiary of British Gas, to upgrade the KeySpan LNG's liquefied natural gas 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 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. Motions to intervene by the Cities of Providence, East Providence, the Governor and Attorney General of Rhode Island, Weaver's Cove Energy, LLC and Northeast Energy Associates were granted on June 12, 2006. On June 20, 2006, the Court ordered the intervenors to show cause, by July 20, 2006, why they should not be limited to one joint brief and one reply brief on each side, subject to certain word limits. The Court is expected to issue a briefing schedule after the responses to the show cause order are filed and 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 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. As of June 30, 2006, our investment in this project was $17.2 million, a portion of which may be subject to reimbursement from BG LNG pursuant to the terms of the development 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 including legal and consulting fees, 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 three and six months ended June 30, 2006 associated with these settlement agreements.

**Liquidity**

Cash flow from operations increased $324.4 million, or 70%, for the six months ended June 30, 2006 compared to the same period last year primarily reflecting the timing of cash payment for the funding of KeySpan's pension and other postretirement plans, the timing of income tax payments and favorable working capital requirements**.** During the six months ended June 30, 2006, KeySpan contributed $25.5 million to its pension and other postretirement plans compared to $114.5 million contributed during the same period in 2005. At this point in time, KeySpan anticipates that its total 2006 pension and other postretirement contributions will be approximately the same as its 2005 contributions. Further, KeySpan's income tax payments were $28.4 million lower during the six months ended June 30, 2006 compared to the same period last year. The favorable working capital requirements primarily reflect receipt of customer payments associated with winter heating season gas sales.

At June 30, 2006, we had cash and temporary cash investments of $40.1 million. During the six months of 2006, we repaid $467.6 million of commercial paper and, at June 30, 2006, $190.0 million of commercial paper was outstanding at a weighted-average annualized interest rate of 5.42%. We had the ability to borrow up to an additional $1.3 billion at June 30, 2006, under the terms of our credit facility.

KeySpan has two credit facilities which total $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 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 June 30, 2006, KeySpan's consolidated indebtedness was 47.3% 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 Note 10. to the Consolidated Financial Statements "2006 LIPA Settlement" 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) | Six Months Ended June 30, 2006 | 2005 |
|---|---|---|
| Gas Distribution | $ 184.9 | $ 154.3 |
| Electric Services | 42.9 | 56.0 |
| Energy Investments | 12.8 | 14.0 |
| Energy Services and other | 6.4 | 6.7 |
| | $ 247.0 | $ 231.0 |

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. The increase in capital expenditures for the six months ended June 30, 2006 compared to the same period last year of $16.0 million reflects an increase in the Gas Distribution segment due, in part, to the timing of capital main and service work, as well as to upgrades to KeySpan's New York LNG facility. In total, KeySpan anticipates incurring approximately the same amount of construction expenditures in 2006 as it incurred in 2005.

*Financing*

KeySpan did not engage in any financing activities in the first six months of 2006, other than commercial paper repayments as noted earlier. At this point in time, KeySpan has no specific plans for additional financing for the remainder of 2006.

The following table represents the ratings of our long-term debt at June 30, 2006. In 2004 Standard & Poor's reaffirmed its ratings on KeySpan's and its subsidiaries' long-term debt and removed its negative outlook. Further in 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 June 30, 2006. 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 $72.1 million of surety bonds associated with certain construction projects currently being performed by former subsidiaries; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of $64.7 million; and (iii) $80.3 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 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees.)

**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. These obligations have remained substantially unchanged since December 31, 2005. (For additional details regarding these obligations see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as Note 6 "Long-Term Debt" and Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" to those Consolidated Financial Statements.)

**Discussions 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.

Below is a discussion of KeySpan's critical accounting policies and assumptions at June 30, 2006. For a more detailed discussion of these policies and assumptions see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations "Discussion of Critical Accounting Policies and Assumptions."

*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 annual operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set annual budgetary guidelines. At June 30, 2006, KeySpan has $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.

*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 orders issued by the MADTE relating to the Eastern Enterprise acquisition in 2000, 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.

As is further discussed under the caption "Regulation and Rate Matters," 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. As part of its application for approval of the KeySpan / National Grid merger, KeySpan has filed a proposed rate plan for KEDNY and KEDLI with the NYPSC. 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*

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.

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At June 30, 2006, we had a funding credit balance in excess of the ERISA minimum funding requirements. Although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Therefore,
for 2006, KeySpan expects to contribute a total of $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. (In addition to Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, see also Note 4 of those Consolidated Financial Statements, "Postretirement Benefits.")

**Regulation and Rate Matters**

*Gas Matters*

The rate agreements for KEDNY and KEDLI have expired. Under the terms of the KEDNY and KEDLI rate agreements, gas distribution rates and all other provisions will remain in effect until changed by the NYPSC. KeySpan has recently filed a proposed rate plan for KEDNY and KEDLI with the NYPSC as part of its application for approval of the KeySpan / National Grid merger. See the "Introduction to the Notes to the Consolidated Financial Statements" for additional details on the filing.

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 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's 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'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 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 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 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. Boston Gas also plans to request full recovery, as an exogenous cost, the 2005 gas cost component of bad debt write-offs from Boston Gas ratepayers beginning November 1, 2006.

For an additional discussion of our current gas distribution rate agreements, see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Regulation and Rate Matters."

*Electric 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% 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.

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. (For a further discussion on the LIPA agreements see Note 10 to the Consolidated Financial Statements "2006

LIPA Settlement," as well as KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Electric Services – LIPA 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. 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.

**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.

We estimate that the remaining cost of our MGP related environmental cleanup activities, including costs associated with the Ravenswood Generating Station, will be approximately $382.3 million and we have recorded a related liability for such amount. We have also recorded an additional $16.6 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of June 30, 2006, we have expended a total of $198.9 million on environmental investigation and remediation activities. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies.")

**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. The most significant contingency involves the evolution of the gas distribution and electric industries towards more competitive and deregulated environments. The risks associated with KeySpan's gas distribution activities have not changed substantially since December 31, 2005. For additional information regarding these risks see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Market and Credit Risk Management Activities." The following is an update to certain matters related KeySpan's electric operations.

*The Ravenswood Generating Station and KeySpan's 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 rerunning 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%.

**Item 3. 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 Generating Station uses 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 Generating Station also hedges the cash flow variability associated with a portion of electric energy sales using OTC electricity swaps.

KeySpan uses market quoted forward prices to value OTC swap contracts.

*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. 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 remaining period July 2006 through October 2006 and further complement our hedging strategy noted above regarding sales to certain large-volume customers. In addition, OTC fuel swaps do not qualify for hedge accounting treatment. The Ravenswood Generating Station has also employed a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133 associated with the purchase of fuel oil. Additionally, KeySpan 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 noted above that were outstanding at June 30, 2006.

| Type of Contract | Year of Maturity | Volumes mmcf | Fixed Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Gas** | | | | | |
| Swaps/Futures - Long Natural Gas | 2006 | 23,328 | 1.71 - 11.26 | 1.94 - 10.24 | (11.1) |
| | 2007 | 7,347 | 1.74 - 11.94 | 1.94 - 11.76 | (0.4) |
| | 2008 | 353 | 9.82 | 7.70 - 10.87 | (0.2) |
| OTC Swaps - Short Natural Gas | 2006 | 931 | 6.17 - 6.29 | 7.52 - 10.50 | (1.1) |
| | 2007 | 1,702 | 5.86 - 5.97 | 9.27 - 11.16 | (6.2) |
| | 2008 | 1,552 | 6.77 - 6.85 | 8.59 - 11.19 | (3.9) |
| | | 35,213 | | | (22.9) |

| Type of Contract | Year of Maturity | Volumes Barrels | Fixed Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Oil** | | | | | |
| Swaps - Long Fuel Oil | 2006 | 115,778 | 57.00 - 66.80 | 53.49 - 58.10 | (2.9) |
| | 2007 | 132,879 | 59.20 - 62.14 | 62.51 | (0.5) |
| | 2008 | 33,862 | 67.60 | 64.23 | (0.1) |
| Swaps - Short Heating Oil | 2006 | 294,696 | 73.50 - 79.38 | 78.12 - 82.74 | (3.0) |
| | | 577,215 | | | (6.5) |

| Type of Contract | Year of Maturity | MWh | Fixed Margin/ Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Electricity** | | | | | |
| Swaps - Energy | 2006 | 972 | 73.50 - 156.25 | 69.96 - 118.90 | 15.0 |
| | 2007 | 142 | 101.50 - 150.50 | 88.72 -150.50 | 1.6 |
| | | 1,114 | | | 16.6 |

| *Change in Fair Value of Derivative Instruments* | 2006 (In $ Millions) |
|---|---|
| Fair value of contracts at January 1, | (18.1) |
| Net (gains) on contracts realized | 59.8 |
| Increase in fair value of all open contracts | (54.5) |
| Fair value of contracts outstanding at June 30, | (12.8) |

*(In Millions of Dollars)*

| | Fair Value of Contracts | | |
|---|---|---|---|
| Sources of Fair Value | Mature Within 12 Months | Thereafter | Total Fair Value |
| Prices actively quoted | $ (18.4) | $ (6.8) | $ (25.2) |
| Local published indicies | 12.4 | - | 12.4 |
| | $ (6.0) | $ (6.8) | $ (12.8) |

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 June 30, 2006 a 10% increase/decrease in natural gas prices would decrease/increase the value of derivative instruments maturing in one year by $3.1 million. Further, a 10% increase/decrease in electricity and fuel prices would decrease/increase the value of derivative instruments maturing in one year by $1.7 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 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 June 30, 2006.

| Type of Contract | Year of Maturity | Volumes mmcf | Floor ($) | Ceiling ($) | Fixed Price ($) | Current Price ($) | Fair Value (In $ Millions) |
|---|---|---|---|---|---|---|---|
| Options | 2006 | 1,038 | 5.50 | 10.00 | - | 7.21 - 10.07 | 1.3 |
| Swaps | 2006 | 29,854 | - | - | 7.35 - 11.63 | 7.21 - 10.07 | (36.3) |
| | 2007 | 51,344 | - | - | 6.81 - 11.99 | 8.90 - 10.72 | (17.9) |
| | 2008 | 4,810 | - | - | 7.68 - 11.64 | 7.95 - 10.87 | (1.6) |
| | | 87,046 | | | | | (54.5) |

See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for a further description of all our derivative instruments.

**Item 4. Controls and Procedures**

We maintain disclosure controls and procedures (as defined under Exchange Act Rule 13a-15(e) and 15d-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 June 30, 2006. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures were effective at the reasonable assurance level in alerting them timely to material information required to be included in KeySpan's periodic SEC reports.

Furthermore, there has been no change in KeySpan's internal control over financial reporting 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.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

See Note 6 to the Consolidated Financial Statements "Financial Guarantees and Contingencies".

### Item 1A. Risk Factors

Certain statements contained in this Quarterly Report on Form 10-Q concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are other than statements of historical facts, are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Without limiting the foregoing, all statements under the captions "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk" relating to our future outlook, anticipated capital expenditures, future cash flows and borrowings, pursuit of potential future acquisition opportunities and sources of funding, are forward-looking statements. Such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties and actual results may differ materially from those discussed in such statements.

Among the factors that could cause actual results to differ materially are:

- the occurrence of any event, change or other circumstances that could give rise to the termination of the merger agreement with National Grid or the failure of the merger to close for any reason;

- volatility of energy prices 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 manage our cost structure successfully and operate efficiently;

- our ability to successfully contract for natural gas supplies required to meet the needs of our customers;

- implementation of new accounting standards or changes in accounting standards or GAAP which may require adjustments to financial statements;

- inflationary trends and interest rates;

- the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of such acquisitions;

- available sources and cost of fuel;

- creditworthiness of counterparties to derivative instruments and commodity contracts;

- the resolution of certain disputes with LIPA concerning each party's rights and obligations under various agreements;

- retention of key personnel;

- federal and state regulatory initiatives that threaten cost and investment recovery and place limits on the type and manner in which we invest in new businesses and conduct operations;

- the impact of federal, state and local utility regulatory policies, legislation 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 facing our unregulated Energy Services businesses;

- the degree to which we develop unregulated business ventures, as well as federal, state and local regulatory policies affecting our ability to retain and operate such business ventures profitably;

- a change in the fair value of our investments that could cause a significant change in the carrying value of such investments or the carrying value of related goodwill;

- timely receipts of payments from our two largest customers LIPA and the NYISO;

- changes in the UCAP pricing structure;

- timing of approval of the 2006 LIPA Agreements and;

- other risks detailed from time to time in other reports and other documents filed by KeySpan with the SEC.

For any of these statements, KeySpan claims the protection of the safe harbor for forward-looking information contained in the Private Securities Litigation Reform Act of 1995, as amended. For additional discussion on these risks, uncertainties and assumptions, see "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk."

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

31.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

*Filed Herewith

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on behalf of the undersigned there unto duly authorized.

**KEYSPAN CORPORATION**

(Registrant)

By: /s/Gerald Luterman
Name: Gerald Luterman
Title: Executive Vice President and
Chief Financial Officer

Date: August 3, 2006

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President and
Chief Financial Officer

Date: August 3, 2006

/s/ Theresa A. Balog
Theresa A. Balog
Vice President and
Chief Accounting Officer

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**ANNUAL REPORT**
**PURSUANT TO SECTION 13 OR 15(d)**
**OF THE SECURITIES EXCHANGE ACT OF 1934**

**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2006

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to _________

**Commission file number 1-14161**

**KEYSPAN CORPORATION**
(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| **NEW YORK** | **11-3431358** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| **One MetroTech Center, Brooklyn, New York** | **11201** |
| **175 East Old Country Road, Hicksville, New York** | **11801** |
| (Address of Principal Executive Offices) | (Zip Code) |

**(718) 403-1000 (Brooklyn)**
**(516) 755-6650 (Hicksville)**
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes**[X]** No**[ ]**

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

Large accelerated filer **[X]** Accelerated filer **[ ]** Non-accelerated filer **[ ]**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes**[ ]** No**[X]**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class of Common Stock | Outstanding at October 19, 2006 |
|---|---|
| $.01 par value | 175,283,247 |

KEYSPAN CORPORATION AND SUBSIDIARIES

INDEX

## CONSOLIDATED BALANCE SHEET
(Unaudited)

| *(In Millions of Dollars)* | **September 30, 2006** | December 31, 2005 |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and temporary cash investments | **$ 40.0** | $ 124.5 |
| Restricted cash | **5.6** | 13.2 |
| Accounts receivable | **779.9** | 1,035.6 |
| Unbilled revenue | **221.0** | 685.6 |
| Allowance for uncollectible accounts | **(52.7)** | (62.8) |
| Gas in storage, at average cost | **788.9** | 766.9 |
| Material and supplies, at average cost | **144.8** | 140.5 |
| Derivative contracts | **46.9** | 142.8 |
| Other | **172.5** | 173.8 |
| | **2,146.9** | 3,020.1 |
| **Investments and Other** | **257.9** | 242.4 |
| **Property** | | |
| Gas | **7,545.8** | 7,275.9 |
| Electric | **2,549.3** | 2,492.3 |
| Other | **430.4** | 416.3 |
| Accumulated depreciation | **(3,096.0)** | (2,922.6) |
| Gas exploration and production, at cost | **186.0** | 184.2 |
| Accumulated depletion | **(112.3)** | (109.2) |
| | **7,503.2** | 7,336.9 |
| **Deferred Charges** | | |
| Regulatory assets: | | |
| Miscellaneous assets | **710.7** | 688.3 |
| Derivative contracts | **260.2** | 30.9 |
| Goodwill and other intangible assets | **1,666.3** | 1,666.3 |
| Derivative contracts | **138.5** | 75.2 |
| Other | **754.7** | 752.5 |
| | **3,530.4** | 3,213.2 |
| **Total Assets** | **$ 13,438.4** | $ 13,812.6 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED BALANCE SHEET
(Unaudited)

| *(In Millions of Dollars)* | **September 30, 2006** | December 31, 2005 |
|---|---|---|
| **LIABILITIES AND CAPITALIZATION** | | |
| **Current Liabilities** | | |
| Accounts payable and other liabilities | **$ 681.9** | $ 1,087.0 |
| Commercial paper | **330.0** | 657.6 |
| Current redemption of long-term debt | **13.2** | 13.0 |
| Taxes accrued | **150.8** | 176.3 |
| Dividends payable | **81.4** | 81.1 |
| Customer deposits | **35.6** | 39.1 |
| Interest accrued | **74.5** | 53.8 |
| Derivative contracts | **279.4** | 47.3 |
| | **1,646.8** | 2,155.2 |
| **Deferred Credits and Other Liabilities** | | |
| Regulatory liabilities: | | |
| Miscellaneous liabilities | **44.8** | 69.9 |
| Removal cost recovered | **549.0** | 516.4 |
| Derivative contracts | **122.2** | 175.4 |
| Asset retirement obligations | **49.4** | 47.4 |
| Deferred income tax | **1,222.4** | 1,157.9 |
| Postretirement benefits and other reserves | **1,144.8** | 1,118.4 |
| Derivative contracts | **47.7** | 44.3 |
| Other | **109.1** | 127.5 |
| | **3,289.4** | 3,257.2 |
| **Commitments and Contingencies (See Note 6)** | **-** | - |
| **Capitalization** | | |
| Common stock - 184,864 shares issued, 175,232 shares outstanding at September 30, 2006, par value $0.01 | **3,985.6** | 3,975.9 |
| Retained earnings | **930.5** | 866.9 |
| Other comprehensive (loss) | **(69.8)** | (74.8) |
| Treasury stock | **(278.9)** | (303.9) |
| Total common shareholders' equity | **4,567.4** | 4,464.1 |
| Long-term debt and capital leases | **3,919.3** | 3,920.8 |
| **Total Capitalization** | **8,486.7** | 8,384.9 |
| **Minority Interest in Subsidiary Companies** | **15.5** | 15.3 |
| **Total Liabilities and Capitalization** | **$ 13,438.4** | $ 13,812.6 |

See accompanying Notes to the Consolidated Financial Statements.

# CONSOLIDATED STATEMENT OF INCOME

(Unaudited)

| *(In Millions of Dollars, Except Per Share Amounts)* | Three Months Ended Sept. 30, **2006** | Three Months Ended Sept. 30, 2005 | Nine Months Ended Sept. 30, **2006** | Nine Months Ended Sept. 30, 2005 |
|---|---|---|---|---|
| **Revenues** | | | | |
| Gas Distribution | **$ 595.5** | $ 629.6 | **$ 3,648.8** | $ 3,476.1 |
| Electric Services | **565.6** | 619.9 | **1,434.6** | 1,488.9 |
| Energy Services | **49.0** | 45.4 | **147.8** | 134.1 |
| Energy Investments | **8.4** | 8.2 | **26.1** | 27.0 |
| Total Revenues | **1,218.5** | 1,303.1 | **5,257.3** | 5,126.1 |
| **Operating Expenses** | | | | |
| Purchased gas for resale | **361.5** | 395.7 | **2,412.7** | 2,206.1 |
| Fuel and purchased power | **172.6** | 254.6 | **418.3** | 546.9 |
| Operations and maintenance | **372.7** | 364.3 | **1,199.3** | 1,143.3 |
| Depreciation, depletion and amortization | **84.2** | 92.1 | **295.7** | 295.8 |
| Operating taxes | **95.9** | 97.1 | **309.9** | 303.0 |
| Total Operating Expenses | **1,086.9** | 1,203.8 | **4,635.9** | 4,495.1 |
| Income from equity investments | **3.2** | 2.5 | **9.5** | 12.5 |
| Sale of assets | **1.0** | 1.0 | **1.4** | 1.2 |
| **Operating Income** | **135.8** | 102.8 | **632.3** | 644.7 |
| **Other Income and (Deductions)** | | | | |
| Interest charges | **(67.1)** | (67.4) | **(192.7)** | (200.1) |
| Gain on sale of investments | **-** | - | **-** | 4.1 |
| Cost of debt redemption | **-** | - | **-** | (20.9) |
| Other | **8.0** | (3.8) | **25.6** | 9.4 |
| Total Other Income and (Deductions) | **(59.1)** | (71.2) | **(167.1)** | (207.5) |
| **Income Taxes** | | | | |
| Current | **(17.9)** | (25.8) | **104.3** | 119.0 |
| Deferred | **44.3** | 34.8 | **53.3** | 41.0 |
| Total Income Taxes | **26.4** | 9.0 | **157.6** | 160.0 |
| Earnings from continuing operations | **50.3** | 22.6 | **307.6** | 277.2 |
| **Discontinued Operations** | | | | |
| Income (loss) from discontinued operations, net of tax | **-** | - | **-** | (4.1) |
| Gain on disposal, net of tax | **-** | - | **-** | 2.3 |
| Loss from discontinued operations | **-** | - | **-** | (1.8) |
| **Net Income** | **50.3** | 22.6 | **307.6** | 275.4 |
| Preferred stock dividend requirements | **-** | - | **-** | 2.2 |
| **Earnings for Common Stock** | **$ 50.3** | $ 22.6 | **$ 307.6** | $ 273.2 |
| **Basic Earnings Per Share:** | | | | |
| Continuing Operations, less preferred stock dividends | **$ 0.29** | $ 0.13 | **$ 1.76** | **$ 1.63** |
| Discontinued Operations | **-** | - | **-** | **(0.01)** |
| Basic Earnings Per Share | **$ 0.29** | $ 0.13 | **$ 1.76** | **$ 1.62** |
| **Diluted Earnings Per Share** | | | | |
| Continuing Operations, less preferred stock dividends | **$ 0.29** | $ 0.13 | **$ 1.75** | **$ 1.62** |
| Discontinued Operations | **-** | - | **-** | **(0.01)** |
| Diluted Earnings Per Share | **$ 0.29** | $ 0.13 | **$ 1.75** | **$ 1.61** |
| **Average Common Shares Outstanding (000)** | **175,114** | 174,332 | **174,935** | 168,465 |
| **Average Common Shares Outstanding - Diluted (000)** | **176,295** | 175,238 | **175,996** | 169,403 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED STATEMENT OF CASH FLOWS
(Unaudited)

| | Nine Months Ended Sept. 30, | |
|---|---|---|
| *(In Millions of Dollars)* | **2006** | 2005 |
| ***Operating Activities*** | | |
| Net income | **$ 307.6** | $ 275.4 |
| **Adjustments to reconcile net income to net cash provided by (used in) operating activities** | | |
| Depreciation, depletion and amortization | **295.7** | 295.8 |
| Deferred income tax | **53.3** | 41.0 |
| Income from equity investments | **(9.5)** | (12.5) |
| Dividends from equity investments | **8.7** | 5.3 |
| Amortization of interest rate swap / financiang fees | **6.2** | (2.5) |
| (Gain) on sale of property and investments | **(1.5)** | (5.3) |
| Loss from discontinued operations | **-** | 1.8 |
| Amortization of property tax prepayments | **106.9** | 91.8 |
| **Changes in assets and liabilities** | | |
| Accounts receivable | **712.5** | 294.3 |
| Materials and supplies, fuel oil and gas in storage | **(26.3)** | (245.2) |
| Accounts payable and other liabilities | **(409.8)** | (165.2) |
| Insurance recovery and regulatory settlements, net | **16.6** | 21.1 |
| Property tax prepayment | **(79.4)** | (69.5) |
| Environmental payments | **(37.8)** | (24.4) |
| Other | **(35.6)** | (29.8) |
| **Net Cash Provided by Operating Activities** | **907.6** | 472.1 |
| ***Investing Activities*** | | |
| Construction expenditures | **(377.6)** | (372.1) |
| Cost of removal | **(23.1)** | (10.8) |
| Derivative margin calls | **(42.7)** | (63.3) |
| Net proceeds from sale of property and investments | **1.5** | 46.9 |
| **Net Cash Used in Investing Activities** | **(441.9)** | (399.3) |
| ***Financing Activities*** | | |
| Treasury stock issued | **21.2** | 41.0 |
| MEDs equity conversion | **-** | 460.0 |
| Payment of long-term debt | **-** | (590.1) |
| Payment of commercial paper | **(327.6)** | (592.2) |
| Common and preferred stock dividends paid | **(243.8)** | (229.1) |
| Other | **-** | 14.0 |
| **Net Cash Used in Financing Activities** | **(550.2)** | (896.4) |
| Net Decrease in Cash and Cash Equivalents | **(84.5)** | (823.6) |
| Cash Flow from Discontinued Operations - Operating | **-** | (15.1) |
| Cash Flow from Discontinued Operations - Investing | **-** | 0.5 |
| Cash Flow from Discontinued Operations - Financing | **-** | 0.2 |
| Cash and Cash Equivalents at Beginning of Period | **124.5** | 922.0 |
| Cash and Cash Equivalents at End of Period | **$ 40.0** | $ 84.0 |

Cash equivalents are short-term marketable securities purchased with maturities of three months or less that were carried at cost which approximates fair value.

See accompanying Notes to the Consolidated Financial Statements.

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

INTRODUCTION TO THE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

KeySpan Corporation (referred to in the Notes to the Financial Statements 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 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.)

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 of KeySpan (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 adoption of the Merger Agreement by the stockholders of KeySpan and the Parent and the receipt of requisite regulatory approvals from certain United States federal and state public utility, antitrust and other regulatory authorities, many of which have been filed or 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 transaction at a meeting held on July 31, 2006.

In addition to seeking approval of the Merger, the application filed with the NYPSC also contained a proposed ten-year rate plan for KeySpan Energy Delivery of New York ("KEDNY") and KeySpan Energy Delivery of Long Island ("KEDLI"), as well as proposals concerning corporate structure, affiliate rules and transactions and the rate treatment for contemplated synergy savings. Specifically, the rate plan proposal provides 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 clause would be increased to recover, on a prospective basis, 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 plan. The proposed rate plan also contemplates 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 Nation Grid plc filed testimony and exhibits with the NYSPSC that refers to both exhibits and attachments that were previously submitted as part of the July 20, 2006 petition.

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

In the meantime, individual applications for a proposed annual increase in revenues for KEDNY and KEDLI were filed on October 3, 2006 with the NYPSC. The proposed revenue increases are for 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 then 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 $14 million for KEDNY and KEDLI, respectively, for gas related expenses that will be recovered through the Gas Adjustment Clause ("GAC") and/or 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, KeySpan does not expect that the rate increases proposed therein will be implemented because KEDNY's and KEDLI's need for rate relief on a stand alone basis will be superseded and rendered moot by an earlier NYPSC approval of the merger between National Grid plc and KeySpan and the approval of the related ten-year rate plan previously noted.

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 repeal 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. (For additional information on the Energy Act and PUHCA 2005 see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7. Management's Discussion and Analyses of Financial Condition and Results of Operations - "Regulation and Rate Matters.")

1. BASIS OF PRESENTATION

In our opinion, the accompanying unaudited Consolidated Financial Statements contain all adjustments necessary to present fairly KeySpan's financial position as of September 30, 2006, and the results of operations for the three and nine months ended September 30, 2006 and September 30, 2005, as well as cash flows for the nine months ended September 30, 2006 and September 30, 2005. The accompanying financial statements should be read in conjunction with the consolidated financial statements and notes included in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005. The December 31, 2005 financial statement information has been derived from the 2005 audited financial statements. Income from interim periods may not be indicative of future results. Certain reclassifications were made to conform prior period financial statements to the current period financial statement presentation.

Consolidated earnings are seasonal in nature primarily due to the significant contributions to earnings of the gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters.

Basic earnings per share ("EPS") is calculated by dividing earnings available 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 available 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 Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share" our basic and diluted EPS are as follows:

| (In Millions of Dollars, Except Per Share Amounts) | Three Months Ended Sept. 30, 2006 | 2005 | Nine Months Ended Sept. 30, 2006 | 2005 |
|---|---|---|---|---|
| Earnings for common stock | $ 50.3 | $ 22.6 | $ 307.6 | $ 273.2 |
| Weighted average shares outstanding (000) | 175,114 | 174,332 | 174,935 | 168,465 |
| Add dilutive securities: | | | | |
| Options | 1,045 | 906 | 970 | 938 |
| Performance shares | 136 | - | 91 | - |
| Total weighted average shares outstanding - assuming dilution | 176,295 | 175,238 | 175,996 | 169,403 |
| Basic earnings per share | $ 0.29 | $ 0.13 | $ 1.76 | $ 1.62 |
| Diluted earnings per share | $ 0.29 | $ 0.13 | $ 1.75 | $ 1.61 |

## 2. BUSINESS SEGMENTS

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

The Gas Distribution segment consists of six gas distribution subsidiaries. KeySpan Energy Delivery New York ("KEDNY") provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Queens and Staten Island. KeySpan Energy Delivery Long 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, Boston Gas Company, Colonial Gas Company, Essex Gas Company and EnergyNorth Natural Gas, Inc., collectively referred to as KeySpan Energy Delivery New England ("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 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 10, "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 New York Independent Systems Operator ("NYISO") energy markets. To finance the purchase and/or construction of the Ravenswood Generating Station, KeySpan entered into a leasing arrangement for each facility. The Electric Services segment also conducts retail marketing of electricity to commercial customers. (See Note 6 "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.

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 its 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. See Footnote 12 "Gas Exploration and Production Property – Depletion" for a discussion of the September 30, 2006 ceiling test calculation.

This 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 26.3% 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. 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 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.

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. At September 30, 2006, the total assets of each reportable segment have not changed materially from those levels reported at December 31, 2005. The reportable segment information is as follows:

| *(In Millions of Dollars)* | Gas Distribution | Electric Services | Energy Services | Energy Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|
| **Three Months Ended Sept. 30, 2006** | | | | | | |
| Unaffiliated revenue | 595.5 | 565.6 | 49.0 | 8.4 | - | 1,218.5 |
| Intersegment revenue | - | - | 2.8 | 1.3 | (4.1) | - |
| Operating Income | (10.8) | 144.4 | 3.0 | 4.7 | (5.5) | 135.8 |
| **Three Months Ended Sept. 30, 2005** | | | | | | |
| Unaffiliated revenue | 629.6 | 619.9 | 45.4 | 8.2 | - | 1,303.1 |
| Intersegment revenue | - | - | 1.7 | 3.7 | (5.4) | - |
| Operating Income | (45.5) | 149.6 | (1.1) | 4.7 | (4.9) | 102.8 |

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

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of $553.5 million and $612.1 million for the three months ended September 30, 2006 and 2005, respectively, represent approximately 45% and 47%, respectively of our consolidated revenues in these periods.

| *(In Millions of Dollars)* | Gas Distribution | Electric Services | Energy Services | Energy Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|
| **Nine Months Ended Sept. 30, 2006** | | | | | | |
| Unaffiliated revenue | 3,648.8 | 1,434.6 | 147.8 | 26.1 | - | 5,257.3 |
| Intersegment revenue | - | - | 7.6 | 4.0 | (11.6) | - |
| Operating Income | 365.1 | 271.7 | 4.6 | 11.3 | (20.4) | 632.3 |
| **Nine Months Ended Sept. 30, 2005** | | | | | | |
| Unaffiliated revenue | 3,476.1 | 1,488.9 | 134.1 | 27.0 | - | 5,126.1 |
| Intersegment revenue | - | 4.6 | 7.9 | 3.7 | (16.2) | - |
| Operating Income | 376.8 | 266.3 | (6.7) | 16.6 | (8.3) | 644.7 |

Eliminating items include the elimination of certain intercompany accounts, as well as activities of our corporate and administrative areas.

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of $1,415.5 million and $1,423.4 million for the nine months ended September 30, 2006 and 2005, respectively, represent approximately 27%, of our consolidated revenues in both periods.

## 3. COMPREHENSIVE INCOME

The table below indicates the components of comprehensive income:

| (In Millions of Dollars) | Three Months Ended Sept. 30, 2006 | Three Months Ended Sept. 30, 2005 | Nine Months Ended Sept. 30, 2006 | Nine Months Ended Sept. 30, 2005 |
|---|---|---|---|---|
| Net Income | $ 50.3 | $ 22.6 | $ 307.6 | $ 275.4 |
| Other comprehensive income (loss), net of tax | | | | |
| Reclassification of (gains) losses included in net income | (4.7) | 10.7 | (43.6) | 18.4 |
| Foreign currency translation adjustments | - | - | - | (5.0) |
| Unrealized gains on marketable securities | 0.2 | 2.9 | 0.5 | 1.4 |
| Unrealized (losses) gains on derivative financial instruments | 7.3 | (59.8) | 48.1 | (78.0) |
| Other comprehensive gain (loss), net of tax | 2.8 | (46.2) | 5.0 | (63.2) |
| Comprehensive Income (Loss) | $ 53.1 | $ (23.6) | $ 312.6 | $ 212.2 |
| Related tax (benefit) expense | | | | |
| Reclassification of (gains) losses included in net income | (2.6) | 5.8 | (23.5) | 9.9 |
| Foreign currency translation adjustments | - | - | - | (2.7) |
| Unrealized gains on marketable securities | 0.1 | 1.6 | 0.3 | 0.8 |
| Unrealized (losses) gains on derivative financial instruments | 4.5 | (33.6) | 27.4 | (44.3) |
| Total Tax (Benefit) Expense | $ 2.0 | $ (26.2) | $ 4.2 | $ (36.3) |

## 4. HEDGING AND DERIVATIVE FINANCIAL INSTRUMENTS

*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 Generating Station.

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 certain of these derivative instruments is subject to SFAS 71 "Accounting for the Effects of Certain Types of Regulation." Therefore, the fair value of these derivatives are 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. 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, however, are not subject to SFAS 71 and thus are not subject to deferral accounting treatment. 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 rate for the highest consumption block otherwise applicable to our firm commercial customers. During 2006, KeySpan used 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. At September 30, 2006, there were no outstanding derivative instruments associated with this strategy. However, KeySpan may elect to enter into similar derivative financial instruments when prevailing market conditions are favorable.

We have three fixed price forward sale contracts with large-volume interruptible gas sales customers. KeySpan uses OTC natural gas swaps to hedge the cash-flow variability of gas purchases associated with these customers. These gas swaps are accounted for as 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 September 30, 2006 was a liability of $2.5 million, all of which is reported in accumulated other comprehensive income and is expected to be reclassified into earnings within the next twelve months.

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 September 30, 2006, Seneca-Upshur has hedge positions in place for approximately 90% 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 September 30, 2006 was a liability of $5.2 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 $2.9 million. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial for the nine months ended September 30, 2006.

The Ravenswood Generating Station hedges the cash flow variability associated with a portion of electric energy sales. Our strategy is to hedge up to 50% of the on-peak capacity of the Ravenswood Generating Station. The maximum length of time over which we have hedged cash flow variability is through March 2007**.** 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 the electric power derivative instruments at September 30, 2006 was $17.1 million, all of which is reported in accumulated other comprehensive income and 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 September 30, 2006, was a liability of $3.8 million all of which is reported in accumulated other comprehensive income and 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 September 30, 2006, was a liability of $14.6 million, of which $13.6 million 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 for the nine months ended September 30, 2006.

The above noted derivative financial instruments are cash flow hedges that are accounted for as 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, 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 fuel and purchased power 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.

*Firm Gas Sales Financial 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 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. At September 30, 2006 the fair value of these derivative instruments was a liability of $276.8 million.

*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 qualify for the normal purchases and sales exception. Certain contracts for the 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 71. At September 30, 2006, these derivatives had a net fair value of $130.1 million.

*Financially-Settled Commodity Derivative Instruments that Do Not Qualify for Hedge Accounting:* KeySpan subsidiaries also have financial derivatives that do not qualify for hedge accounting treatment under SFAS 133. In 2006, 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 noted above regarding sales to certain large-volume customers. As of September 30, 2006, these derivatives have expired. However, KeySpan may elect to enter into similar derivative financial instruments when prevailing market conditions are favorable.

The Ravenswood Generating Station also employs a limited number of financial derivatives that have not been designated for hedge accounting treatment under SFAS 133 to economically hedge the cash flow variability for a portion of forecasted purchases of natural gas that will be consumed during the generation of electricity. The fair value of these derivative instruments at September 30, 2006 was a liability of $2.3 million. In addition, the Ravenswood Generating Station employs a limited number of financial derivatives that have not been designated for hedge accounting treatment to economically hedge the cash flow variability for a portion of forecasted electric energy sales. The fair value of these derivative instruments at September 30, 2006 was $3.6 million; such amount was recorded in the Consolidated Statement of Income to reflect the change in the market value associated with these derivative instruments for the nine months ended September 30, 2006.

On January 18, 2006, KeySpan entered into an International SWAP Dealers Association Master Agreement for a fixed for float unforced capacity financial swap (the “ Swap Agreement”) with Morgan Stanley Capital Group Inc. (“Morgan Stanley”). The Swap Agreement has a three year term that began on May 1, 2006. The notional quantity was 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 occurs on a monthly 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 and is subject to fair value accounting treatment. The recognized fair value associated with this instrument is immaterial to the consolidated financial statements at September 30, 2006. As noted, this is a financial derivative instrument and is unrelated to any physical production of electricity.

KeySpan has a management contract with Merrill Lynch Trading, under which KeySpan and Merrill Lynch Trading will share the responsibilities for managing KeySpan’s upstream gas distribution assets associated with its Massachusetts gas distribution subsidiaries, as well as providing city-gate delivered supply. This contract, which replaces the prior arrangement with Merrill Lynch Trading, allows for both KeySpan and Merrill Lynch Trading to employ derivative instruments to maximize the profitability of KeySpan’s portfolio of gas distribution assets. Profits associated with these activities are shared between KeySpan, Merrill Lynch Trading and KeySpan’s Massachusetts ratepayers. At September 30, 2006, KeySpan’s proportionate share of the fair value associated with these derivative instruments amounted to $10.8 million. KeySpan has recorded a regulatory liability of $7.8 million on the Consolidated Balance Sheet representing the portion to be shared with Massachusetts ratepayers. The remaining amount was recorded as a benefit to revenues. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

*Interest Rate Derivative Instruments:* KeySpan anticipates issuing, subject to execution of definitive agreements, approximately $400 million Senior Unsecured Notes at KEDNY and approximately $100 million Senior Unsecured Notes at KEDLI in the fourth quarter of 2006. The Notes are anticipated to be issued with ten year maturities. 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. At September 30, 2006 the fair value of these derivative instruments was a liability of $2.9 million. The accounting for these derivative instruments is subject to SFAS 71. Therefore, the fair value of these derivatives was recorded as a current liability, with an offsetting position recorded as a regulatory asset on the Consolidated Balance Sheet.

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.

The table below summarizes the fair value of all of the above outstanding derivative instruments at September 30, 2006 and December 31, 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)* | Sept. 30, 2006 | December 31, 2005 |
|---|---|---|
| **Gas Contracts:** | | |
| Other current assets | $ 26.2 | $ 132.1 |
| Other deferred charges | 138.2 | 75.2 |
| Regulatory asset | 257.3 | 30.9 |
| Other current liability | (272.7) | (39.8) |
| Other deferred liabilities | (47.7) | (44.3) |
| Regulatory liability | (122.2) | (175.4) |
| **Oil Contracts:** | | |
| Other current assets | - | 0.5 |
| Other current liability | (3.8) | (6.8) |
| **Electric Contracts:** | | |
| Other current assets | 20.7 | 10.2 |
| Other deferred charges | 0.3 | - |
| Other current liability | - | (0.7) |
| **Interest Rate Contracts:** | | |
| Regulatory asset | 2.8 | - |
| Other current liability | (2.8) | - |
| | $ (3.7) | $ (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 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. 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 the third quarter of 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 upcoming 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.

*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 September 30, 2006, KeySpan has received $5.6 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 September 30, 2006, KeySpan has $51.6 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.

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 the reported results of operations, financial position and cash flows and lowers overall business risk.

## 5. RECENT ACCOUNTING PRONOUNCEMENTS

On September 29, 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard 158 ("SFAS 158") "Employers' Accounting for Defined Benefit Pensions and Other Postretirement Benefit Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)." SFAS 158 requires employers to fully recognize all postretirement plans funded status on the balance sheet as a net liability or asset and will require an offsetting adjustment to accumulated other comprehensive income in shareholders' equity. KeySpan estimates, using actual results through January 1, 2006 adjusted for the amortization of unrecognized gains and losses and prior service cost during 2006, that the pre-tax increase in its total postretirement liabilities resulting from the adoption of the recognition provisions of SFAS 158 will be approximately $1 billion. Certain of KeySpan's subsidiaries are subject to deferral accounting requirements pursuant to rate agreements with the NYPSC and the Massachusetts Department of Telecommunications and Energy ("MADTE"). Further, KeySpan has certain contractual rights to reimbursement for postretirement liabilities in its agreements with the Long Island Power Authority ("LIPA"). As such, a portion of the offsetting position to the increase in the total postretirement liabilities will be reflected as a regulatory asset and long-term receivable. The amount to be recorded as a regulatory asset and long-term receivable and the related impact on shareholders' equity is subject to final determination. At this point in time, KeySpan believes that it will remain in compliance with all applicable financial covenants upon implementation of SFAS 158. 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 is currently reviewing the income tax implications, if any, of SFAS 158.

The recognition and disclosure provisions of SFAS 158 are effective for fiscal years ending after December 15, 2006, on a prospective basis. SFAS 158 does not permit retroactive application of its provisions; however, SFAS 158 requires footnote disclosure of the incremental effect on the balance sheet on a line item basis in the year of adoption.

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. This Statement 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 this Statement 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 this

Statement, and at this point in time cannot determine what impact, if any, this Statement 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 requires application for fiscal years beginning after December 15, 2006. KeySpan is currently reviewing the requirements of this Statement, and at this point in time cannot determine what impact, if any, this Statement will have on its results of operations or financial position. This Statement will have no impact on cash flow.

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.

## 6. FINANCIAL GUARANTEES AND CONTINGENCIES

*Variable Interest Entity:* 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 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 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.

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 $311.4 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 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.”

*Asset Retirement Obligations*: KeySpan has various asset retirement obligations primarily associated with its gas distribution and electric generation activities. These obligations have remained substantially unchanged from December 31, 2005, except for normal accretion adjustments. Generally, KeySpan’s largest asset retirement obligations relate to: (i) legal requirements 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; or dispose of sections of gas main when removed from the pipeline system; (ii) cleaning and removal requirements associated with storage tanks containing waste oil and other waste contaminants; and (iii) legal requirements to remove asbestos upon major renovation or demolition of structures and facilities. At September 30, 2006, these obligations total $49.4 million. See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding these obligations.

Environmental Matters

*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 KeySpan, have been identified to the Department of Environmental Conservation ("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/or 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 the effect emerging case law will have on contribution suits which may be brought against other parties who impacted these sites for their share of remedial cost. KeySpan continues to evaluate how to proceed with respect to participation in the BCP or alternative DEC remediation programs. Regardless of which cleanup program is ultimately employed, KeySpan fully intends to investigate and remediate these sites, as necessary, and has adjusted its planned expenditures accordingly.

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 $75.2 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. Subject to the issues described above, 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 $59.1 million.

KeySpan presently estimates the remaining cost of its KEDNY and KEDLI MGP-related environmental remediation activities will be $333.7 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 September 30, 2006, we have reflected a regulatory asset of $378.4 million for KEDNY/KEDLI MGP sites. In October 2003, KEDNY and KEDLI filed a joint petition with the NYPSC seeking rate treatment for additional environmental costs that may be incurred at all of the New York MGP sites. That petition is still pending. 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. See the "Introduction to the Notes to the Consolidated Financial Statements" for additional details on the filings.

KeySpan is 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. KeySpan is 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 $1.5 million, which amount has been accrued by us. Expenditures incurred to date total $3.5 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.

KeySpan presently estimates the remaining cost of the Massachusetts KEDNE MGP-related environmental cleanup activities will be $10.5 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 the November 8, 2000, the acquisition date of these subsidiaries, with respect to these MGP-related activities total $32.8 million.

KeySpan 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 in New Hampshire. At four of these sites, KeySpan has entered into cost sharing agreements with other parties who share responsibility for remediation of these sites. EnergyNorth also 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. The Nashua River Asbestos Site now has been fully remediated.

KeySpan presently estimates the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $26.7 million, which amount has been accrued 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 acquisition date of this subsidiary, with respect to the MGP-related activities total $21.7 million.

By rate orders, the Massachusetts Department of Telecommunications and Energy ("MADTE") and the New Hampshire Public Utility Commission ("NHPUC") provide for the recovery of site investigation and remediation costs and, accordingly, at September 30, 2006, we have reflected a regulatory asset of $49.3 million for the KEDNE MGP sites.

*KeySpan New England, LLC Sites*: KeySpan is aware of three non-utility sites associated with KeySpan New England, LLC, a successor company to Eastern Enterprises, for which it 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. In 1989, 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 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 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.

KeySpan presently estimates the remaining cost of the environmental cleanup activities for these three non-utility sites will be approximately $13.4 million, which amount has been accrued 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 $19.5 million.

KeySpan believes 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 Settlements:* KeySpan has entered into confidential settlement agreements with certain of its insurance carriers for recovery of costs associated with the investigation and remediation of its MGP sites and the KeySpan New England LLC non-utility sites. Pursuant to these settlements, KeySpan recorded a benefit of $5.5 million in its Consolidated Statement of Income for the nine months ended September 30, 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 $20 million from insurance carriers in settlements for recovery of environmental costs associated with remediation of MGP sites.

See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005 Note 7, to those Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for further information on environmental matters.

Legal Matters

From time to time KeySpan is subject to various legal proceedings arising out of the ordinary course of its business. Except as described below, or in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, we do not consider any of such proceedings to be material to our business or likely to result in a material adverse effect on 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.

On July 12, 2006, a purported class action was filed alleging damages resulting from contamination associated with the historic operations of a former manufactured gas plant in Bay Shore, New York. On September 6, 2006 KeySpan filed a motion to dismiss this matter which is pending. In addition, on October 31, 2006, a lawsuit was filed alleging damages resulting from the contamination associated with the historic operations of a former manufactured gas plant in Staten Island, New York. KeySpan has been conducting site investigation and remediation activities at this location pursuant to an Order on Consent with the DEC. KeySpan intends to contest each of these proceedings vigorously. 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 the 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 10 "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 10 "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.

As reported in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, pursuant to indemnity obligations contained in the Long Island Lighting Company ("LILCO") / KeySpan merger agreement, KeySpan has been in discussions with the Internal Revenue Service ("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. Two issues were resolved in the second quarter of 2006. It is anticipated that the remaining issues, including the primary issue relating to the valuation of certain assets transferred in the KeySpan/LILCO business combination, will be settled following approval by the Joint Committee on Taxation. The IRS submitted the case to the Joint Committee on Taxation on October 30, 2006. 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 11 "Income Taxes" for additional information.

Financial Guarantees

KeySpan has issued financial guarantees in the normal course of business, on behalf of its subsidiaries, to various third party creditors. At September 30, 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:

| *Nature of Guarantee (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) | | 71.4 | 2006 - 2008 |
| Commodity Guarantees and Other | (vi) | | 77.0 | 2006 - 2009 |
| Letters of Credit | (vii) | | 80.3 | 2006 - 2010 |
| | | $ | 1,710.5 | |

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 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 of the lease has been extended to 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 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 September 30, 2006, the total cost to complete such remaining bonded projects is estimated to be approximately $26.5 million.

(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 September 30, 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.

## 7. 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 this 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 September 30, 2006, after adjusting for forfeitures, there are approximately 3.1 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 three and nine months ended September 30, 2005 would have decreased to the pro-forma amounts indicated below:

| (*In Millions of Dollars, Except Per Share Amounts)* | Three Months Ended September 30, 2005 | | Nine Months Ended September 30, 2005 | |
|---|---|---|---|---|
| Earnings available for common stock: | | | | |
| As reported | $ | 22.6 | $ | 273.2 |
| Add: recorded stock-based compensation expense, net of tax | | 1.3 | | 7.4 |
| Deduct: total stock-based compensation expense, net of tax | | (1.8) | | (8.8) |
| Pro-forma earnings | $ | 22.1 | $ | 271.8 |
| Earnings per share: | | | | |
| Basic - as reported | $ | 0.13 | $ | 1.62 |
| Basic - pro-forma | $ | 0.13 | $ | 1.61 |
| Diluted - as reported | $ | 0.13 | $ | 1.61 |
| Diluted - pro-forma | $ | 0.13 | $ | 1.60 |

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 nine months ended September 30, 2006, KeySpan recorded an expense of $1.0 million for stock option awards previously accounted for under APB 25 and which have not 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, Except Per Share Amounts*) | Nine Months Ended September 30, 2006 | Nine Months Ended September 30, 2005 |
|---|---|---|
| Performance shares | $ 6.1 | $ 2.5 |
| Restricted stock | 3.9 | 0.6 |
| Stock options | 4.6 | 4.2 |
| EDSPP discount | 3.8 | 3.9 |
| Total stock-based compensation included in operations and maintenance expense | 18.4 | 11.2 |
| Income tax benefit | (6.4) | (3.9) |
| Total stock based compensation expense, net of tax | $ 12.0 | $ 7.3 |

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 nine months ended September 30, 2006 and 2005, cash received from stock options exercised was $24.9 million and $42.7 million, respectively. The actual tax benefit realized for tax deductions from stock options exercised was $2.6 million and $5.3 million for the nine months ended September 30, 2006 and 2005, respectively. The benefits received from these tax deductions were 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.

The 2006 performance share award reflects the new performance condition criteria under SFAS 123R. In 2006, 314,560 performance shares were granted to officers. 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 September 30, 2006 associated with all of the performance share awards was $13.8 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 these awards is being amortized to compensation expense over the period in which the awards vest. 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 will be fully expensed by the end of this year and the 2006 award was expensed in the first quarter of 2006. Upon a change of control, all restricted stock awards will vest immediately. The unearned compensation as of September 30, 2006, associated with these awards was $0.1 million.

*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 414,602 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 stock option grant:

| | 2005 |
|---|---|
| Fair value of grants issued | $ 6.15 |
| Dividend yield | 4.64% |
| Expected volatility | 22.63% |
| Risk free rate | 4.10% |
| Expected lives | 6.4 years |
| Exercise price | $ 39.25 |

A summary of the status of our fixed stock option plans and changes is presented below for the nine months ended September 30, 2006:

| Fixed Options | Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value *(In Millions)* |
|---|---|---|---|
| Outstanding at beginning of period | 10,443,055 | $ 33.74 | |
| Granted during the year | - | $ - | |
| Exercised | (774,984) | $ 32.18 | |
| Forfeited | (136,436) | $ 36.77 | |
| Outstanding at end of period | 9,531,635 | $ 33.82 | $ 65.4 |
| Exercisable at end of period | 6,984,633 | $ 32.74 | $ 55.5 |

The total intrinsic value of the options exercised during the nine months ended September 30, 2006 and 2005 was approximately $6.6 million and $11.4 million, respectively.

| Remaining Contractual Life | Options Outstanding at September 30, 2006 | | Weighted Average Exercise Price | Range of Exercise Price | Options Exercisable at September 30, 2006 | | Weighted Average Exercise Price | Range of Exercise Price |
|---|---|---|---|---|---|---|---|---|
| 1 years | - | $ | - | $ - | - | $ | - | $ - |
| 2 years | 185,000 | $ | 32.63 | $32.63 | 185,000 | $ | 32.63 | $32.63 |
| 3 years | 704,625 | $ | 28.00 | $ 24.73 - 29.38 | 704,625 | $ | 28.00 | $ 24.73 - 29.38 |
| 4 years | 382,181 | $ | 26.97 | $ 21.99 - 27.06 | 382,181 | $ | 26.97 | $ 21.99 - 27.06 |
| 5 years | 972,837 | $ | 22.69 | $ 22.50 - 32.76 | 972,837 | $ | 22.69 | $ 22.50 - 32.76 |
| 6 years | 1,557,199 | $ | 39.50 | $39.50 | 1,557,199 | $ | 39.50 | $39.50 |
| 7 years | 1,769,595 | $ | 32.66 | $32.66 | 1,436,495 | $ | 32.66 | $32.66 |
| 8 years | 1,174,801 | $ | 32.40 | $32.40 | 770,961 | $ | 32.40 | $32.40 |
| 9 years | 1,424,134 | $ | 37.54 | $37.54 | 656,945 | $ | 37.54 | $37.54 |
| 10 years | 1,361,263 | $ | 39.25 | $39.25 | 318,390 | $ | 39.25 | $39.25 |
| | 9,531,635 | | | | 6,984,633 | | | |

As of September 30, 2006, there are approximately 2.5 million options which have not yet vested. The unearned compensation cost related to these stock option awards is $4.7 million which is expected to be recognized over a weighted average period of 2 years.

## 8. POSTRETIREMENT BENEFITS

*Pension Plans:* The following information represents the consolidated net periodic pension cost for the three and nine months ended September 30, 2006 and 2005, 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 the 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:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Service cost, benefits earned during the period | $ 14.9 | $ 14.2 | $ 47.0 | $ 42.5 |
| Interest cost on projected benefit obligation | 39.1 | 37.1 | 116.3 | 111.4 |
| Expected return on plan assets | (45.5) | (43.2) | (139.5) | (129.8) |
| Net amortization and deferral | 22.7 | 18.4 | 66.5 | 55.4 |
| Total pension cost | $ 31.2 | $ 26.5 | $ 90.3 | $ 79.5 |

*Other Postretirement Benefits:* The following information represents the consolidated net periodic other postretirement benefit cost for the three and nine months ended September 30, 2006 and 2005 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:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Service cost, benefits earned during the period | $ 4.7 | $ 6.1 | $ 18.6 | $ 18.3 |
| Interest cost on accumulated | | | | |
| postretirement benefit obligation | 15.9 | 19.0 | 56.2 | 56.8 |
| Expected return on plan assets | (9.2) | (9.0) | (27.5) | (27.1) |
| Net amortization and deferral | 9.7 | 14.9 | 43.0 | 44.9 |
| Other postretirement cost | $ 21.1 | $ 31.0 | $ 90.3 | $ 92.9 |

During the first nine months of 2006, KeySpan contributed $90.0 million to its pension plans and $18.0 million to its other postretirement benefit plans. KeySpan anticipates contributing an additional $12.0 million to its other postretirement benefit plans during the remainder of 2006. Estimated contribution levels are subject to change based on future market returns, interest rates and certain other measurements. Actual contributions, therefore, may vary from these levels.

## 9. COMMERCIAL PAPER

At September 30, 2006, KeySpan had two credit facilities totaling $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 September 30, 2006, KeySpan's consolidated indebtedness was 48.3% 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 September 30, 2006, we had cash and temporary cash investments of $40.0 million. During the first nine months of 2006, we repaid $327.6 million of commercial paper and, at September 30, 2006, $330.0 million of commercial paper was outstanding at a weighted average annualized interest rate of 5.38%. At September 30, 2006, KeySpan had the ability to issue up to an additional $1.2 billion, under its commercial paper program.

10. 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 the Long Island Lighting Company's ("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 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. 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 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 $91 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. 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. 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.

*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.

## 11. INCOME TAXES

KeySpan's consolidated effective income tax rate, including city and state income taxes, was 33.9% for the nine months ended September 30, 2006 compared to 36.6% for the corresponding period in 2005. During the second quarter of 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. In addition, pursuant to indemnity obligations contained in the LILCO / KeySpan merger agreement, KeySpan has 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. Two issues were resolved in the second quarter of 2006. As a result of settling the two issues with the IRS, as well as the New York City tax issue, KeySpan realized a tax benefit of $16.4 million for the nine months ended September 30, 2006. It is anticipated that the remaining issues including the primary issue relating to the valuation of certain assets transferred in the KeySpan/LILCO business combination of May 1998 will be settled following approval by the Joint Committee on Taxation. The IRS submitted the case to the Joint Committee on Taxation on October 30, 2006. Further, a $3.4 million benefit was recorded in the third quarter of 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 nine months ended September 30, 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.

12. GAS EXPLORATION AND PRODUCTION PROPERTY - DEPLETION

KeySpan has 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 September 30, 2006, these subsidiaries had net exploration and production property in the amount of $73.7 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 September 30, 2006, KeySpan estimated that its capitalized costs exceeded the ceiling test limitation by $25.8 million. KeySpan used an average wellhead price of $3.63 per MCF for this measurement. In accordance with current SEC guidelines, we have included estimated future cash flows from our hedging program in the ceiling test calculation. At September 30, 2006, Seneca-Upshur's cash flow hedges had an average fixed price of approximately $7.00 per MCF. Therefore, since the fixed price of $7.00 MCF was in excess of the average wellhead price of $3.63 per MCF, the cash flow hedges resulted in a favorable impact to the ceiling test calculation of $15.2 million.

Subsequent to September 30, 2006, the average wellhead price increased substantially and was $7.77 per MCF on October 26, 2006. As permitted by current SEC guidelines, KeySpan elected to use this measurement date to re-compute the ceiling test limitation. Based on this price, KeySpan determined that its capitalized costs did not exceed the ceiling test limitation, and as a result, a non-cash impairment charge was not recorded in the third quarter of 2006. As noted previously, at September 30, 2006, Seneca-Upshur's cash flow hedges had an average fixed price of approximately $7.00 per MCF. Therefore, since the fixed price of $7.00 MCF was below the more current average wellhead price of $7.77 per MCF, the cash flow hedges resulted in an unfavorable impact to the re-computed ceiling test calculation of $3.5 million.

## 13. KEYSPAN GAS EAST CORPORATION SUMMARY FINANCIAL INFORMATION

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 the Long Island Lighting Company. KEDLI established a program for the issuance, from time to time, of up to $600 million aggregate principal amount of Medium-Term Notes, which are 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** | | | | | |
|---|---|---|---|---|---|
| | Three Months Ended September 30, 2006 | | | | |
| *(In Millions of Dollars)* | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
| **Revenues** | $ 0.2 | $ 163.3 | $ 1,055.2 | $ (0.2) | $ 1,218.5 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 112.9 | 248.6 | - | 361.5 |
| Fuel and purchased power | - | - | 172.6 | - | 172.6 |
| Operations and maintenance | 13.0 | 33.3 | 326.4 | - | 372.7 |
| Intercompany expense | - | 1.3 | (1.1) | (0.2) | - |
| Depreciation and amortization | - | 15.0 | 69.2 | - | 84.2 |
| Operating taxes | - | 15.5 | 80.4 | - | 95.9 |
| Total Operating Expenses | 13.0 | 178.0 | 896.1 | (0.2) | 1,086.9 |
| Income from equity investments | - | - | 4.2 | - | 4.2 |
| **Operating Income (Loss)** | (12.8) | (14.7) | 163.3 | - | 135.8 |
| Interest charges | (42.5) | (13.4) | (20.5) | 9.3 | (67.1) |
| Other income and (deductions) | 93.9 | 1.1 | (16.8) | (70.2) | 8.0 |
| **Total Other Income and (Deductions)** | 51.4 | (12.3) | (37.3) | (60.9) | (59.1) |
| **Income Taxes (Benefit)** | (11.7) | (11.5) | 49.6 | - | 26.4 |
| **Net Income (Loss)** | $ 50.3 | $ (15.5) | $ 76.4 | $ (60.9) | $ 50.3 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Three Months Ended September 30, 2005 | | | | |
| **Revenues** | $ 0.2 | $ 185.1 | $ 1,118.0 | $ (0.2) | $ 1,303.1 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 136.5 | 259.2 | - | 395.7 |
| Fuel and purchased power | - | - | 254.6 | - | 254.6 |
| Operations and maintenance | 3.5 | 32.6 | 328.2 | - | 364.3 |
| Intercompany expense | - | 1.2 | (1.0) | (0.2) | - |
| Depreciation and amortization | - | 14.1 | 78.0 | - | 92.1 |
| Operating taxes | - | 15.5 | 81.6 | - | 97.1 |
| Total Operating Expenses | 3.5 | 199.9 | 1,000.6 | (0.2) | 1,203.8 |
| Income from equity investments | - | - | 2.5 | - | 2.5 |
| Gain on sale of property | - | - | 1.0 | - | 1.0 |
| **Operating Income (Loss)** | (3.3) | (14.8) | 120.9 | - | 102.8 |
| Interest charges | (37.3) | (13.7) | (22.4) | 6.0 | (67.4) |
| Other income and (deductions) | 50.4 | 0.3 | (28.3) | (26.2) | (3.8) |
| **Total Other Income and (Deductions)** | 13.1 | (13.4) | (50.7) | (20.2) | (71.2) |
| **Income Taxes (Benefit)** | (12.8) | (9.9) | 31.7 | - | 9.0 |
| **Net Income (Loss)** | $ 22.6 | $ (18.3) | $ 38.5 | $ (20.2) | $ 22.6 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Nine Months Ended September 30, 2006 | | | | |
| **Revenues** | $ 0.5 | $ 952.9 | $ 4,304.4 | $ (0.5) | $ 5,257.3 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 631.6 | 1,781.1 | - | 2,412.7 |
| Fuel and purchased power | - | - | 418.3 | - | 418.3 |
| Operations and maintenance | 30.2 | 104.1 | 1,065.0 | - | 1,199.3 |
| Intercompany expense | - | 4.0 | (3.5) | (0.5) | - |
| Depreciation and amortization | - | 58.8 | 236.9 | - | 295.7 |
| Operating taxes | - | 48.5 | 261.4 | - | 309.9 |
| Total Operating Expenses | 30.2 | 847.0 | 3,759.2 | (0.5) | 4,635.9 |
| Income from equity investments | - | - | 9.5 | - | 9.5 |
| Gain on sale of assets | - | - | 1.4 | - | 1.4 |
| **Operating Income (Loss)** | (29.7) | 105.9 | 556.1 | - | 632.3 |
| Interest charges | (122.2) | (40.7) | (51.5) | 21.7 | (192.7) |
| Other income and (deductions) | 418.8 | 2.1 | (50.7) | (344.6) | 25.6 |
| **Total Other Income and (Deductions)** | 296.6 | (38.6) | (102.2) | (322.9) | (167.1) |
| **Income Taxes (Benefit)** | (40.7) | 23.9 | 174.4 | - | 157.6 |
| **Net Income** | $ 307.6 | $ 43.4 | $ 279.5 | $ (322.9) | $ 307.6 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Nine Months Ended September 30, 2005 | | | | |
| **Revenues** | $ 0.5 | $ 916.1 | $ 4,210.0 | $ (0.5) | $ 5,126.1 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 588.1 | 1,618.0 | - | 2,206.1 |
| Fuel and purchased power | - | - | 546.9 | - | 546.9 |
| Operations and maintenance | 10.9 | 96.4 | 1,036.0 | - | 1,143.3 |
| Intercompany expense | - | 3.7 | (3.2) | (0.5) | - |
| Depreciation and amortization | - | 59.1 | 236.7 | - | 295.8 |
| Operating taxes | - | 47.8 | 255.2 | - | 303.0 |
| Total Operating Expenses | 10.9 | 795.1 | 3,689.6 | (0.5) | 4,495.1 |
| Income from equity investments | - | - | 12.5 | - | 12.5 |
| Gain on sale of property | - | - | 1.2 | - | 1.2 |
| **Operating Income (Loss)** | (10.4) | 121.0 | 534.1 | - | 644.7 |
| Interest charges | (104.8) | (46.1) | (64.9) | 15.7 | (200.1) |
| Other income and (deductions) | 364.8 | 3.2 | (62.4) | (313.0) | (7.4) |
| **Total Other Income and (Deductions)** | 260.0 | (42.9) | (127.3) | (297.3) | (207.5) |
| **Income Taxes (Benefit)** | (25.8) | 28.2 | 157.6 | - | 160.0 |
| Earnings from Continuing Operations | 275.4 | 49.9 | 249.2 | (297.3) | 277.2 |
| **Discontinued Operations** | - | - | (1.8) | - | (1.8) |
| **Net Income** | $ 275.4 | $ 49.9 | $ 247.4 | $ (297.3) | $ 275.4 |

**Balance Sheet**

| (In Millions of Dollars) | Guarantor | KEDLI | September 30, 2006<br>Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & temporary cash investments | $ 8.6 | $ 3.3 | $ 28.1 | $ - | $ 40.0 |
| Accounts receivable, net | 0.6 | 101.8 | 624.8 | - | 727.2 |
| Other current assets | 2.1 | 268.5 | 1,109.1 | - | 1,379.7 |
| | 11.3 | 373.6 | 1,762.0 | - | 2,146.9 |
| **Equity Investments** | 4,893.5 | - | 138.7 | (4,774.3) | 257.9 |
| **Property** | | | | | |
| Gas | - | 2,146.0 | 5,399.8 | - | 7,545.8 |
| Other | - | 25.3 | 3,140.4 | - | 3,165.7 |
| Accumulated depreciation and depletion | - | (425.5) | (2,782.8) | - | (3,208.3) |
| | - | 1,745.8 | 5,757.4 | - | 7,503.2 |
| **Intercompany Accounts Receivable** | 976.1 | 289.7 | 1,980.7 | (3,246.5) | - |
| **Deferred Charges** | 1,971.0 | 409.3 | 1,150.1 | - | 3,530.4 |
| **Total Assets** | $ 7,851.9 | $ 2,818.4 | $ 10,788.9 | $ (8,020.8) | $ 13,438.4 |
| **LIABILITIES AND CAPITALIZATION** | | | | | |
| **Current Liabilities** | | | | | |
| Accounts payable | $ 32.2 | $ 102.8 | $ 546.9 | $ - | $ 681.9 |
| Commercial paper | 330.0 | - | - | - | 330.0 |
| Other current liabilities | 207.8 | 84.4 | 342.7 | - | 634.9 |
| | 570.0 | 187.2 | 889.6 | - | 1,646.8 |
| **Intercompany Accounts Payable** | 128.8 | 473.4 | 1,130.4 | (1,732.6) | - |
| **Deferred Credits and Other Liabilities** | | | | | |
| Deferred income tax | 24.3 | 364.1 | 834.0 | - | 1,222.4 |
| Other deferred credits and liabilities | 680.1 | 203.3 | 1,183.6 | - | 2,067.0 |
| | 704.4 | 567.4 | 2,017.6 | - | 3,289.4 |
| **Capitalization** | | | | | |
| Common shareholders' equity | 4,586.7 | 939.5 | 3,815.5 | (4,774.3) | 4,567.4 |
| Long-term debt | 1,862.0 | 650.9 | 2,920.3 | (1,513.9) | 3,919.3 |
| **Total Capitalization** | 6,448.7 | 1,590.4 | 6,735.8 | (6,288.2) | 8,486.7 |
| **Minority Interest in Subsidiary Companies** | - | - | 15.5 | - | 15.5 |
| **Total Liabilities & Capitalization** | $ 7,851.9 | $ 2,818.4 | $ 10,788.9 | $ (8,020.8) | $ 13,438.4 |

**Balance Sheet**

| *(In Millions of Dollars)* | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | December 31, 2005 | | | | |
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & 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 | - | 2,111.3 | 5,164.6 | - | 7,275.9 |
| Other | - | - | 3,092.8 | - | 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 Subsidiary Companies** | - | - | 15.3 | - | 15.3 |
| **Total Liabilities & Capitalization** | $ 7,951.3 | $ 2,594.4 | $ 10,678.2 | $ (7,411.3) | $ 13,812.6 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Nine Months Ended September 30, 2006 Guarantor | KEDLI | Other Subsidiaries | Consolidated |
|---|---|---|---|---|
| **Operating Activities** | | | | |
| Net Cash (Used in) Provided by Operating Activities | $ (11.3) | $ 124.1 | $ 794.8 | $ 907.6 |
| **Investing Activities** | | | | |
| Capital expenditures | - | (63.1) | (314.5) | (377.6) |
| Cost of removal | - | (5.5) | (17.6) | (23.1) |
| Derivative margin calls | - | (17.6) | (25.1) | (42.7) |
| Proceeds from sale of property | - | - | 1.5 | 1.5 |
| Net Cash Provided by (Used in) Investing Activities | - | (86.2) | (355.7) | (441.9) |
| **Financing Activities** | | | | |
| Treasury stock issued | 21.1 | - | - | 21.1 |
| Payment of debt, net | (327.5) | - | - | (327.5) |
| Common and preferred stock dividends paid | (243.8) | - | - | (243.8) |
| Intercompany dividen payments | 8.4 | - | (8.4) | - |
| Net intercompany accounts | 482.2 | (38.1) | (444.1) | - |
| Net Cash (Used in) Financing Activities | (59.6) | (38.1) | (452.5) | (550.2) |
| Net (Decrease) in Cash and Cash Equivalents | $ (70.9) | $ (0.2) | $ (13.4) | $ (84.5) |
| Cash and Cash Equivalents at Beginning of Period | 79.5 | 3.5 | 41.5 | 124.5 |
| Cash and Cash Equivalents at End of Period | $ 8.6 | $ 3.3 | $ 28.1 | $ 40.0 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Nine Months Ended September 30, 2005 Guarantor | KEDLI | Other Subsidiaries | Consolidated |
|---|---|---|---|---|
| **Operating Activities** | | | | |
| Net Cash Provided by (Used in )Operating Activities | $ (326.2) | $ 156.7 | $ 641.6 | $ 472.1 |
| **Investing Activities** | | | | |
| Capital expenditures | - | (70.9) | (301.2) | (372.1) |
| Cost of removal | - | (1.6) | (9.2) | (10.8) |
| Proceeds from sale of investment | - | (2.1) | 49.0 | 46.9 |
| Derivative margin calls | - | - | (63.3) | (63.3) |
| Net Cash (Used in) Investing Activities | - | (74.6) | (324.7) | (399.3) |
| **Financing Activities** | | | | |
| Treasury stock issued | 41.0 | - | - | 41.0 |
| Payment of debt, net | (1,092.2) | - | (15.1) | (1,107.3) |
| Redemption of preferred stock | (75.0) | - | - | (75.0) |
| Common and preferred stock dividends paid | (229.1) | - | - | (229.1) |
| MEDs equity conversion | 460.0 | - | - | 460.0 |
| Intercompany dividend payments | 317.0 | - | (317.0) | - |
| Net intercompany accounts | 304.0 | (80.0) | (224.0) | - |
| Other | (2.4) | - | 16.4 | 14.0 |
| Net Cash (Used in) Financing Activities | (276.7) | (80.0) | (539.7) | (896.4) |
| Net Increase (Decrease) in Cash and Cash Equivalents | $ (602.9) | $ 2.1 | $ (222.8) | $ (823.6) |
| 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 | $ (22.2) | $ 1.2 | $ 105.0 | $ 84.0 |

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of

**Operations**

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.

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, 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.

**Consolidated Review of Results**

The following is a summary of transactions affecting comparative earnings for the three and nine months ended September 30, 2006, compared to the three and nine months ended September 30, 2005. Capitalized terms used in the following discussion, but not otherwise defined, have the same meaning as when used in the Notes to the Consolidated Financial Statements included under Item 1. References to "KeySpan," "we," "us," and "our" mean KeySpan Corporation, together with its consolidated subsidiaries.

Operating income by segment, as well as consolidated earnings for common stock is set forth in the following table for the periods indicated.

| *(In Millions of Dollars, Except per Share)* | Three Months Ended September 30, 2006 | 2005 | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|---|---|
| Gas Distribution | $ (10.8) | $ (45.5) | $ 365.1 | $ 376.8 |
| Electric Services | 144.4 | 149.6 | 271.7 | 266.3 |
| Energy Services | 3.0 | (1.1) | 4.6 | (6.7) |
| Energy Investments | 4.7 | 4.7 | 11.3 | 16.6 |
| Eliminations and other | (5.5) | (4.9) | (20.4) | (8.3) |
| **Operating Income** | 135.8 | 102.8 | 632.3 | 644.7 |
| **Other Income and (Deductions)** | | | | |
| Interest charges | (67.1) | (67.4) | (192.7) | (200.1) |
| Gain on sale of investments | - | - | - | 4.1 |
| Cost of debt redemption | - | - | - | (20.9) |
| Other income and (deductions) | 8.0 | (3.8) | 25.6 | 9.4 |
| Total Other Income and (Deductions) | (59.1) | (71.2) | (167.1) | (207.5) |
| **Earnings before income taxes** | 76.7 | 31.6 | 465.2 | 437.2 |
| Income taxes | 26.4 | 9.0 | 157.6 | 160.0 |
| **Earnings from continuing operations** | 50.3 | 22.6 | 307.6 | 277.2 |
| Discontinued operations | - | - | - | (1.8) |
| **Net Income** | 50.3 | 22.6 | 307.6 | 275.4 |
| Preferred stock dividend requirements | - | - | - | 2.2 |
| **Earnings for Common Stock** | $ 50.3 | $ 22.6 | $ 307.6 | $ 273.2 |
| Basic Earnings per Share | | | | |
| Continuing operations, less preferred stock dividends | $ 0.29 | $ 0.13 | $ 1.76 | $ 1.63 |
| Discontinued operations | - | - | - | (0.01) |
| | $ 0.29 | $ 0.13 | $ 1.76 | $ 1.62 |

## Results of Operations For The Quarter Ended September 30, 2006 vs 2005

KeySpan’s earnings for common stock for the three months ended September 30, 2006, were $50.3 million, or $0.29 per share, compared to $22.6 million or $0.13 per share realized during the corresponding quarter last year, an increase of $27.7 million, or $0.16 per share. The favorable comparative operating results primarily reflect an increase in operating income of $33.0 million or 32%.

The primary driver behind the increase in operating income was lower operating expenses in the Gas Distribution segment of $30.9 million. The Electric Services segment results were slightly lower than last year, reflecting a decrease in net electric revenues associated with the Ravenswood Generating Station, KeySpan’s merchant electric generating facility. During the quarter, this segment also recognized a gain on a fixed for floating unforced capacity financial swap which is reflected in operating results of this segment. (See the discussion under the caption “Review of Operating Segments” for further details on each segment.)

For the third quarter of 2006, other income and (deductions) reflects a net expense of $59.1 million compared to a net expense of $71.2 million for the third quarter of 2005. Included in the caption "Other Income and (Deductions)" are interest charges and certain other miscellaneous items. The favorable variation of $12.1 million is due, in part, to an increase in interest income on certain investments. Further, during the third quarter of 2005, KeySpan recorded an $8.5 million non-cash charge associated with the fair value of outstanding derivative financial instruments that did not qualify for hedge accounting treatment.

Income tax expense increased $17.4 million for the third quarter of 2006 compared to the same quarter in 2005, due to the increase in pre-tax income. Offsetting this increase, to some extent, was a $3.4 million benefit recorded in the third quarter of 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.

**Results of Operations For The Nine Months Ended September 30, 2006 vs 2005**

KeySpan's earnings for common stock for the nine months ended September 30, 2006, were $307.6 million, compared to $273.2 million realized during the same period last year, an increase of $34.4 million. The favorable comparative earnings primarily reflect: (i) the benefits associated with the settlement of certain outstanding issues with the New York City Department of Taxation and Finance and the Internal Revenue Service ("IRS"); and (ii) debt redemption costs incurred in 2005, but not repeated in 2006; offset by (iii) a decrease in operating income.

KeySpan's earnings per share for the nine months ended September 30, 2006, were $1.76 per share, compared to $1.62 per share realized during the same period last year, an increase of $0.14 per share. Earnings per share for the nine months ended September 30, 2006 reflect a higher level of outstanding common stock compared to last year. 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 in 2006 from this issuance, in addition to KeySpan's employee stock purchase plans, was approximately $0.07 per share. (See KeySpan's Annual Report of Form 10-K for the year ended December 31, 2005, Note 6 to the Consolidated Financial Statements "Long-Term Debt and Commercial Paper" for additional details on the MEDs Equity Units.)

Operating income decreased $12.4 million, or 2% for the nine months ended September 30, 2006, compared to the corresponding period last year. Comparative operating income reflects lower earnings from the Gas Distribution segment and Energy Investments segments of $11.7 million and $5.3 million, respectively, offset by higher earnings from KeySpan's electric operations and its Energy Services segment of $5.4 million and $11.3 million respectively. Operating income from the Gas Distribution segment was adversely impacted by the warm weather experienced during the first quarter of 2006 (KeySpan's primary heating season) which resulted in a decrease to comparative net gas revenues. The decrease in operating income from the Energy Investments segment reflects 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. The Electric Services segment results were favorably affected by a gain recognized on a fixed for floating unforced capacity financial swap. The favorable comparative results from the Energy Services segment were due to higher gross margins on engineering and service contracts and lower general and administrative expenses. The operating income variation as reflected in "elimination and other" is due primarily to incremental costs residing at KeySpan's holding company level primarily related to the anticipated KeySpan / National Grid plc merger including legal and consulting fees, as well as to corporate advertising expenses. (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 nine months ended September 30, 2006, other income and (deductions) reflects a net expense of $167.1 million compared to a net expense of $207.5 million for the same period of 2005. The favorable variation of $40.4 million is due, in part, to debt redemption costs incurred in 2005. In 2005, KeySpan redeemed $500 million 6.15% Series Notes due 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 nine months ended September 30, 2006 decreased $7.4 million compared to the same period in 2005, reflecting, in part, the reversal of a previously recorded $6 million reserve established in connection with an income tax dispute with the New York City Department of Taxation and Finance. During the second quarter of 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 interest reserve established in connection with this dispute. 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 nine months ended September 30, 2006, compared to the same period in 2005, also reflects higher interest income on certain investments. Further, in 2005, KeySpan recorded an $8.5 million non-cash charge associated with the fair value of outstanding derivative financial instruments that did not qualify for hedge accounting treatment.

Other income and (deductions) for the nine months ended September 30, 2005, reflects 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 $2.4 million for the nine months ended September 30, 2006, compared to same period of 2005, despite the higher pre-tax income, primarily reflecting the settlement of certain outstanding issues with the New York City Department of Taxation and Finance and the IRS.

Pursuant to indemnity obligations contained in the Long Island Lighting Company ("LILCO") / KeySpan merger agreement, KeySpan has 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. Two issues were resolved in the second quarter of 2006. It is anticipated that the remaining issues, including the primary issue relating to the valuation of certain assets transferred in the KeySpan/LILCO business combination, will be settled following approval by the Joint Committee on Taxation. In addition, as noted above, KeySpan resolved its dispute with New York City Department of Taxation and Finance with respect to income taxes relating to its merchant electric generating facility. As a result of settling the two issues with the IRS, as well as the New York City issue, KeySpan realized a tax benefit of $16.4 million during the nine months ended September 30, 2006. Further, as noted previously, during the third quarter of 2006 KeySpan recorded a $3.4 million benefit for prior investment tax credits to which KeySpan is entitled.

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.

Additionally, it should be noted that KeySpan recorded a $1.8 million loss from discontinued operations for the nine months ended September 30, 2005. In the fourth quarter of 2004, KeySpan's investment in its mechanical contracting subsidiaries was written-down to fair value. During the first six months of 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 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 nine months ended September 30, 2005.

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.

In light of the pending merger between KeySpan and National Grid plc and the widespread integration efforts being undertaken by both companies, KeySpan believes that it is no longer relevant to comment on previously issued guidance on projected 2006 earnings.

## Review of Operating Segments

KeySpan reports its segment results 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, and 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 gas distribution companies - Boston Gas Company, Colonial Gas Company, Essex 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.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Revenues | $ 595.5 | $ 629.6 | $ 3,648.8 | $ 3,476.1 |
| Cost of gas | 362.8 | 399.8 | 2,416.5 | 2,214.9 |
| Revenue taxes | 6.9 | 7.8 | 43.1 | 43.0 |
| Net Revenues | 225.8 | 222.0 | 1,189.2 | 1,218.2 |
| Operating Expenses | | | | |
| Operations and maintenance | 145.5 | 162.9 | 512.4 | 519.8 |
| Depreciation and amortization | 52.3 | 63.5 | 197.3 | 207.4 |
| Operating taxes | 38.8 | 41.1 | 114.4 | 114.2 |
| Total Operating Expenses | 236.6 | 267.5 | 824.1 | 841.4 |
| Operating Income | $ (10.8) | $ (45.5) | $ 365.1 | $ 376.8 |
| Firm gas sales and transportation (MDTH) | 27,682 | 28,020 | 203,437 | 228,260 |
| Transportation - Electric Generation (MDTH) | 28,689 | 9,756 | 55,797 | 21,188 |
| Other Sales (MDTH) | 48,274 | 47,937 | 146,217 | 142,398 |
| Warmer (Colder) than Normal - New York | N/A | N/A | 14% | (3%) |
| Warmer (Colder) than Normal - New England | N/A | N/A | 5% | (12%) |

A MDTH is 10,000 therms (British Thermal Units) 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*

For the third quarter of 2006, the Gas Distribution segment realized a seasonal operating loss of $10.8 million, compared to a seasonal operating loss of $45.5 million realized in the third quarter of 2005. The favorable comparative operating results were primarily due to a decrease of $30.9 million in operating expenses as a result of a lower provision for uncollectible accounts receivable of $16.4 million and a decrease in depreciation charges of $11.6 million.

For the nine months ended September 30, 2006, operating income decreased $11.7 million compared to the same period last year, primarily due to a decrease in net gas revenues of $29.0 million, primarily resulting from the warm first quarter weather. Operating expenses, however, decreased $17.3 million due to a lower provision for uncollectible accounts receivable of $13.9 million and a decrease in depreciation charges of $7.9 million, partially offset by higher employee benefit costs, primarily postretirement expenses.

*Net Revenues*

Net gas revenues from our gas distribution operations decreased $29.0 million, or 2%, for the nine months ended September 30, 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 heating season – January through April. As measured in heating degree days, weather during that period in our New York and New England service territories was approximately 13% and 8% warmer than normal, respectively, and was approximately 15% warmer than last year across KeySpan's service territories.

Net revenues from firm gas customers (residential, commercial and industrial customers) decreased $43.8 million in the first nine months of 2006 compared to the same period last year. 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 season, the use of more efficient gas heating equipment and higher gas costs. KeySpan estimates that the warm winter weather resulted in an adverse impact to net gas revenues of approximately $26 million, net of the benefits from the weather normalization adjustment and weather derivatives discussed below.

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 $25 million during the nine months ended September 30, 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 winter heating season. Weather, during the first quarter of 2006 was significantly warmer than normal as noted earlier. However, during the entire primary winter heating season –November 2005 through March 2006 – weather was slightly colder than normal. Therefore, there was no earnings impact associated with these weather derivatives for the first nine months of 2006. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" 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 $14.8 million during the nine months ended September 30, 2006, compared to the same period last year primarily reflecting higher pricing.

*Firm Sales, Transportation and Other Quantities*

Firm gas sales and transportation quantities for the nine months ended September 30, 2006, decreased 11% compared to the same period in 2005 due primarily to the warmer weather this year compared to last year. Customer additions and oil-to-gas conversions offset the full impact of the warmer weather. 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 will share the responsibilities for managing KeySpan's upstream gas distribution 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 increase in gas costs for the nine months ended September 30, 2006, compared to the same period of 2005 of $201.6 million, or 9%, reflects an increase of 20% in the price per dekatherm of gas purchased for firm gas sales customers, offset by a 13% decrease in the quantity of gas purchased due to the warm winter heating season weather. 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 third quarter of 2006 compared to the same quarter last year decreased $30.9 million, or 12%. Operations and maintenance expense decreased $17.4 million, or 11%, in 2006 compared to 2005 primarily reflecting a decrease of $16.4 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. The beneficial impact of this MADTE order was the primary driver behind the reduction in the provision for uncollectible accounts receivable, combined with a decrease in firm sales quantities in 2006 compared to 2005. See the discussion under the caption "Regulation and Rate Matters - Gas Matters" for additional details of the MADTE order.

The decrease in depreciation and amortization charges of $11.2 million, or 18%, for the third quarter of 2006 compared to the third quarter of 2005, was primarily due to an adjustment recorded this quarter to the depreciation allowance to correct for an error in useful lives associated with certain gas distribution assets.

For the nine months ended September 30, 2006, operating expenses decreased $17.3 million, or 2% compared to the same period last year. Operations and maintenance expense decreased $7.4 million, or 1%, in 2006 compared to 2005 due to a decrease of $13.9 million in the provision for uncollectible accounts receivable, resulting from the MADTE order noted above and lower firm sales quantities in 2006 compared to 2005. This beneficial impact to operations and maintenance expense was partially offset by increases in postretirement expenses and regulatory fees.

The decrease in depreciation and amortization charges of $10.1 million, or 5%, for the nine months ended September 30, 2006 compared to the same period of 2005, reflects a decrease in depreciation charges of $7.9 million and lower regulatory amortization charges of $2.2 million. As noted previously, 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.

*Gas Supply and Pricing*

KeySpan believes it has adequate gas supply available to meet its gas load demand in its service territories for the 2006/2007 winter heating season as KeySpan expects its gas storage to be 100% full at the start of the winter heating season. The current gas rate structure of each of our gas distribution utilities includes 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 price elasticity resulting in 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 financial derivatives, KeySpan anticipates that it will effectively hedge 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, which we supported the expansion of through the Energy Policy Act of 2005. Management believes that these measures help mitigate the impact of high 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 our market segments, through the expansion of our gas distribution system for new 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 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 natural gas to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. In addition, KeySpan has a 26.3% interest 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 of 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 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; (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.” (For a further discussion on these LIPA agreements see Note 10 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) | Three Months Ended September 30, 2006 | 2005 | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|---|---|
| Revenues from Operations | $ 539.0 | $ 619.9 | $ 1,390.3 | $ 1,493.5 |
| Purchased fuel | 172.5 | 254.2 | 418.0 | 546.0 |
| Net Revenues from Operations | 366.5 | 365.7 | 972.3 | 947.5 |
| Derivative Financial Instrument | 26.6 | - | 44.3 | - |
| Net Electric Revenues | 393.1 | 365.7 | 1,016.6 | 947.5 |
| Operating Expenses | | | | |
| Operations and maintenance | 176.8 | 150.6 | 527.3 | 480.8 |
| Depreciation | 24.9 | 21.5 | 77.1 | 67.6 |
| Operating taxes | 47.5 | 45.0 | 141.0 | 133.8 |
| Total Operating Expenses | 249.2 | 217.1 | 745.4 | 682.2 |
| Sale Of Property | 0.5 | 1.0 | 0.5 | 1.0 |
| Operating Income | $ 144.4 | $ 149.6 | $ 271.7 | $ 266.3 |
| Electric sales (MWH)* | 1,718,241 | 2,351,722 | 3,605,693 | 4,798,239 |
| Capacity(MW)* | 2,450 | 2,450 | 2,450 | 2,450 |
| Cooling degree days | 839 | 1,125 | 1,115 | 1,438 |

*Reflects the operations of the Ravenswood Generating Station only.

*Executive Summary*

Operating income decreased $5.2 million, or 3%, for the three months ended September 30, 2006, compared to the same quarter last year, due primarily to a decrease in net revenues from the Ravenswood Generating Station of $50.4 million as a result of lower energy margins and capacity revenues, as well as to higher operating expenses of $4.1 million, partially offset by higher revenues associated with KeySpan's service agreements with LIPA of approximately $24 million, which are primarily timing in nature. KeySpan also recognized a gain of $26.6 million on a fixed for floating unforced capacity financial swap.

For the nine months ended September 30, 2006, operating income increased $5.4 million, or 2%, compared to the same period last year, due, in part, to a $44.3 million gain recognized on the fixed for floating unforced capacity financial swap, higher off-system sales associated with service agreements with LIPA of $4.5 million, an increase of $4.4 million in revenues associated with our electric marketing activities and slightly lower operating expenses. These benefits to comparative operating income were partially offset by a decrease in net revenues from the Ravenswood Generating Station of $51.6 million as a result of lower energy margins and capacity revenues.

*Net Revenues*

Total electric net revenues realized during the third quarter of 2006 were $27.4 million higher than such revenues realized during the corresponding period last year.

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 three months ended September 30, 2006 KeySpan recognized a gain of $26.6 million from this derivative financial instrument. (See Note 4 to the Consolidated Financial Statements, "Hedging and Derivative Financial Instruments," for further information on this swap agreement.)

Net revenues for the third quarter of 2006 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $52.0 million compared to the third quarter of 2005. This increase reflects, in part, the recovery of operations and maintenance costs billed to LIPA, which increased by approximately $28 million. Therefore, approximately $24 million of the increase in net revenues resulted in a benefit to operating income. The major portion of this increase is timing in nature with $4.6 million resulting from an increase in off-system sales. (For a description of the LIPA Agreements and power purchase agreements, see KeySpan's 2005 Annual Report on Form 10-K for the year ended December 31, 2005 Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "Electric Services – Revenue Mechanisms.")

Net revenues associated with KeySpan's electric marketing activities decreased $0.8 million during the third quarter of 2006 compared to the same quarter of 2005.

Net revenues from the Ravenswood Generating Station decreased $50.4 million, or 31% for the three months ended September 30, 2006, compared to the same quarter last year reflecting lower capacity revenues of $27.0 million and a decrease in energy margins of $23.4 million. The decrease in capacity revenues was due to additional capacity installed in New York City in 2006.

The decrease in energy margins for the third quarter of 2006 reflects, in part, a 28% decrease in realized "spark-spreads" (the selling price of electricity less the cost of fuel, exclusive of hedging gains or losses). Further, the level of megawatt hours ("MWh") sold into the New York Independent System Operator ("NYISO") energy market decreased 27% due to increased competition and cooler comparative weather. As measured in cooling-degree days, weather was 25% cooler during the third quarter of 2006 compared to the third quarter of 2005. Combined, these two items reduced energy margins by $44.6 million. Partially offsetting these adverse impacts to energy margins were the benefits recognized from derivative financial instruments. 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 Generating Station. We have also 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 Generating Station. These derivative instruments resulted in hedging gains, which are reflected in net electric margins, of $9.4 million for the third quarter of 2006 compared to hedging losses of $11.8 million for the third quarter of 2005. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for further information on KeySpan's hedging strategy.)

Total electric net revenues realized during the nine months ended September 30, 2006, were $69.1 million higher than such revenues realized during the corresponding period last year. For the nine months ended September 30, 2006, KeySpan recognized a gain of $44.3 million from the fixed for floating unforced capacity derivative financial instrument described previously.

Net revenues for the nine months ended September 30, 2006, from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $72.0 million compared to the same period of 2005, reflecting the recovery of approximately $67 million in operations and maintenance costs billed to LIPA and therefore had no impact on operating income. The remaining increase reflects higher off-system energy sales.

Net revenues associated with KeySpan's electric marketing activities increased $4.4 million during the nine months ended September 30, 2006 compared to the same period of 2005.

The Ravenswood Generating Station, however, realized a decrease of $51.6 million in net revenues during the nine months ended September 30, 2006, compared to the same period last year, reflecting lower capacity revenues of $61.7 million, partially offset by an increase in energy margins of $10.1 million. Installed capacity additions during 2006 in New York City were the primary driver behind the decrease in capacity revenues.

The increase in energy margins for the nine months ended September 30, 2006 reflects the settlement of derivative financial instruments. As noted previously, 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 Generating Station and to hedge the cash flow variability associated with a portion of forecasted electric energy sales. These derivative instruments resulted in hedging gains, which are reflected in net electric margins, of $72.1 million during the nine months ended September 30, 2006 compared to hedging losses of $4.5 million during the same period of 2005. The benefits to energy margins from KeySpan's hedging strategy were offset by a 36% decrease in realized "spark-spreads." Further, the level of MWh sold into the NYISO energy market decreased 25% due to additional competition and cooler weather. As measured in cooling-degree days, weather was 22% cooler during the nine months ended September 30, 2006 compared to the same period of 2005. Combined, these two items resulted in an adverse impact to comparative net revenues of $66.5 million.

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 "Market and Credit Risk Management Activities" for further details on these matters.

In addition, on September 29, 2006, the NYISO Management Committee recommended approval of an in-City capacity mitigation proposal (the "Mitigation Proposal"). The Mitigation Proposal imposes a reduced 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 Mitigation 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 causes market clearing prices to be 3% or more above $82/kW-year, then the offer is mitigated (reduced) to $82/kW-year. Essentially, the Ravenswood Generating Station and the other owners of generation divested by Consolidated Edison may not set the market clearing price in excess of this new offer cap. The Mitigation Proposal is in addition to the existing in-City capacity mitigation measures.

The Mitigation Proposal must be approved by the NYISO Board of Directors and the FERC. On October 11, 2006, KeySpan and other parties filed appeals to the NYISO Board of Directors requesting that the Mitigation Proposal be rejected and more thoroughly analyzed and revised pursuant to detailed stakeholder meetings. 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 Mitigation 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.

*Operating Expenses*

Operating expenses increased $32.1 million during the third quarter of 2006 compared to the second quarter of 2005 primarily reflecting a $28 million increase in recoverable costs from LIPA, as noted previously. The remaining increase primarily reflects higher postretirement expenses and an increase in plant overhaul costs and non-outage work performed on KeySpan’s Long Island based generating units.

Operating expenses increased $63.2 million during the nine months ended September 30, 2006, compared to the same period of 2005 reflecting a $67 million increase in recoverable costs from LIPA, as noted previously, partially offset by a decrease in overhaul costs 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 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 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 long-term reliability of New York State's electric grid. At September 30, 2006, total capitalized costs associated with the siting, permitting and procurement of equipment for the Melville facility were $63.1 million.

On February 6, 2006, the NYISO's New York City local reliability rules that required that 80% of the electric capacity needs of New York City be provided by "in-City" generators was increased to 83%. However, in March 2006, the NYISO Operating Committee reversed its decision and returned the local reliability rules to 80%. See the discussion under the caption "Market and Credit Risk Management Activities – Regulatory Issues and the Competitive Environment" for further information regarding this matter.

**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.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Revenues | $ 51.8 | $ 47.1 | $ 155.4 | $ 142.0 |
| Operating expenses | 48.8 | 48.2 | 150.8 | 148.7 |
| Operating Income (Loss) | $ 3.0 | $ (1.1) | $ 4.6 | $ (6.7) |

The Energy Services segment posted operating profits of $3.0 million and $4.6 million for the three and nine months ended September 30, 2006, respectively, compared to operating losses of $1.1 million and $6.7 million incurred for the three and nine months ended September 30, 2005, respectively. The improved performance reflects higher gross profit and operating margins on engineering contracts and appliance service work, as well as the completion and favorable pricing associated with these contracts, an increase in bandwidth sales and a reduction in general and administrative expenses as a result of cost containment measures implemented in 2005.

**Energy Investments**

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 its 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.

As of September 30, 2006, based on an average wellhead price of $3.63 per MCF, adjusted for derivative instruments, KeySpan estimated that its capitalized costs exceeded the ceiling test limitation by $25.8 million. However, as permitted by current SEC guidelines, KeySpan elected to use a measurement date closer to the filing of its September 30, 2006 Form 10-Q to re-compute the ceiling test limitation. Using an average wellhead price on October 26, 2006 of $7.77 per MCF, adjusted for derivative instruments, KeySpan determined that its capitalized costs did not exceed the ceiling test limitation. Therefore, an impairment charge was not considered necessary at September 30, 2006. 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. See Note 12 to the Consolidated Financial Statements "Gas Exploration and Production Property- Depletion" for additional details.

This segment is also engaged in pipeline development activities. KeySpan and 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 26.3% 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.

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. On March 18, 2005, the sale was completed and generated cash proceeds of $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. This gain was recorded in other income and (deductions) on the Consolidated Statement of Income.

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2006 | 2005 | 2006 | 2005 |
| Revenues | $ 9.7 | $ 11.9 | $ 30.1 | $ 30.7 |
| Less: Operation and maintenance expense | 5.5 | 7.0 | 19.5 | 19.0 |
| Other operating expenses | 2.7 | 2.7 | 9.0 | 7.7 |
| Add: Equity earnings | 3.2 | 2.5 | 9.5 | 12.5 |
| Sale of assets | - | - | 0.2 | 0.1 |
| Operating Income | $ 4.7 | $ 4.7 | $ 11.3 | $ 16.6 |

As indicated in the above table, operating income for the Energy Investments segment for the third quarter of 2006 remained consistent with the third quarter of 2005, as an increase in earnings from our investment in the Iroquois Gas Transmission System of $0.6 million was offset by lower realized gas prices associated with our Seneca-Upshur investment.

For the nine months ended September 30, 2006, operating income decreased $5.3 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 winter weather. Finally, equity earnings were adversely impacted by the sale of Premier in March 2005.

*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 Secretary of Commerce 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 and a decision from that court is pending. 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

Policy Act of 2005 (the "Energy Act"), Islander East appealed the denial of the Clean Water Act permit directly to the United States Court of Appeals for the Second Circuit and moved to stay the Connecticut case pending the Second Circuit's decision. The State of Connecticut filed a motion to challenge the constitutionality of the provisions of the Energy Act providing this appeal. The appeal was argued in January 2006 and oral arguments on the constitutional and jurisdictional issues were held in April 2006. The Second Circuit Court of Appeals ruled on October 5, 2006 that the Energy Act is constitutional and that 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 conduct, within 75 days of October 5, 2006, "the sort of complete and reasoned review required by law." KeySpan anticipates that this pipeline will be in service in late 2008. As of September 30, 2006, KeySpan's total capitalized costs associated with the siting and permitting of the Islander East pipeline were approximately $29.5 million.

As noted, KeySpan also owns a 26.3% 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. Additionally, in November and December 2005, Consolidated Edison, KEDLI and Columbia Transmission 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. On May 3, 2006, Millennium filed a further amendment to its August 1, 2005 filing requesting, among other things, that the FERC vacate those portions of its certificate not included in its August 1, 2005 filing; that request is pending before the FERC. On June 9, 2006, the FERC issued a favorable draft supplemental environmental impact statement. On July 11, 2006, Millennium informed the FERC that the anticipated in-service date for Millennium Phase 1 will be extended from November 1, 2007 to November 1, 2008, or earlier, if feasible. On October 13, 2006, the FERC issued its Final Supplemental Environmental Impact Statement with respect to Millennium and its companion applicants. Millennium's amended application and those of its companion applicants are pending decision by the FERC. As of September 30, 2006, KeySpan's investment in the Millennium Pipeline project was $17.7 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 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 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 subsequently stayed the litigation pending resolution of the FERC appeal process discussed above. As of September 30, 2006, our investment in this project was $16.8 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 nine months ended September 30, 2006 associated with these settlement agreements.

**Liquidity**

Cash flow from operations increased $435.5 million, or 90%, for the nine months ended September 30, 2006 compared to the same period last year primarily due to favorable working capital requirements and income tax payments. The favorable working capital requirements were primarily driven by receipt of customer payments associated with winter heating season gas sales. In addition, KeySpan's income tax payments were $74.1 million lower during the nine months ended September 30, 2006, compared to the same period last year.

At September 30, 2006, we had cash and temporary cash investments of $40.0 million. During the nine months ended September 30, 2006, we repaid $327.6 million of commercial paper and, at September 30, 2006, $330.0 million of commercial paper was outstanding at a weighted-average annualized interest rate of 5.38%. We had the ability to borrow up to an additional $1.2 billion at September 30, 2006, under the terms of our credit facility.

KeySpan has two credit facilities which total $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 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 September 30, 2006, KeySpan's consolidated indebtedness was 48.3% 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 Note 10. to the Consolidated Financial Statements "2006 LIPA Settlement" 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) | Nine Months Ended September 30, 2006 | 2005 |
|---|---|---|
| Gas Distribution | $ 288.6 | $ 270.1 |
| Electric Services | 58.3 | 72.8 |
| Energy Investments | 5.0 | 17.8 |
| Energy Services and other | 25.7 | 11.4 |
| | $ 377.6 | $ 372.1 |

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. The increase in capital expenditures for the nine months ended September 30, 2006 compared to the same period last year of $5.5 million reflects an increase in the Gas Distribution segment due, in part, to the timing of capital main and service work, as well as to upgrades to KeySpan's New York LNG facility. In total, KeySpan anticipates incurring approximately the same amount of construction expenditures in 2006 as it incurred in 2005.

*Financing*

KeySpan did not engage in any financing activities in the first nine months of 2006, other than commercial paper repayments as noted earlier. However, KeySpan anticipates issuing, subject to execution of definitive agreements, approximately $400 million Senior Unsecured Notes at KEDNY and approximately $100 million Senior Unsecured Notes at KEDLI in the fourth quarter of 2006, pursuant to a private placement that is exempt from registration under the Securities Act of 1933. The Notes were priced on October 26, 2006 at 5.55% and are anticipated to be issued with ten year maturities. The net proceeds from the issuance of the Notes will be used by KEDNY and KEDLI to refinance existing intercompany indebtedness and/or for general working capital purposes.

The following table represents the ratings of our long-term debt at September 30, 2006. In 2004 Standard & Poor's reaffirmed its ratings on KeySpan's and its subsidiaries' long-term debt and removed its negative outlook. Further in 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 September 30, 2006. 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 $71.4 million of surety bonds associated with certain construction projects currently being performed by former subsidiaries; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of $77.0 million; and (iii) $80.3 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 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees.)

## 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. These obligations have remained substantially unchanged since December 31, 2005. (For additional details regarding these obligations see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as Note 6 "Long-Term Debt" and Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" to those Consolidated Financial Statements.)

## Discussions 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.

Below is a discussion of KeySpan's critical accounting policies and assumptions at September 30, 2006. For a more detailed discussion of these policies and assumptions see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations "Discussion of Critical Accounting Policies and Assumptions."

*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 annual operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set annual budgetary guidelines. At September 30, 2006, KeySpan has $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.

*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 orders issued by the MADTE relating to the Eastern Enterprise acquisition in 2000, 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.

As is further discussed under the caption "Regulation and Rate Matters," 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. 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*

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.

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At September 30, 2006, we had a funding credit balance in excess of the ERISA minimum funding requirements. Although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Therefore,

for 2006, KeySpan expects to contribute a total of $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. (In addition to Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, see also Note 4 of those Consolidated Financial Statements, "Postretirement Benefits.")

## Regulation and Rate Matters

*Gas Matters*

The rate agreements for KEDNY and KEDLI have expired. Under the terms of the KEDNY and KEDLI rate agreements, gas distribution rates and all other provisions will remain in effect until changed by the NYPSC. 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.

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, as well as 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's weighted-average cost of capital. On October 31, 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 subject to further review by the MADTE.

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'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 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 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. 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.

For an additional discussion of our current gas distribution rate agreements, see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Regulation and Rate Matters."

*Electric 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% 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.

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. (For a further discussion on the LIPA agreements see Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement," as well as KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Electric Services – LIPA 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. 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.

## 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.

We estimate that the remaining cost of our MGP related environmental cleanup activities, including costs associated with the Ravenswood Generating Station, will be approximately $372.4 million and we have recorded a related liability for such amount. We have also recorded an additional $13.4 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of September 30, 2006, we have expended a total of $211.8 million on environmental investigation and remediation activities. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies.")

## 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. The most significant contingency involves the evolution of the gas distribution and electric industries towards more competitive and deregulated environments. The risks associated with KeySpan's gas distribution activities have not changed substantially since December 31, 2005. For additional information regarding these risks see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2005, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Market and Credit Risk Management Activities." The following is an update to certain matters related KeySpan's electric operations.

*The Ravenswood Generating Station and KeySpan's 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 rerunning 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%.

In addition, for information concerning the pending in-City capacity mitigation proposal, see the discussion in "Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations – Electric Services."

## Item 3. 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 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. The Ravenswood Generating Station uses 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 Generating Station also hedges the cash flow variability associated with a portion of electric energy sales using OTC electricity swaps.

KeySpan uses market quoted forward prices to value OTC swap contracts.

*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. We had 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 noted above regarding sales to certain large-volume customers. As of September 30, 2006, these options, as well as the OTC gas and oil swaps, have expired. The Ravenswood Generating Station has also employed a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133 associated with the purchase of fuel oil. Additionally, KeySpan 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 noted above that were outstanding at September 30, 2006.

| Type of Contract | Year of Maturity | Volumes mmcf | Fixed Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Gas** | | | | | |
| Swaps/Futures - Long Natural Gas | 2006 | 4,101 | 4.82 - 11.94 | 4.20 - 7.35 | (11.7) |
| | 2007 | 3,651 | 9.82 - 11.94 | 7.20 - 8.76 | (5.1) |
| | 2008 | 360 | 9.82 | 7.26 - 9.14 | (0.3) |
| OTC Swaps - Short Natural Gas | 2006 | 683 | 6.17 - 10.69 | 4.20 - 7.35 | 2.5 |
| | 2007 | 2,622 | 5.86 - 11.54 | 7.20 - 8.76 | (4.6) |
| | 2008 | 1,596 | 6.77 - 6.85 | 7.26 - 9.14 | (2.7) |
| | 2009 | 1,300 | 7.60 - 10.90 | 7.02 - 8.89 | 1.0 |
| | | 14,313 | | | (20.9) |

| Type of Contract | Year of Maturity | Volumes Barrels | Fixed Price $ | Current Price $ | Fair Value (In Millions) |
|---|---|---|---|---|---|
| Oil | | | | | |
| Swaps - Long Fuel Oil | 2006 | 51,755 | 57.90 - 67.60 | 46.80 | (0.8) |
| | 2007 | 251,812 | 59.20 - 69.08 | 53.69 - 58.18 | (2.7) |
| | 2008 | 34,544 | 67.60 | 58.18 | (0.3) |
| | | 338,111 | | | (3.8) |

| Type of Contract | Year of Maturity | MWh | Fixed Margin/ Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Electricity** | | | | | |
| Swaps - Energy | 2006 | 471,800 | 59.90 - 123.00 | 44.75 - 88.25 | 11.6 |
| | 2007 | 144,800 | 97.60 - 150.50 | 78.92 - 108.69 | 9.4 |
| | | 616,600 | | | 21.0 |

| *Change in Fair Value of Derivative Instruments* | **2006 (In $ Millions)** |
|---|---|
| Fair value of contracts at January 1, | (18.1) |
| Net (gains) on contracts realized | (67.1) |
| Increase in fair value of all open contracts | 81.5 |
| Fair value of contracts outstanding at September 30, | (3.7) |

*(In Millions of Dollars)*

| | Fair Value of Contracts | | |
|---|---|---|---|
| Sources of Fair Value | **Mature Within 12 Months** | **Thereafter** | **Total Fair Value** |
| Prices actively quoted | $ (18.6) | $ (2.2) | $ (20.8) |
| Local published indicies | 17.1 | - | 17.1 |
| | $ (1.5) | $ (2.2) | $ (3.7) |

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 September 30, 2006 a 10% increase/decrease in natural gas prices would decrease/increase the value of derivative instruments maturing in one year by $5.1 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 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 September 30, 2006.

| Type of Contract | Year of Maturity | Volumes mmcf | Fixed Price ($) | Current Price ($) | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| Swaps | 2006 | 29,636 | 6.05 - 12.29 | 5.62 - 7.35 | (94.2) |
| | 2007 | 66,936 | 6.81 - 12.29 | 7.20 - 8.76 | (159.4) |
| | 2008 | 11,985 | 7.16 - 11.64 | 7.26 - 9.14 | (23.2) |
| | | 108,557 | | | (276.8) |

See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for a further description of all our derivative instruments.

## Item 4. Controls and Procedures

We maintain disclosure controls and procedures (as defined under Exchange Act Rule 13a-15(e) and 15d-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 September 30, 2006. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures were effective at the reasonable assurance level in alerting them timely to material information required to be included in KeySpan's periodic SEC reports.

Furthermore, there has been no change in KeySpan's internal control over financial reporting 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.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

See Note 6 to the Consolidated Financial Statements "Financial Guarantees and Contingencies".

### Item 1A. Risk Factors

Certain statements contained in this Quarterly Report on Form 10-Q concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are other than statements of historical facts, are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Without limiting the foregoing, all statements under the captions "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk" relating to our future outlook, anticipated capital expenditures, future cash flows and borrowings, pursuit of potential future acquisition opportunities and sources of funding, are forward-looking statements. Such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties and actual results may differ materially from those discussed in such statements.

Among the factors that could cause actual results to differ materially are:

- the occurrence of any event, change or other circumstances that could give rise to the termination of the merger agreement with National Grid plc or the failure of the merger to close for any reason;

- volatility of energy prices 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 manage our cost structure successfully and operate efficiently;

- our ability to successfully contract for natural gas supplies required to meet the needs of our customers;

- implementation of new accounting standards or changes in accounting standards or GAAP which may require adjustments to financial statements;

- inflationary trends and interest rates;

- the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of such acquisitions;

- available sources and cost of fuel;

- creditworthiness of counterparties to derivative instruments and commodity contracts;

- the resolution of certain disputes with LIPA concerning each party's rights and obligations under various agreements;

- retention of key personnel;

- federal and state regulatory initiatives that threaten cost and investment recovery and place limits on the type and manner in which we invest in new businesses and conduct operations;

- the impact of federal, state and local utility regulatory policies, legislation 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 facing our unregulated Energy Services businesses;

- the degree to which we develop unregulated business ventures, as well as federal, state and local regulatory policies affecting our ability to retain and operate such business ventures profitably;

- a change in the fair value of our investments that could cause a significant change in the carrying value of such investments or the carrying value of related goodwill;

- timely receipts of payments from our two largest customers LIPA and the NYISO;

- changes in the UCAP pricing structure;

- timing of approval of the 2006 LIPA Agreements and;

- other risks detailed from time to time in other reports and other documents filed by KeySpan with the SEC.

For any of these statements, KeySpan claims the protection of the safe harbor for forward-looking information contained in the Private Securities Litigation Reform Act of 1995, as amended. For additional discussion on these risks, uncertainties and assumptions, see "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk."

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

## Item 4. Submission of Matters to a Vote of Security Holders

### (a) Date of Meeting

The Annual Meeting of Stockholders of KeySpan Corporation was held on August 17, 2006.

### (b) and (c) Name of Each Director Elected at the Meeting and Description of Each Matter Voted on and Number of Votes Cast

| | For | Against | Withheld |
|---|---|---|---|
| 1. The proposal to elect directors to serve until the next meeting of stockholders or until their successors are elected. | | | |
| Robert B. Catell | 141,113,738 | — | 8,301,560 |
| Andrea S. Christensen | 142,856,453 | — | 6,558,845 |
| Robert J. Fani | 143,069,405 | — | 6,345,893 |
| Alan H. Fishman | 133,692,168 | — | 15,723,130 |
| James R. Jones | 142,516,931 | — | 6,898,367 |
| James L. Larocca | 142,674,326 | — | 6,740,972 |
| Gloria C. Larson | 142,588,762 | — | 6,826,536 |
| Stephen W. McKessy | 142,533,304 | — | 6,881,994 |
| Edward D. Miller | 142,520,380 | — | 6,894,918 |
| Vikki L. Pryor | 142,790,782 | | 6,624,516 |

| | For | Against | Abstain | Non-Vote |
|---|---|---|---|---|
| 2. The proposal to ratify the appointment of Deloitte & Touche LLP as independent registered public accounting firm as auditors of the Company for the fiscal year ending December 31, 2006. | 143,871,717 | 3,332,653 | 2,210,928 | — |

| | For | Against | Abstain | Non-Vote |
|---|---|---|---|---|
| 3. The proposal to adopt the Agreement and Plan of Merger dated February 25, 2006, among National Grid plc, National Grid US8 Inc. and KeySpan Corporation. | 109,184,628 | 7,442,564 | 2,160,682 | 30,627,424 |

| | For | Against | Abstain | Non-Vote |
|---|---|---|---|---|
| 4. The shareholder proposal to adopt simple majority vote. | 65,114,814 | 48,536,898 | 5,136,162 | 30,627,424 |

## Item 5. Other Information

None

## Item 6. Exhibits

31.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

*Filed Herewith

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on behalf of the undersigned there unto duly authorized.

**KEYSPAN CORPORATION**

(Registrant)

By: /s/Gerald Luterman
Name: Gerald Luterman
Title: Executive Vice President and
Chief Financial Officer

Date: November 3, 2006

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President and
Chief Financial Officer

Date: November 3, 2006

/s/ Theresa A. Balog
Theresa A. Balog
Vice President and
Chief Accounting Officer

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**ANNUAL REPORT**

**PURSUANT TO SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2007

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to _________

**Commission file number 1-14161**

**KEYSPAN CORPORATION**
(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| **NEW YORK** | **11-3431358** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| **One MetroTech Center, Brooklyn, New York** | **11201** |
| **175 East Old Country Road, Hicksville, New York** | **11801** |
| (Address of Principal Executive Offices) | (Zip Code) |

**(718) 403-1000 (Brooklyn)**
**(516) 755-6650 (Hicksville)**
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes**[X]** No[ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

Large accelerated filer **[X]** Accelerated filer **[ ]** Non-accelerated filer **[ ]**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes**[ ]** No**[X]**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class of Common Stock | Outstanding at April 13, 2007 |
|---|---|
| $.01 par value | 175,762,812 |

KEYSPAN CORPORATION AND SUBSIDIARIES

INDEX

# CONSOLIDATED BALANCE SHEET

(Unaudited)

| *(In Millions of Dollars)* | **March 31, 2007** | December 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and temporary cash investments | $ **326.5** | $ 210.9 |
| Restricted cash | **7.7** | 7.9 |
| Accounts receivable | **1,278.9** | 943.7 |
| Unbilled revenue | **519.2** | 531.2 |
| Allowance for uncollectible accounts | **(81.7)** | (56.9) |
| Gas in storage, at average cost | **328.4** | 646.0 |
| Material and supplies, at average cost | **146.7** | 137.1 |
| Derivative contracts | **40.3** | 54.1 |
| Prepayments | **101.7** | 236.2 |
| Other | **89.3** | 76.8 |
| | **2,757.0** | 2,787.0 |
| **Equity Investments and Other** | **273.1** | 269.7 |
| **Property** | | |
| Gas | **7,710.2** | 7,639.4 |
| Electric | **2,591.9** | 2,575.4 |
| Other | **436.6** | 441.5 |
| Accumulated depreciation | **(3,200.3)** | (3,151.2) |
| Gas production and development, at cost | **187.5** | 186.9 |
| Accumulated depletion | **(115.2)** | (113.7) |
| | **7,610.7** | 7,578.3 |
| **Deferred Charges** | | |
| Regulatory assets: | | |
| Miscellaneous assets | **946.1** | 937.5 |
| Derivative contracts | **37.7** | 196.3 |
| Goodwill and other intangible assets, net of amortization | **1,666.3** | 1,666.3 |
| Derivative contracts | **113.7** | 127.3 |
| Other | **880.6** | 875.1 |
| | **3,644.4** | 3,802.5 |
| **Total Assets** | $ **14,285.2** | $ 14,437.5 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED BALANCE SHEET
(Unaudited)

| *(In Millions of Dollars)* | **March 31, 2007** | December 31, 2006 |
|---|---|---|
| **LIABILITIES AND CAPITALIZATION** | | |
| **Current Liabilities** | | |
| Accounts payable and other liabilities | **$ 815.9** | $ 1,026.0 |
| Commercial paper | **-** | 85.0 |
| Current maturities of long-term debt and capital leases | **136.2** | 1.2 |
| Taxes accrued | **293.5** | 200.8 |
| Dividends payable | **83.4** | 83.3 |
| Customer deposits | **35.5** | 33.5 |
| Interest accrued | **83.3** | 58.5 |
| Other current liability, derivative contracts | **24.9** | 219.7 |
| | **1,472.7** | 1,708.0 |
| **Deferred Credits and Other Liabilities** | | |
| Regulatory liabilities: | | |
| Miscellaneous liabilities | **41.7** | 43.4 |
| Removal costs recovered | **567.0** | 556.2 |
| Derivative accounts | **86.9** | 120.6 |
| Asset retirement obligations | **48.0** | 47.3 |
| Deferred income tax | **1,124.5** | 1,176.4 |
| Postretirement benefits and other reserves | **1,672.2** | 1,667.3 |
| Derivative contracts | **85.2** | 43.1 |
| Other | **212.3** | 121.6 |
| | **3,837.8** | 3,775.9 |
| **Commitments and Contingencies (See Note 6)** | **-** | - |
| **Capitalization** | | |
| Common stock | **3,999.4** | 3,994.0 |
| Retained earnings | **1,103.6** | 973.7 |
| Retained earnings - cumulative effect of FIN 48 implementation (See Note 11) | **(5.2)** | - |
| Accumulated other comprehensive loss | **(158.9)** | (175.3) |
| Treasury stock | **(263.4)** | (273.6) |
| Total common shareholders' equity | **4,675.5** | 4,518.8 |
| Long-term debt and capital leases | **4,283.3** | 4,419.1 |
| **Total Capitalization** | **8,958.8** | 8,937.9 |
| **Minority Interest in Consolidated Companies** | **15.9** | 15.7 |
| **Total Liabilities and Capitalization** | **$ 14,285.2** | $ 14,437.5 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED STATEMENT OF INCOME

(Unaudited)

| *(In Millions of Dollars, Except Per Share Amounts)* | Three Months Ended March 31, 2007 | 2006 |
|---|---|---|
| **Revenues** | | |
| Gas Distribution | $ **2,415.5** | $ 2,180.1 |
| Electric Services | **384.4** | 424.8 |
| Energy Services | **52.6** | 48.4 |
| Energy Investments | **10.0** | 7.8 |
| Total Revenues | **2,862.5** | 2,661.1 |
| **Operating Expenses** | | |
| Purchased gas for resale | **1,672.7** | 1,511.4 |
| Fuel and purchased power | **128.2** | 130.0 |
| Operations and maintenance | **430.9** | 406.0 |
| Depreciation, depletion and amortization | **112.3** | 110.3 |
| Operating taxes | **122.6** | 118.2 |
| Total Operating Expenses | **2,466.7** | 2,275.9 |
| Income from equity investments | **3.7** | 3.4 |
| Gain on sale of property | **-** | 0.5 |
| **Operating Income** | **399.5** | 389.1 |
| **Other Income and (Deductions)** | | |
| Interest charges | **(61.6)** | (66.2) |
| Other | **8.2** | 11.4 |
| Total Other Income and (Deductions) | **(53.4)** | (54.8) |
| **Income Taxes** | | |
| Current | **177.2** | 159.4 |
| Deferred | **(44.5)** | (33.1) |
| Total Income Taxes | **132.7** | 126.3 |
| **Earnings for Common Stock** | $ **213.4** | $ 208.0 |
| **Basic Earnings Per Share** | $ **1.22** | $ 1.19 |
| **Diluted Earnings Per Share** | $ **1.21** | $ 1.18 |
| **Average Common Shares Outstanding (000)** | **175,600** | 174,704 |
| **Average Common Shares Outstanding - Diluted (000)** | **176,855** | 175,743 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

| *(In Millions of Dollars)* | **Three Months Ended March 31, 2007** | 2006 |
|---|---|---|
| ***Operating Activities*** | | |
| Net income | **$ 213.4** | $ 208.0 |
| **Adjustments to reconcile net income to net cash provided by (used in) operating activities** | | |
| Depreciation, depletion and amortization | **112.3** | 110.3 |
| Deferred income tax | **(44.5)** | (33.1) |
| Income from equity investments | **(3.7)** | (3.4) |
| Dividends from equity investments | **2.3** | - |
| Amortization of financing fees / interest rate swap | **2.2** | 2.1 |
| Amortization of property taxes | **26.0** | 33.4 |
| **Changes in assets and liabilities** | | |
| Accounts receivable | **(423.2)** | 12.3 |
| Materials and supplies, fuel oil and gas in storage | **387.9** | 283.5 |
| Accounts payable and other liabilities | **(136.4)** | (308.1) |
| Taxes accrued | **158.5** | 166.0 |
| Interest accrued | **24.7** | 19.6 |
| Environmental payments | **(11.5)** | (10.0) |
| Other | **41.2** | 63.3 |
| **Net Cash Provided by Operating Activities** | **349.2** | 543.9 |
| ***Investing Activities*** | | |
| Construction expenditures | **(107.4)** | (122.2) |
| Cost of removal | **(12.2)** | (6.7) |
| Derivative margin call | **41.6** | - |
| Return of investment | **7.6** | - |
| **Net Cash Used in Investing Activities** | **(70.4)** | (128.9) |
| ***Financing Activities*** | | |
| Common/Treasury stock issued | **5.7** | 15.5 |
| Payment of commercial paper | **(85.0)** | (160.8) |
| Payment of long-term debt | **(0.6)** | - |
| Common stock dividends paid | **(83.3)** | (81.1) |
| **Net Cash Used in Financing Activities** | **(163.2)** | (226.4) |
| Net Increase in Cash and Cash Equivalents | **115.6** | 188.6 |
| Cash and Cash Equivalents at Beginning of Period | **210.9** | 124.5 |
| Cash and Cash Equivalents at End of Period | **$ 326.5** | $ 313.1 |
| Interest Paid | **$ 39.1** | $ 42.6 |
| Income Tax Paid | **$ 9.7** | $ 13.1 |

Cash equivalents are short-term marketable securities purchased with maturities of three months or less that were carried at cost which approximates fair value.

See accompanying Notes to the Consolidated Financial Statements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

INTRODUCTION TO THE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

KeySpan Corporation (referred to in the Notes to the Financial Statements as "KeySpan," "we," "us" and "our") is a holding company under the Public Utility 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 "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 of KeySpan (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. As contemplated in the Merger Agreement, National Grid plc has provided notice extending the termination date of the Merger Agreement through August 25, 2007.

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, many of which have been filed or obtained. Specifically, we filed our application for approval of the Merger pursuant to the Federal Power Act in May 2006 and in October 2006 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 ("HSR"), which provides a one year period to complete the Merger. Depending on the timing of the closing, KeySpan and National Grid plc may be required to re-file an application under HSR. We also 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 State Public Service Commission ("NYPSC"). 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. KeySpan also sought approval of the Merger from the New Hampshire Public Utility Commission ("NHPUC"). In April 2007, the staff of the NHPUC advised the NHPUC that KeySpan, National Grid plc, the New Hampshire Office of Consumer Advocate and the staff of the NHPUC had reached a settlement in principle that would, upon finalization of the settlement documents, resolve all issues in the pending Merger approval application before the NHPUC. The filing of testimony and the scheduling of hearings has been postponed pending finalization of the settlement documentation, the timing and resolution of which cannot yet be determined. In addition, the Merger was approved by our shareholders at our Annual Meeting on August 17, 2006**.** Shareholders of National Grid plc approved the transaction at a meeting held on July 31, 2006.

On April 6, 2007, the Attorney General of the Commonwealth of Massachusetts filed a petition with the Massachusetts Department of Telecommunications and Energy ("MADTE") to initiate an oversight investigation related to the Merger between KeySpan and National Grid plc. The petition does not specifically seek MADTE approval of the Merger, which under current law has been interpreted as not being required in connection with mergers of utility holding companies which only indirectly affect the ownership of utility subsidiaries operating within the Commonwealth of Massachusetts. Rather, the petition requests that the MADTE investigate the impact of the Merger on rates and service quality of the utility subsidiaries owned and operated by KeySpan and National Grid plc in the Commonwealth of Massachusetts. On April 13, 2007 KeySpan and National Grid plc filed a response to the Attorney General's petition agreeing to cooperate in such a proceeding and recommending a proposed procedural schedule. KeySpan cannot predict the outcome of this proceeding or its impact, if any, on the Merger.

For a discussion on the impact of the Merger on KeySpan's service agreements with LIPA, see Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement."

In addition to seeking approval of the Merger, the application filed with the NYPSC also contained a proposed ten-year rate plan for KeySpan Energy Delivery of New York ("KEDNY") and KeySpan Energy Delivery of Long Island ("KEDLI"), as well as proposals concerning corporate structure, affiliate rules and transactions and the rate treatment for contemplated synergy savings. Specifically, the rate plan proposal provides 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 clause would be increased to recover, on a prospective basis, 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 plan. The proposed rate plan also contemplates 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 and/or transportation adjustment clause. The proposed rate of return on equity is 11.0% for both KEDNY and KEDLI.

The NYPSC has suspended the implementation of the proposed tariff changes for 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 submitted 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. Settlement discussions have been ongoing. In order to accommodate the settlement discussions, KeySpan agreed to a one-month extension of the rates suspension period, if required. In the event that a settlement is not reached, the administrative law judge ("ALJ") will issue a decision after conducting adjudicatory hearings. Any settlement would also be subject to approval by the NYPSC after conducting a public hearing. Ultimately, the NYPSC may accept, reject, or modify all or any part of the settlement or any ALJ decision regarding the Merger or rate approval applications.

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.

## 1. BASIS OF PRESENTATION

In our opinion, the accompanying unaudited Consolidated Financial Statements contain all adjustments necessary to present fairly KeySpan's financial position as of March 31, 2007, and the results of operations for the three months ended March 31, 2007 and March 31, 2006, as well as cash flows for the three months ended March 31, 2007 and March 31, 2006. The accompanying financial statements should be read in conjunction with the consolidated financial statements and notes included in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006. The December 31, 2006 financial statement information has been derived from the 2006 audited financial statements.

Income from interim periods may not be indicative of future results. Consolidated earnings are seasonal in nature primarily due to the significant contributions to earnings of the gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters.

Basic earnings per share ("EPS") is calculated by dividing earnings available 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 available 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 Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share" our basic and diluted EPS are as follows:

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars, Except Per Share Amounts)* | 2007 | 2006 |
| Earnings for common stock | $ 213.4 | $ 208.0 |
| Weighted average shares outstanding (000) | 175,600 | 174,704 |
| Add dilutive securities: | | |
| Options | 1,051 | 828 |
| Performance shares | 204 | 211 |
| Total weighted average shares outstanding - assuming dilution | 176,855 | 175,743 |
| Basic earnings per share | $ 1.22 | $ 1.19 |
| Diluted earnings per share | $ 1.21 | $ 1.18 |

## 2. BUSINESS SEGMENTS

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

The Gas Distribution segment consists of 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, Boston Gas Company, Colonial Gas Company, Essex Gas Company and EnergyNorth Natural Gas, Inc., collectively referred to as KeySpan Energy Delivery New England ("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 10, "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 New York Independent Systems Operator ("NYISO") energy markets. To finance the purchase and/or construction of the Ravenswood Generating Station, KeySpan entered into a leasing arrangement for each facility. The Electric Services segment also conducts retail marketing of electricity to commercial customers. (See Note 6 "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.

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.

This segment is also engaged in pipeline development activities. KeySpan and Spectra 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.

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. At March 31, 2007, the total assets of each reportable segment have not changed materially from those levels reported at December 31, 2006. The reportable segment information is as follows:

| *(In Millions of Dollars)* | Gas Distribution | Electric Services | Energy Services | Energy Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|
| **Three Months Ended March 31, 2007** | | | | | | |
| Unaffiliated revenue | 2,415.5 | 384.4 | 52.6 | 10.0 | - | 2,862.5 |
| Intersegment revenue | - | 3.9 | 2.1 | 1.3 | (7.3) | - |
| Operating Income | 402.5 | (1.5) | 1.4 | 5.1 | (8.0) | 399.5 |
| **Three Months Ended March 31, 2006** | | | | | | |
| Unaffiliated revenue | 2,180.1 | 424.8 | 48.4 | 7.8 | - | 2,661.1 |
| Intersegment revenue | - | - | 2.5 | 1.3 | (3.8) | - |
| Operating Income | 336.4 | 65.0 | (0.4) | 3.0 | (14.9) | 389.1 |

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

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of $337.7 million and $422.7 million for the three months ended March 31, 2007 and 2006, respectively, represent approximately 12% and 16%, respectively of our consolidated revenues in these periods.

## 3. COMPREHENSIVE INCOME

The table below indicates the components of comprehensive income:

| *(In Thousands of Dollars)* | **Three Months Ended March 31, 2007** | **2006** |
|---|---|---|
| Net Income | $ 213.4 | $ 208.0 |
| Other comprehensive income, net of tax | | |
| Reclassification of (gains) losses included in net income | 6.5 | (35.7) |
| Unrealized (losses) gains on derivative financial instruments | (3.1) | 45.9 |
| Unrealized gains (losses) on marketable securities | (0.1) | 0.4 |
| Accrued underfunded pension and other postretirement obligation (1) | 13.1 | - |
| Other comprehensive income, net of tax | 16.4 | 10.6 |
| Comprehensive Income | $ 229.8 | $ 218.6 |
| Related tax (benefit) expense | | |
| Reclassification of (gains) losses included in net income | $ 4.2 | $ (19.2) |
| Unrealized (losses) gains on derivative financial instruments | (1.9) | 25.4 |
| Unrealized gains (losses) on marketable securities | (0.1) | 0.2 |
| Total Tax Expense | $ 2.2 | $ 6.4 |

(1) For the three months ended March 31, 2007, KeySpan recorded a $13.1 million increase in other comprehensive income, with a corresponding reduction to deferred income taxes to properly reflect the deferred tax benefit arising from the implementation of Statement of Financial Accounting Standards ("SFAS") 158 "Employers' Accounting for Defined Benefit Pensions and Other Postretirement Benefit Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)" at December 31, 2006. This correction has no impact on KeySpan's Consolidated Statements of Income and Cash Flows for the three months ended March 31, 2007. KeySpan believes this correction is immaterial to its current and prior year's Financial Statements.

## 4. HEDGING AND DERIVATIVE FINANCIAL INSTRUMENTS

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 and receive hedge accounting treatment 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 the forecasted sales of a portion of its natural gas production. At March 31, 2007, Seneca-Upshur has hedge positions in place for approximately 70% of its estimated 2007 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 March 31, 2007 was a liability of $6.9 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 $3.5 million. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial for the three months ended March 31, 2007.

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 was immaterial to KeySpan's consolidated financial statements at March 31, 2007. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial as of March 31, 2007.

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 December 2008. To accomplish our stated risk management strategy, KeySpan employs financially-settled electric-power swap contracts with offsetting financially-settled oil swap contracts, physical natural gas forward contracts and OTC natural gas swaps. We use market quoted forward prices to value the electric-power swap contracts. The fair value of the electric power derivative instruments at March 31, 2007 was a liability of $5.4 million. We use market quoted forward prices to value the oil swap contracts and natural gas contracts. The fair value of these derivative instruments at March 31, 2007 was $0.3 million.

On January 18, 2006, KeySpan entered into an International SWAP Dealers Association Master Agreement for a fixed for float unforced capacity financial swap (the "Swap Agreement") with Morgan Stanley Capital Group Inc. ("Morgan Stanley"). The Swap Agreement has a three year term that began on May 1, 2006. The notional quantity was 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 occurs on a monthly 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 March 31, 2007. As noted, this is a financial derivative instrument and is unrelated to any physical production of electricity.

The NYPSC, Consolidated Edison and other load serving entities ("LSEs") have proposed price mitigation measures for in-City capacity that would apply to the Ravenswood Generating Station. These price mitigation measures essentially proposed to reduce the capacity bid price that the

Ravenswood Generating Station could bid into the NYISO energy market. However, the FERC found that the NYISO filing failed to meet the burden of proof required to support revisions to market rules. Nevertheless, on its own motion, FERC initiated a proceeding to investigate and consider the justness and reasonableness of the NYISO's in-City capacity market, including whether and how market rules should be revised to provide a fair level of compensation that will attract and retain needed infrastructure. This matter has been referred to a settlement judge and settlement discussions are on-going. At this time, we are unable to predict the outcome of this proceeding and what effect it may have on the potential revenue that could be realized from physical sales of in-City capacity or on the 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 purchases 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 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 March 31, 2007 the fair value of these derivative instruments was $8.7 million.

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 qualify for the normal purchases and sales exception. Certain contracts for the 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 71. At March 31, 2007, these derivatives had a net fair value of $72.2 million.

KeySpan has a management contract with Merrill Lynch Trading, under which KeySpan and Merrill Lynch Trading will share the responsibilities for managing KeySpan's upstream gas distribution assets associated with its Massachusetts gas distribution subsidiaries, as well as providing city-gate delivered supply. This contract allows for both KeySpan and Merrill Lynch Trading to employ derivative instruments to maximize the profitability of KeySpan's portfolio of gas distribution assets. Profits associated with these activities are shared between KeySpan, Merrill Lynch Trading and KeySpan's Massachusetts ratepayers. The accounting for this contract is subject to SFAS 71 since the contract was executed by KeySpan's regulated gas distribution utilities. At March 31, 2007, KeySpan's proportionate share of the fair value associated with these derivative instruments amounted to $26.2 million, $18.6 million of which has been deferred for future sharing among the alliance members and Massachusetts ratepayers. The remaining amount was recorded as a benefit to revenues since the inception of the contract. KeySpan provides these services internally for its New York and New

Hampshire gas distribution subsidiaries.

The table below summarizes the fair value of all of the above outstanding derivative instruments at March 31, 2007 and December 31, 2006 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)* | March 31, 2007 | December 31, 2006 |
|---|---|---|
| **Gas Contracts:** | | |
| Other current assets | 38.8 | 30.7 |
| Other deferred charges | 113.6 | 127.1 |
| Regulatory asset | 37.7 | 196.3 |
| Other current liability | (18.3) | (211.7) |
| Other deferred liabilities | (84.5) | (42.1) |
| Regulatory liability | (86.9) | (120.6) |
| **Oil Contracts:** | | |
| Other current assets | 0.4 | 0.3 |
| Other current liability | (1.0) | (7.2) |
| Other deferred liabilities | (0.1) | (0.5) |
| **Electric Contracts:** | | |
| Other current assets | 1.1 | 23.2 |
| Other deferred charges | 0.1 | 0.3 |
| Other current liability | (5.6) | (0.8) |
| Other deferred liabilities | (0.7) | (0.6) |

*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 would have paid KeySpan $37,500 per heating degree day when the actual temperature was 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 would have received on these purchased put options was $15 million. The net premium cost for these options was $1.7 million and was 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. However, weather for the first quarter of 2007 was colder than normal. Therefore, for the entire winter heating season –November 2006 through March 2007 – weather was slightly colder than normal. As a result, in the first quarter of 2007 KeySpan reversed the $9.1 million accrual recorded in the fourth quarter of 2006. 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.

*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 March 31, 2007, KeySpan has received $7.7 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 March 31, 2007, KeySpan has $1.3 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.

## 5. RECENT ACCOUNTING PRONOUNCEMENTS

In February 2007, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities." This statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This statement requires a business entity to report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. An entity may decide whether to elect the fair value option for each eligible item on its election date, subject to certain requirements described in the statement. This statement shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007. KeySpan is currently reviewing the requirements of this statement and, at this point in time, we cannot determine the impact, if any, that this statement may have on results of operations and financial position.

In September 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.

In July 2006, the FASB issued Interpretation No. 48 "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes" and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. KeySpan adopted the provisions of FIN 48 on January 1, 2007. See Note 11, "Adoption of FASB Interpretation Number 48" for additional details on the impact of this implementation on KeySpan's financial statements.

## 6. FINANCIAL GUARANTEES AND CONTINGENCIES

*Variable Interest Entity:* 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 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 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.

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 $304 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 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."

*Asset Retirement Obligations:* KeySpan has various asset retirement obligations primarily associated with its gas distribution and electric generation activities. These obligations have remained substantially unchanged from December 31, 2006, except for normal accretion adjustments and costs incurred. Generally, KeySpan's largest asset retirement obligations relate to: (i) legal requirements 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; or dispose of sections of gas main when removed from the pipeline system; (ii) cleaning and removal requirements associated with storage tanks containing waste oil and other waste contaminants; and (iii) legal requirements to remove asbestos upon major renovation or demolition of structures and facilities. At March 31, 2007, these obligations total $48.0 million. See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding these obligations.

Environmental Matters

*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 KeySpan, have been identified to the Department of Environmental Conservation ("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/or remediation activities associated with certain sites and one waterway. In February 2007, KeySpan entered into an ACO for fourteen 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 $84.8 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 $65.4 million.

KeySpan presently estimates the remaining cost of its KEDNY and KEDLI MGP-related environmental remediation activities will be $317.8 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.

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 March 31, 2007, we have reflected a regulatory asset of $367.7 million for KEDNY/KEDLI MGP sites. KeySpan has 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. See the "Introduction to the Notes to the Consolidated Financial Statements" for additional details on the filings.

KeySpan is 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. KeySpan is 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 $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, 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.

KeySpan presently estimates the remaining cost of the Massachusetts KEDNE MGP-related environmental cleanup activities will be $7.9 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 acquisition date of these subsidiaries, with respect to these MGP-related activities total $35.6 million.

KeySpan 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 in New Hampshire. At four of these sites, KeySpan has entered into cost sharing agreements with other parties who share responsibility for remediation of these sites. EnergyNorth also 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. The Nashua River Asbestos Site now has been fully remediated.

KeySpan presently estimates the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $24.7 million, which amount has been accrued 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 acquisition date of this subsidiary, with respect to the MGP-related activities total $23.7 million.

By rate orders, the Massachusetts Department of Telecommunications and Energy ("MADTE") and the New Hampshire Public Utility Commission ("NHPUC") provide for the recovery of site investigation and remediation costs and, accordingly, at March 31, 2007, we have reflected a regulatory asset of $39.6 million for the KEDNE MGP sites. Colonial Gas Company and Essex Gas Company are not subject to the provisions of SFAS 71, "Accounting for the Effects of Certain Types of Regulation" 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*: KeySpan is aware of three non-utility sites associated with KeySpan New England, LLC, a successor company to Eastern Enterprises, for which it 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 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 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 sought a judicial determination on the allocation of liability for the Everett Facility. A confidential settlement agreement was executed on terms favorable to KeySpan and the Beazer lawsuit has been discontinued.

KeySpan presently estimates the remaining cost of the environmental cleanup activities for these three non-utility sites will be approximately $9.2 million, which amount has been accrued 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 $23.6 million.

KeySpan believes 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.

See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006 Note 7, to those Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for further information on environmental matters.

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. 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 the Electric Services segment from a series of agreements with LIPA pursuant to which we manage LIPA's transmission and distribution system and supply approximately one half of LIPA's customers' electricity needs. KeySpan and LIPA have entered into agreements to extend, amend, and restate these contractual arrangements. Further, following the announcement of the proposed Merger of KeySpan and National Grid plc, LIPA, National Grid plc and KeySpan engaged in discussions concerning the impact of the transaction on LIPA's operations. See Note 10 "2006 LIPA Settlement" for further details of these agreements and discussions.

Financial Guarantees

KeySpan has issued financial guarantees in the normal course of business, on behalf of its subsidiaries, to various third party creditors. At March 31, 2007, 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:

| *Nature of Guarantee (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) | 70.2 | 2007 - 2010 |
| Commodity Guarantees and Other | (vi) | 52.7 | 2007 - 2009 |
| Letters of Credit | (vii) | 76.6 | 2007 - 2010 |
| | | $ 1,681.3 | |

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 current maturities of long-term debt and capital leases, and long-term debt on the Consolidated Balance Sheet as appropriate.

(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 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 of the lease has been extended to 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 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 and 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 March 31, 2007, the total cost to complete such remaining bonded projects is estimated to be approximately $27.0 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 March 31, 2007.

(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.

## 7. 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 this 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 March 31, 2007, 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 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. All stock option awards previously accounted for under APB 25 were fully vested by December 31, 2006.

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)* | Three Months Ended March 31, 2007 | Three Months Ended March 31, 2006 |
|---|---|---|
| Performance shares | $ 1.8 | $ 2.3 |
| Restricted stock | 0.7 | 3.7 |
| Stock options | 0.7 | 1.5 |
| EDSPP discount | 1.3 | 1.5 |
| Total stock-based compensation included in operations and maintenance expense | 4.5 | 9.0 |
| Income tax benefit | (1.6) | (3.2) |
| Total stock based compensation expense, net of tax | $ 2.9 | $ 5.8 |

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. During the three months ended March 31, 2007 and 2006 cash received from stock options exercised was $5.2 million and $15.5 million, respectively. The tax benefit realized for tax deductions from stock options exercised during the three months ended March 31, 2007 and 2006 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 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 2005 award is being expensed ratably over its remaining performance period.

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 March 31, 2007 associated with all of the performance share awards was $9.9 million.

There were no performance share awards granted in the first quarter of 2007.

*Restricted Stock Awards*

KeySpan has made certain grants of restricted stock to officers, directors and certain other management employees under the Incentive Plan. Awards of restricted stock were made in 2002, 2005, 2006 and 2007. These awards may not be sold or otherwise transferred until certain restrictions have lapsed. The unearned stock-based compensation related to these awards is being amortized to compensation expense over the period in which the awards vest. 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. Upon a change of control, all restricted stock awards will vest immediately. The unearned compensation as of March 31, 2007, associated with restricted stock was $6.8 million.

*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 299,977 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 2007 or 2006.

A summary of the status of our fixed stock option plans and changes is presented below for the three months ended March 31, 2007:

| Fixed Options | Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value *(In Millions)* |
|---|---|---|---|
| Outstanding at beginning of period | 9,403,104 | $ 33.82 | |
| Exercised | (150,102) | $ 34.71 | |
| Forfeited | (4,737) | $ 38.26 | |
| Outstanding at end of period | 9,248,265 | $ 33.80 | $ 66.2 |
| Exercisable at end of period | 7,919,622 | $ 33.15 | $ 61.9 |

The total intrinsic value of the options exercised during the three months ended March 31, 2007 and 2006 was approximately $0.9 million and $3.1 million, respectively.

| Remaining Contractual Life | Options Outstanding at March 31, 2007 | Weighted Average Exercise Price | Range of Exercise Price | Options Exercisable at March 31, 2007 | Weighted Average Exercise Price | Range of Exercise Price |
|---|---|---|---|---|---|---|
| 1 years | 185,000 | $ 32.63 | 32.63 | 185,000 | $ 32.63 | 32.63 |
| 2 years | 671,430 | $ 28.01 | 24.73 - 29.38 | 671,430 | $ 28.01 | 24.73 - 29.38 |
| 3 years | 381,741 | $ 26.98 | 21.99 - 27.06 | 381,741 | $ 26.98 | 21.99 - 27.06 |
| 4 years | 954,537 | $ 22.69 | 22.50 - 32.76 | 954,537 | $ 22.69 | 22.50 - 32.76 |
| 5 years | 1,469,933 | $ 39.50 | 39.50 | 1,469,933 | $ 39.50 | 39.50 |
| 6 years | 1,712,230 | $ 32.66 | 32.66 | 1,712,230 | $ 32.66 | 32.66 |
| 7 years | 1,139,776 | $ 32.40 | 32.40 | 940,496 | $ 32.40 | 32.40 |
| 8 years | 1,394,490 | $ 37.54 | 37.54 | 972,730 | $ 37.54 | 37.54 |
| 9 years | 1,339,128 | $ 39.25 | 39.25 | 631,525 | $ 39.25 | 39.25 |
| | 9,248,265 | | | 7,919,622 | | |

As of March 31, 2007, there are approximately 1.3 million options which have not yet vested. The unearned compensation cost related to these stock option awards is $2.5 million which is expected to be recognized over the next two years.

## 8. POSTRETIREMENT BENEFITS

*Pension Plans:* The following information represents the consolidated net periodic pension cost for the three months ended March 31, 2007 and 2006, 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 the 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:

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 |
| Service cost, benefits earned during the period | $ 15.7 | $ 16.1 |
| Interest cost on projected benefit obligation | 40.6 | 38.6 |
| Expected return on plan assets | (52.1) | (47.0) |
| Net amortization and deferral | 15.9 | 21.9 |
| Total pension cost | $ 20.1 | $ 29.6 |

*Other Postretirement Benefits:* The following information represents the consolidated net periodic other postretirement benefit cost for the three months ended March 31, 2007 and 2006 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:

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 |
| Service cost, benefits earned during the period | $ 6.1 | $ 6.9 |
| Interest cost on accumulated postretirement benefit obligation | 19.4 | 20.2 |
| Expected return on plan assets | (9.8) | (9.1) |
| Net amortization and deferral | 12.2 | 16.6 |
| Other postretirement cost | $ 27.9 | $ 34.6 |

During the first three months of 2007, KeySpan contributed $18.0 million to its pension plans. KeySpan anticipates contributing an additional $113.0 million to its other postretirement benefit plans during the remainder of 2007. Estimated contribution levels are subject to change based on future market returns, interest rates and certain other measurements. Actual contributions, therefore, may vary from these levels.

## 9. COMMERCIAL PAPER

At March 31, 2007, KeySpan had two credit facilities totaling $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 March 31, 2007, KeySpan's consolidated indebtedness was 48.6% 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 March 31, 2007, we had cash and temporary cash investments of $326.5 million. During the first three months of 2007, we repaid $85.0 million of commercial paper and, at March 31, 2007, no commercial paper was outstanding. At March 31, 2007, KeySpan had the ability to issue up to an additional $1.5 billion, under its commercial paper program.

## 10. 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 the Long Island Lighting Company's ("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 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 retroactive to 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. 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 Merger of KeySpan and National Grid plc, LIPA, National Grid plc and KeySpan engaged in discussions concerning the impact of the transaction on LIPA's operations. On March 23, 2007, KeySpan, National Grid plc and LIPA announced that the parties reached an agreement in principle pursuant to which LIPA agreed to waive its contractual right to terminate the 1998 LIPA Agreements and the 2006 LIPA Agreements upon consummation of the Merger between KeySpan and National Grid plc, in exchange for enhancements to certain of the 2006 LIPA Agreements and certain other considerations. The amended and enhanced agreements become effective upon completion of the Merger between KeySpan and National Grid plc and are subject to approval by the LIPA Board of Trustees, the New York State Attorney General and the New York State Comptroller.

*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 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 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 KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006 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 the steam generating units at KeySpan's Far Rockaway and/or E.F. Barrett Generating Stations (and certain related assets) at a price equal to the net book value of each facility. In December 2006, KeySpan and LIPA entered into an amendment to the 2006 Option Agreement whereby the parties agreed to extend the expiration of the option period to the later of (i) December 31, 2007 or (ii) 180 days following the effective date of the 2006 Option Agreement. 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 the three months ended March 31, 2007 and 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.

## 11. ADOPTION OF FASB INTERPRETATION NUMBER 48

On July 13, 2006 the FASB issued Interpretation No. 48 "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes" and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on: the classification of unrecognized tax benefits; disclosures for interest and penalties; accounting and disclosures for interim reporting periods; and transition requirements. FIN 48 is effective for fiscal years beginning after December 15, 2006.

KeySpan adopted the provisions of FIN 48 on January 1, 2007. The total amount of unrecognized tax benefits as of the date of adoption was $79.6 million. As a result of the implementation of FIN 48, we recognized a $20.5 million increase in the liability for unrecognized tax benefits which was accounted for as a reduction in retained earnings of $5.2 million and an increase to deferred tax assets of $15.3 million.

Included in the balance of unrecognized tax benefits at January 1, 2007, are $55.3 million of tax benefits that, if recognized, would affect the effective tax rate.

KeySpan recognizes interest accrued related to unrecognized tax benefits in tax expense on the Consolidated Statement of Income. During the years ended December 31, 2006, 2005 and 2004, we recognized approximately $0.9 million, $7.6 million and $0.4 million in interest, respectively. KeySpan had accrued interest payable of $8.9 million and $8.0 million at December 31, 2006 and 2005, respectively. Upon adoption of FIN 48, on January 1, 2007, KeySpan increased its accrued interest payable to $24.3 million, which is included in the total of unrecognized benefits as of the date of adoption. We do not anticipate that the total amounts of unrecognized tax benefits will significantly increase or decrease within the next twelve months.

KeySpan is subject to federal, state and local income tax. Through its various subsidiaries, KeySpan operates predominately in New York, Massachusetts and New Hampshire. The following table summarizes the open tax years for each major jurisdiction:

| Jurisdiction | Open Tax Years |
|---|---|
| Federal | 2000 - 2006 |
| New York State | 2000 - 2006 |
| New York City | 2000 - 2006 |
| Massachusetts | 2000 - 2006 |
| New Hampshire | 2003 - 2006 |

The Internal Revenue Service has recently commenced the examination of KeySpan's tax returns for the years ended December 31, 2000 through December 31, 2004. In addition, several of our subsidiaries are currently under audit by New York State and New York City for the tax years ended

December 31, 2000 through December 31, 2005. Although the tax years ended December 31, 2003 through December 31, 2005 are open in Massachusetts and New Hampshire, none of our subsidiaries in these states are currently being audited by the income tax authorities. At this time, we do not believe that the outcome of any examination will have a material impact on KeySpan's financial statements.

## 12. KEYSPAN GAS EAST CORPORATION SUMMARY FINANCIAL INFORMATION

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**

| | Three Months Ended March 31, 2007 | | | | |
|---|---|---|---|---|---|
| *(In Millions of Dollars)* | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
| **Revenues** | $ 0.2 | $ 594.5 | $ 2,268.0 | $ (0.2) | $ 2,862.5 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 394.3 | 1,278.4 | - | 1,672.7 |
| Fuel and purchased power | - | - | 128.2 | - | 128.2 |
| Operations and maintenance | 1.4 | 37.8 | 391.7 | - | 430.9 |
| Intercompany expense | - | 1.3 | (1.1) | (0.2) | - |
| Depreciation and amortization | - | 28.4 | 83.9 | - | 112.3 |
| Operating taxes | - | 18.7 | 103.9 | - | 122.6 |
| Total Operating Expenses | 1.4 | 480.5 | 1,985.0 | (0.2) | 2,466.7 |
| Income from equity investments | - | - | 3.7 | - | 3.7 |
| **Operating Income (Loss)** | (1.2) | 114.0 | 286.7 | - | 399.5 |
| Interest charges | (41.0) | (12.7) | (19.7) | 11.8 | (61.6) |
| Other income and (deductions) | 250.9 | 1.7 | (14.2) | (230.2) | 8.2 |
| **Total Other Income and (Deductions)** | 209.9 | (11.0) | (33.9) | (218.4) | (53.4) |
| **Income Taxes (Benefit)** | (4.7) | 37.8 | 99.6 | - | 132.7 |
| **Net Income** | $ 213.4 | $ 65.2 | $ 153.2 | $ (218.4) | $ 213.4 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Three Months Ended March 31, 2006 | | | | |
| **Revenues** | $ 0.2 | $ 543.7 | $ 2,117.4 | $ (0.2) | $ 2,661.1 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 364.9 | 1,146.5 | - | 1,511.4 |
| Fuel and purchased power | - | - | 130.0 | - | 130.0 |
| Operations and maintenance | 7.9 | 36.3 | 361.8 | - | 406.0 |
| Intercompany expense | - | 1.2 | (1.0) | (0.2) | - |
| Depreciation and amortization | - | 25.1 | 85.2 | - | 110.3 |
| Operating taxes | - | 17.7 | 100.5 | - | 118.2 |
| Total Operating Expenses | 7.9 | 445.2 | 1,823.0 | (0.2) | 2,275.9 |
| Income from equity investments | - | - | 3.4 | - | 3.4 |
| Gain on sale of property | - | - | 0.5 | - | 0.5 |
| **Operating Income (Loss)** | (7.7) | 98.5 | 298.3 | - | 389.1 |
| Interest charges | (39.8) | (14.1) | (53.0) | 40.7 | (66.2) |
| Other income and (deductions) | 249.2 | - | 19.4 | (257.2) | 11.4 |
| **Total Other Income and (Deductions)** | 209.4 | (14.1) | (33.6) | (216.5) | (54.8) |
| **Income Taxes (Benefit)** | (6.3) | 29.9 | 102.7 | - | 126.3 |
| **Net Income** | $ 208.0 | $ 54.5 | $ 162.0 | $ (216.5) | $ 208.0 |

**Balance Sheet**

| (In Millions of Dollars) | Guarantor | KEDLI | March 31, 2007<br>Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & temporary cash investments | $ 61.3 | $ 139.5 | $ 125.7 | $ - | $ 326.5 |
| Accounts receivable, net | 0.5 | 300.0 | 896.7 | - | 1,197.2 |
| Other current assets | 1.0 | 193.9 | 1,038.4 | - | 1,233.3 |
| | 62.8 | 633.4 | 2,060.8 | - | 2,757.0 |
| **Equity Investments and Other** | 5,241.3 | - | 145.6 | (5,113.8) | 273.1 |
| **Property** | | | | | |
| Gas | - | 2,216.6 | 5,493.6 | - | 7,710.2 |
| Other | - | 1.3 | 3,214.7 | - | 3,216.0 |
| Accumulated depreciation and depletion | - | (443.9) | (2,871.6) | - | (3,315.5) |
| | - | 1,774.0 | 5,836.7 | - | 7,610.7 |
| **Intercompany Accounts Receivable** | 949.7 | 188.6 | 1,851.2 | (2,989.5) | - |
| **Deferred Charges** | 1,959.3 | 449.4 | 1,235.7 | - | 3,644.4 |
| **Total Assets** | $ 8,213.1 | $ 3,045.4 | $ 11,130.0 | $ (8,103.3) | $ 14,285.2 |
| **LIABILITIES AND CAPITALIZATION** | | | | | |
| **Current Liabilities** | | | | | |
| Accounts payable and other liabilities | $ 64.8 | $ 89.0 | $ 662.1 | $ - | $ 815.9 |
| Commercial paper | - | - | - | - | - |
| Other current liabilities | 278.1 | 155.0 | 223.7 | - | 656.8 |
| | 342.9 | 244.0 | 885.8 | - | 1,472.7 |
| **Intercompany Accounts Payable** | 7.5 | 502.7 | 891.6 | (1,401.8) | - |
| **Deferred Credits and Other Liabilities** | | | | | |
| Deferred income tax | 3.4 | 413.0 | 708.1 | - | 1,124.5 |
| Other deferred credits and liabilities | 1,212.1 | 197.2 | 1,304.0 | - | 2,713.3 |
| | 1,215.5 | 610.2 | 2,012.1 | - | 3,837.8 |
| **Capitalization** | | | | | |
| Common shareholders' equity | 4,785.7 | 1,062.6 | 3,941.0 | (5,113.8) | 4,675.5 |
| Long-term debt and capital leases | 1,861.5 | 625.9 | 3,383.6 | (1,587.7) | 4,283.3 |
| **Total Capitalization** | 6,647.2 | 1,688.5 | 7,324.6 | (6,701.5) | 8,958.8 |
| **Minority Interest in Subsidiary Companies** | - | - | 15.9 | - | 15.9 |
| **Total Liabilities & Capitalization** | $ 8,213.1 | $ 3,045.4 | $ 11,130.0 | $ (8,103.3) | $ 14,285.2 |

**Balance Sheet**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | | | December 31, 2006 | | |
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & 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 |
| **Equity 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 and other liabilities | $ 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 and capital leases | 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 Subsidiary Companies** | - | - | 15.7 | - | 15.7 |
| **Total Liabilities & Capitalization** | $ 8,071.7 | $ 2,869.1 | $ 11,121.6 | $ (7,624.9) | $ 14,437.5 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Three Months Ended March 31, 2007 Guarantor | KEDLI | Other Subsidiaries | Consolidated |
|---|---|---|---|---|
| **Operating Activities** | | | | |
| Net Cash (Used in) Provided by Operating Activities | $ (23.5) | $ 110.2 | $ 262.5 | $ 349.2 |
| **Investing Activities** | | | | |
| Construction expenditures | - | (19.4) | (88.0) | (107.4) |
| Cost of removal | - | (1.4) | (10.8) | (12.2) |
| Derivative margin calls | - | 14.1 | 27.5 | 41.6 |
| Return of investment | - | - | 7.6 | 7.6 |
| Net Cash (Used in) Investing Activities | - | (6.7) | (63.7) | (70.4) |
| **Financing Activities** | | | | |
| Treasury stock issued | 5.7 | - | - | 5.7 |
| Payment of debt, net | (85.0) | - | (0.6) | (85.6) |
| Common stock dividends paid | (83.3) | - | - | (83.3) |
| Intercompany dividend payments | 2.0 | - | (2.0) | - |
| Net intercompany accounts | 104.9 | 1.3 | (106.2) | - |
| Net Cash (Used in) Provided by Financing Activities | (55.7) | 1.3 | (108.8) | (163.2) |
| Net (Decrease) Increase in Cash and Cash Equivalents | $ (79.2) | $ 104.8 | $ 90.0 | $ 115.6 |
| Cash and Cash Equivalents at Beginning of Period | 140.5 | 34.7 | 35.7 | 210.9 |
| Cash and Cash Equivalents at End of Period | $ 61.3 | $ 139.5 | $ 125.7 | $ 326.5 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Three Months Ended March 31, 2006 Guarantor | KEDLI | Other Subsidiaries | Consolidated |
|---|---|---|---|---|
| **Operating Activities** | | | | |
| Net Cash Provided by Operating Activities | $ 32.7 | $ 142.1 | $ 369.1 | $ 543.9 |
| **Investing Activities** | | | | |
| Construction expenditures | - | (20.8) | (101.4) | (122.2) |
| Cost of removal | - | (0.6) | (6.1) | (6.7) |
| Net Cash (Used in) Investing Activities | - | (21.4) | (107.5) | (128.9) |
| **Financing Activities** | | | | |
| Treasury stock issued | 15.5 | - | - | 15.5 |
| Payment of debt, net | (160.8) | - | - | (160.8) |
| Common stock dividends paid | (81.1) | - | - | (81.1) |
| Net intercompany accounts | 390.3 | (120.6) | (269.7) | - |
| Net Cash Provided by (Used in) Financing Activities | 163.9 | (120.6) | (269.7) | (226.4) |
| Net Increase (Decrease) in Cash and Cash Equivalents | $ 196.6 | $ 0.1 | $ (8.1) | $ 188.6 |
| Cash and Cash Equivalents at Beginning of Period | 79.6 | 3.5 | 41.4 | 124.5 |
| Cash and Cash Equivalents at End of Period | $ 276.2 | $ 3.6 | $ 33.3 | $ 313.1 |

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Consolidated Review of Results**

The following is a summary of transactions affecting comparative earnings for the three months ended March 31, 2007, compared to the three months ended March 31, 2006. Capitalized terms used in the following discussion, but not otherwise defined, have the same meaning as when used in the Notes to the Consolidated Financial Statements included under Item 1. References to "KeySpan," "we," "us," and "our" mean KeySpan Corporation, together with its consolidated subsidiaries.

Operating income by segment, as well as consolidated earnings for common stock is set forth in the following table for the periods indicated.

| *(In Millions of Dollars, Except per Share)* | | | | |
|---|---|---|---|---|
| Quarter Ended March 31, | | 2007 | | 2006 |
| Gas Distribution | $ | 402.5 | $ | 336.4 |
| Electric Services | | (1.5) | | 65.0 |
| Energy Services | | 1.4 | | (0.4) |
| Energy Investments | | 5.1 | | 3.0 |
| Eliminations and other | | (8.0) | | (14.9) |
| **Operating Income** | | 399.5 | | 389.1 |
| Other income and (deductions) | | | | |
| Interest charges | | (61.6) | | (66.2) |
| Other income and (deductions) | | 8.2 | | 11.4 |
| | | (53.4) | | (54.8) |
| Income taxes | | 132.7 | | 126.3 |
| **Earnings for Common Stock** | $ | 213.4 | $ | 208.0 |
| **Basic Earnings per Share** | $ | 1.22 | $ | 1.19 |

KeySpan's earnings for common stock for the three months ended March 31, 2007 were $213.4 million, or $1.22 per share, compared to $208.0 million or $1.19 per share realized during the three months ended March 31, 2006, an increase of $5.4 million, or $0.03 per share.

As indicated in the above table, operating income increased $10.4 million, or 3% for the quarter ended March 31, 2007, compared to the corresponding quarter last year. The Gas Distribution segment realized an increase in operating income of $66.1 million, which was effectively offset by a decrease in operating income associated with KeySpan's electric operations of $66.5 million. Operating income from the Gas Distribution segment benefited from the comparatively colder weather during the first quarter of 2007 compared to the first quarter of 2006, as well as from load growth additions which, combined, resulted in an increase to net gas revenues. The Electric Services segment results were adversely impacted by a decrease in electric revenues from KeySpan's merchant electric generating facilities. Further, during the first quarter of 2007, this segment also realized an expected seasonal loss on a fixed for floating unforced capacity financial swap which is reflected in the operating results of this segment.

Operating income for the first quarter of 2007 from KeySpan's two other operating segments – Energy Services and Energy Investments - increased $1.8 million and $2.1 million, respectively, compared to the first quarter of 2006. The increase in operating income from the Energy Services segment reflects lower administrative and general expenses, as well as higher bandwidth sales associated with KeySpan's fiber optic subsidiary, while the increase in operating income from the Energy Investments segment was due to higher revenues related to KeySpan's Liquefied Natural Gas ("LNG") transportation subsidiary.

The operating income variation reflected in "elimination and other" is due primarily to a decrease in costs residing at KeySpan's holding company level such as corporate advertising expenses, sponsorship fees and certain employee benefit costs that are not allocated to KeySpan's operating segments. (See the discussion under the caption "Review of Operating Segments" for further details on each segment.)

Other income and (deductions) reflects interest charges and other miscellaneous items. For the three months ended March 31, 2007, other income and (deductions) reflects a net expense of $53.4 million compared to a net expense of $54.8 million for the three months ended March 31, 2006. The favorable variation in other income and (deductions) of $1.4 million reflects a decrease in interest charges of $4.6 million year-over-year. Comparative interest expense reflects the benefit from lower commercial paper borrowings and regulatory carrying charges in the first quarter of 2007, partially offset by the adverse impact from a higher level of outstanding long-term debt. During the first quarter of 2007, KeySpan had no outstanding commercial paper borrowings compared to approximately $500 million in outstanding borrowings during the first quarter of 2006. Long-term debt at March 31, 2007, however, was $486 million higher than last year reflecting the November 2006 issuance of $500 million Senior Unsecured Notes. The benefit to earnings from the lower interest charges was partially offset by a decrease in income on certain investments.

Income tax expense for the first quarter of 2007 and 2006 generally reflects the level of pre-tax income.

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 reports its segment results 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.

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 |
| Revenues | $ 2,415.5 | $ 2,180.1 |
| Cost of gas | 1,673.6 | 1,512.6 |
| Revenue taxes | 28.9 | 26.2 |
| Net Revenues | 713.0 | 641.3 |
| Operating Expenses | | |
| Operations and maintenance | 191.2 | 190.4 |
| Depreciation and amortization | 79.8 | 75.9 |
| Operating taxes | 39.5 | 38.6 |
| Total Operating Expenses | 310.5 | 304.9 |
| Operating Income | $ 402.5 | $ 336.4 |
| Firm gas sales and transportation (MDTH) | 150,030 | 126,904 |
| Transportation - Electric Generation (MDTH) | 5,209 | 6,471 |
| Other Sales (MDTH) | 48,557 | 52,332 |
| Warmer (Colder) than Normal - New York | 2.8% | 13.0% |
| Warmer (Colder) than Normal - New England | 3.0% | 7.7% |

A MDTH is 10,000 therms (British Thermal Units) 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 $66.1 million for the three months ended March 31, 2007 compared to the same quarter last year, due to an increase in net gas revenues (revenues less the cost of gas and associated revenue taxes) of $71.7 million, primarily resulting from the comparatively colder weather during the first quarter of 2007 compared to the first quarter of 2006 and load growth additions. Operating expenses increased $5.6 million due to higher regulatory amortization charges and repair and maintenance costs.

*Net Revenues*

Net gas revenues from our gas distribution operations increased $71.7 million, or 11%, in the first quarter of 2007 compared to the same quarter of 2006. Both the New York and New England based gas distribution operations benefited from the significantly colder weather experienced throughout the northeastern United States during the first quarter of 2007 compared to the first quarter of 2006 and from load growth additions. As measured in heating degree days, weather during the first quarter of 2007 in all of our service territories was approximately 3% colder than normal and approximately 15% and 11% colder than last year in our New York and New England service territories, respectively.

Net revenues from firm gas customers (residential, commercial and industrial customers) increased $56.5 million in the first quarter of 2007 compared to the same quarter last year. The combination of an increase in usage per customer due to the comparatively colder weather, as well as load growth additions from oil-to-gas conversions, primarily for space heating purposes and new construction in 2006, resulted in a beneficial impact to net gas revenues of $47.5 million, net of the weather normalization adjustments and weather derivatives discussed below. (Approximately 16% of this increase is from load growth.)

Also included in net gas revenues is the recovery of property taxes that added $3.3 million to net revenues during the first quarter of 2007. 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. Additionally, 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. KeySpan, Merrill Lynch Trading and KeySpan's Massachusetts gas sales customers share in the profits generated from the optimization of these assets. For the three months ended March 31, 2007, KeySpan recognized a $5.7 million profit on this contract, after sharing with Merrill Lynch Trading and KeySpan's Massachusetts gas sales customers.

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. Since weather was colder than normal during the first quarter of 2007, KeySpan refunded $1.6 million to its firm gas heating sales customers during the quarter. 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 2006/2007 winter heating season - November 2006 through March 2007. These financial derivatives afford KeySpan some protection against warmer than normal weather. Weather during the fourth quarter of 2006 was warmer than normal; accordingly KeySpan recorded a $9.1 million benefit to earnings in the fourth quarter of 2006 to reflect the accrual for the weather hedges. However, as noted, weather for the first quarter of 2007 was colder than normal in KeySpan's New England service territory. Therefore, for the entire winter heating season –November 2006 through March 2007 – weather was slightly colder than normal. As a result, in the first quarter of 2007 KeySpan reversed the $9.1 million accrual recorded in the fourth quarter of 2006. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for further information.)

Firm gas distribution rates for KEDNY, KEDLI and KEDNE in 2007, other than for the recovery of gas costs, have remained substantially unchanged from rates charged in 2006.

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 $15.2 million during the first quarter of 2007 compared to the same quarter last year reflecting higher pricing and higher sales quantities.

*Firm Sales, Transportation and Other Quantities*

Firm gas sales and transportation quantities for the quarter ended March 31, 2007, increased 18% compared to the same period in 2006 due primarily to the colder weather this year compared to last year and to customer additions and oil-to-gas conversions. 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. As mentioned previously, 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 share in the profits generated from the optimization of these assets. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

*Purchased Gas for Resale*

The increase in gas costs for the first quarter of 2007 compared to the first quarter of 2006 of $161.0 million, or 11%, reflects the increase in the quantity of gas purchased due to the comparatively colder first quarter weather. The price per dekatherm of gas purchased for firm gas sales customers remained relatively constant between years. 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 during the first quarter of 2007 compared to the same quarter of 2006 increased $5.6 million, or 2%. Operations and maintenance expense increased slightly, $0.8 million, as higher repair and maintenance costs of $5.1 million were essentially offset by lower employee benefit costs, primarily postretirement expenses, of $4.3 million. These variations are, for the most part, timing in nature.

Depreciation and amortization charges increased $3.9 million due mostly to an increase of $3.3 million for the amortization of deferred property taxes. As noted previously, the amortization of these deferred taxes does not impact net income since we recovered a similar amount from our ratepayers in revenues.

*Gas Supply and Pricing*

KeySpan had adequate gas supply available to meet its gas load demand in its service territories for the 2006/2007 winter heating season as KeySpan's gas storage was 100% full at the start of the winter heating season. The current gas rate structure of each of our gas distribution utilities includes 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 Massachusetts Department of Telecommunications and Energy ("MADTE") order, received in the fourth quarter of 2005, permitting Boston Gas Company 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 financial derivatives, KeySpan 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 mitigated 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. 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 our market segments through the expansion of our gas distribution system for new 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 where natural gas is already in the home for other uses 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 each have a 50% ownership interest in Islander East Pipeline Company, LLC ("Islander East"). Once in service, the pipeline is expected to have the capacity to transport up to 260,000 DTH of natural gas to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. In addition, KeySpan has a 26.25% interest in the Millennium Pipeline development project which is anticipated to transport up to 525,000 DTH of natural gas a day to a point of interconnection with the Algonquin pipeline in Ramapo, New York. KEDLI has executed a Precedent Agreement for 175,000 DTH of 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 Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement"). The Electric Services segment also provides retail marketing of electricity to commercial customers.

On March 23, 2007, KeySpan, National Grid plc and LIPA announced that the parties reached an agreement in principle pursuant to which LIPA agreed to waive its contractual right to terminate the 1998 LIPA Agreements and the 2006 LIPA Agreements upon consummation of the Merger between KeySpan and National Grid plc, in exchange for enhancements to certain of the 2006 LIPA Agreements and certain other considerations. The amended and enhanced agreements become effective upon completion of the Merger between KeySpan and National Grid plc and are subject to approval by the LIPA Board of Trustees, the New York State Attorney General and the New York State Comptroller.

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

| (In Millions of Dollars) | Three Months Ended March 31, 2007 | 2006 |
|---|---|---|
| Revenues | $ 398.2 | $ 424.8 |
| Purchased fuel | 132.3 | 130.0 |
| Net Revenues from Operations | 265.9 | 294.8 |
| Derivative Financial Instrument | (9.9) | - |
| Net Electric Revenues | 256.0 | 294.8 |
| Operating Expenses | | |
| Operations and maintenance | 185.3 | 155.3 |
| Depreciation | 25.1 | 27.1 |
| Operating taxes | 47.1 | 47.4 |
| Total Operating Expenses | 257.5 | 229.8 |
| Operating Income | $ (1.5) | $ 65.0 |
| Electric sales (MWH)* | 878,309 | 806,677 |
| Capacity(MW)* | 2,450 | 2,450 |
| Cooling degree days | N/A | N/A |

*Reflects the operations of the Ravenswood Generating Station only.

*Executive Summary*

Operating income decreased $66.5 million for the three months ended March 31, 2007, compared to the same quarter last year, due, in part, to a decrease in net revenues from the Ravenswood Generating Station of $53.8 million primarily resulting from the comparative impact associated with derivative financial instruments. Although KeySpan's hedging strategies during the first quarter of 2007 were consistent with past KeySpan policy to hedge the cash flow variability associated with a portion of forecasted fuel purchases and electric energy sales associated with the Ravenswood Generating Station, the results from these strategies were significantly lower year-over-year. Further, during the quarter, the Electric Services segment realized an expected seasonal loss of $9.9 million on a fixed for floating unforced capacity financial swap.

*Net Revenues*

Total electric net revenues realized during the first quarter of 2007 were $38.8 million, or 13%, lower than such revenues realized during the corresponding quarter last year.

Net revenues from the Ravenswood Generating Station decreased $53.8 million for the three months ended March 31, 2007 compared to the same quarter last year mainly due to lower energy margins of $43.0 million. Further, capacity margins decreased $10.8 million as a result of additional capacity installed in New York City last year.

The decrease in energy margins associated with the Ravenswood Generating Station was due, in part, to the comparative impact of KeySpan's hedging activities. We employ derivative financial instruments to economically hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil consumed at the Ravenswood Generating Station, as well as for a portion of forecasted electric energy sales. For the first three months of 2007, KeySpan's hedging strategies, which are reflected in net electric revenues, resulted in a gain of $7.6 million compared to hedging gains of $55.6 million realized during the same period last year, resulting in a net comparative reduction in operating income of $48.0 million. Due to the dual-fuel capability of the Ravenswood Generating Station and the impact that the two hurricanes in the summer of 2005 in the Gulf Coast of the United States had on oil and gas prices, KeySpan was able to "lock-in" very favorable fuel pricing and resultant electric energy margins during the later part of 2005 for the first quarter of 2006.

Offsetting, to some extent, the adverse impact of the comparative hedging results, was an increase in physical "spark-spreads" (the selling price of electricity less the cost of fuel, exclusive of hedging gains or losses), which resulted in a benefit of $5.0 million to energy margins for the first quarter 2007 compared to the same quarter of 2006. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for further information on KeySpan's hedging strategy.)

The rules and regulations for capacity, energy sales and the sale of certain ancillary services to the New York Independent System Operator ("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 "Market and Credit Risk Management Activities" for further details on these matters.

KeySpan has 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 first quarter of 2007, KeySpan realized an expected seasonal loss of $9.9 million from this derivative financial instrument.
Net revenues for the first quarter of 2007 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $24.9 million compared to the same quarter of 2006. The increase is due, for the most part, to recovery of operations and maintenance charges billed to LIPA of approximately $19.5 million. These recoveries had no impact on operating income since actual expenses increased by a like amount. Therefore, only approximately $5.4 million of the increase in net revenues resulted in a benefit to operating income. This increase in net revenues from the LIPA service agreements was driven by higher capacity revenues, which are predominately timing in nature, as well as higher off-system electric energy sales and emission credit sales. (For a description of the LIPA Agreements and power purchase agreements, see KeySpan's 2006 Annual Report on Form 10-K for the year ended December 31, 2006 Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "Electric Services – Revenue Mechanisms.")

Revenues associated with KeySpan's electric marketing activities during the first quarter of 2007 have remained consistent with such revenues realized during the same quarter of 2006.

*Operating Expenses*

For the three months ended March 31, 2007, operating expenses increased $27.7 million compared to the same quarter of 2006. Operations and maintenance expenses increased $30.0 million reflecting, in part, a $19.5 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 actually impacted operating income increased approximately $10.5 million. These expenses reflect an increase in overhaul costs and non-outage maintenance work performed on the Ravenswood Generating Station and our Long Island based electric generating units, as well as to the timing of maintenance work on LIPA's transmission and distribution system.

Depreciation expense and operating taxes decreased $2.3 million in the first quarter of 2007 compared to the same quarter of 2006. The decrease reflects costs primarily associated with KeySpan's Long Island based electric generating units that are fully recoverable from LIPA.

*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 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 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 long-term reliability of New York State's electric grid. At March 31, 2007, total capitalized costs associated with the siting, permitting and procurement of equipment for the Melville facility were $64.2 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.

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 |
| Revenues | $ 54.7 | $ 50.9 |
| Operating expenses | 53.3 | 51.3 |
| Operating Income (Loss) | $ 1.4 | $ (0.4) |

The Energy Services segment posted an operating profit of $1.4 million for the three months ended March 31, 2007, compared to an operating loss of $0.4 million incurred during the three months ended March 31, 2006. The improved performance reflects favorable earnings 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 2007 compared to 2006 as a result of the implementation of cost containment measures.

**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.

This segment is also engaged in pipeline development activities. KeySpan and Spectra 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 for these energy-related investments is set forth in the following table for the periods indicated.

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 |
| Revenues | $ 11.3 | $ 9.1 |
| Less: Operation and maintenance expense | 6.3 | 6.6 |
| Other operating expenses | 3.6 | 3.1 |
| Add: Equity earnings | 3.7 | 3.4 |
| Gain on sale of property | - | 0.2 |
| Operating Income | $ 5.1 | $ 3.0 |

As indicated in the above table, operating income for the Energy Investments segment increased $2.1 million in the first quarter of 2007 compared to the corresponding quarter of 2006 due, mainly, to an increase in operating income from a KeySpan subsidiary engaged in the transportation of liquefied natural gas.

*Other Matters*

In order to serve the anticipated market requirements in our New York service territories, KeySpan and Spectra Energy Corporation each have a 50% ownership 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. 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. Oral argument was conducted on April 10, 2007. Subject to obtaining final permits and financing, Islander East anticipates that this pipeline will be in service in late 2008. As of March 31, 2007, KeySpan's total capitalized costs associated with the siting and permitting of the Islander East pipeline were approximately $31.1 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 March 31, 2007, KeySpan's investment in the Millennium Pipeline project was $19.5 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 third or fourth 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. An unfavorable outcome to the FERC litigation would mean that KeySpan would be unable to construct the proposed upgrade. Similarly, if the FERC litigation is resolved favorably but the Rhode Island litigation is not, KeySpan could be required to obtain a permit under Rhode Island State law. If the Rhode Island State law permit were denied, an appeal would lie only to Rhode Island State court. Accordingly, an unfavorable outcome to the Rhode Island litigation could similarly have a material impact on KeySpan's ability to proceed with the proposed upgrade.

Pursuant to a letter agreement with BG LNG Services extending the term of the current precedent agreement referenced above, BG LNG Services elected to reimburse KeySpan LNG $7.6 million for a portion of its development costs. If the project is placed into service, BG LNG Services may elect to have this contribution count as a contribution reducing BG LNG Services cost of service for the Project or return to BG LNG Services in full on the service commencement date, in which case such costs will be included in the cost of service under the service agreement. As of March 31, 2007, our investment in this project was $11.2 million.

**Allocated Costs**

We are subject to the jurisdiction of the FERC under Public Utility Holding Company Act of 2005 ("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 corporate advertising expenses, sponsorship fees and certain employee benefit costs that are not allocated to KeySpan's operating segments.

**Liquidity**

Cash flow from operations decreased $194.7 million in the first quarter of 2007 compared to the same quarter of 2006 primarily reflecting changes in working capital requirements. The variation in working capital requirements was primarily driven by receipt of customer payments during the first three months of 2006 associated with the 2005 fourth quarter winter heating season. Outstanding accounts receivable balances associated with KeySpan's gas distribution activities at December 31, 2005 were high due to strong gas sales in 2005 and unusually high natural gas prices. The collection of these accounts receivables generated significant cash flow in 2006.

At March 31, 2007, we had cash and temporary cash investments of $326.5 million. During the first quarter of 2007, we repaid $85.0 million of commercial paper and, at March 31, 2007, Keyspan had no commercial paper outstanding. We had the ability to borrow up to an additional $1.5 billion at March 31, 2007, under the terms of our credit facility.

KeySpan has two credit facilities which total $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 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 March 31, 2007, KeySpan's consolidated indebtedness was 48.6% 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. 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 Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement" 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:

| | Three Months Ended March 31, | |
|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 |
| Gas Distribution | $ 83.9 | $ 85.8 |
| Electric Services | 18.5 | 28.9 |
| Energy Investments | 3.8 | 5.4 |
| Energy Services and other | 1.2 | 2.1 |
| | $ 107.4 | $ 122.2 |

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. The decrease in capital expenditures for the three months ended March 31, 2007 compared to the same period last year of $14.8 million reflects a decrease in the Electric Services segment which, at this point in time, is mainly due to the timing. KeySpan anticipates incurring approximately the same amount of construction expenditures in 2007 as it incurred in 2006.

*Financing*

KeySpan did not engage in any financing activities in the first quarter of 2007, other than commercial paper repayments as noted earlier. At this point in time, KeySpan does not anticipate engaging in any financing activities for the remainder of the year.

The following table represents the ratings of our long-term debt at March 31, 2007. In 2004 Standard & Poor's reaffirmed its ratings on KeySpan's and its subsidiaries' long-term debt. Further in 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 March 31, 2007. 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 $70.2 million of surety bonds associated with certain construction projects currently being performed by former subsidiaries; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of $52.7 million; and (iii) $76.6 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 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees.)

## Contractual Obligations

KeySpan has certain contractual obligations related to its outstanding long-term debt, outstanding credit facility borrowings, outstanding commercial paper borrowings (when applicable), operating and capital leases, and demand charges associated with certain commodity purchases. These obligations have remained substantially unchanged since December 31, 2006. (For additional details regarding these obligations see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as Note 6 "Long-Term Debt" and Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" to those Consolidated Financial Statements.)

## Discussions 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.

Below is a discussion of KeySpan's critical accounting policies and assumptions at March 31, 2007. For a more detailed discussion of these policies and assumptions see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations "Discussion of Critical Accounting Policies and Assumptions."

*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 annual operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set annual budgetary guidelines. At March 31, 2007, 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.

*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 orders issued by the MADTE relating to the Eastern Enterprise acquisition in 2000, 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.

As is further discussed under the caption "Regulation and Rate Matters," in October 2003 the MADTE rendered its decision on the Boston Gas Company 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*

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.

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At March 31, 2007, we had a funding credit balance in excess of the ERISA minimum funding requirements. Although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Therefore, for 2007 KeySpan expects to contribute a total of $131 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. (In addition to Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, see also Note 4 of those Consolidated Financial Statements, "Postretirement Benefits.")

*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.

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. 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.

**Regulation and Rate Matters**

*Gas Matters*

The rate agreements for KEDNY and KEDLI have expired. Under the terms of the KEDNY and KEDLI rate agreements, gas distribution rates and all other provisions will remain in effect until changed by the NYPSC. 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.

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 $8.7 million under the Plan. In addition, an increase of $3.7 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 Boston Gas's 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'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 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 base rates continue as set by the NHPUC in 1993.

For an additional discussion of our current gas distribution rate agreements, see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Regulation and Rate Matters."

*Electric 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. The settlement agreement reflects a cost of equity of 9.5%, as well as 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. (For a further discussion on the LIPA agreements see Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement," as well as KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Electric Services – LIPA Agreements.")

*The Public Utility Holding Company Act of 2005*

Pursuant to PUHCA 2005, FERC 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. The SEC's jurisdiction over KeySpan's activities is limited to the registration and issuance of our securities under the federal securities laws. Moreover, our affiliate transactions also remain subject to certain regulations of the NYPSC, MADTE and NHPUC, in addition to FERC.

**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.

We estimate that the remaining cost of our MGP related environmental cleanup activities, including costs associated with the Ravenswood Generating Station, will be approximately $351.8 million and we have recorded a related liability for such amount. We have also recorded an additional $9.2 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of March 31, 2007, we have expended a total of $236.7 million on environmental investigation and remediation activities. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies.")

**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, 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. The most significant contingency involves the evolution of the gas distribution and electric industries towards more competitive and deregulated environments. The risks associated with KeySpan's gas distribution operations have not changed substantially since December 31, 2006. For additional information regarding these risks see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Market and Credit Risk Management Activities." The following is an update to certain matters related to KeySpan's electric operations.

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 require 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, 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, which appeal is pending.

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 proposed to 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, from the current offer cap of $105/kW-year to $82/kW-year plus 3%.

FERC rejected the $82 In-City Capacity Mitigation Proposal filed by the NYISO. FERC found that the NYISO filing failed to meet the burden of proof required to support revisions to market rules.

Nevertheless, on its own motion, FERC initiated a proceeding to investigate and consider the justness and reasonableness of the NYISO's in-City capacity market, including whether and how market rules should be revised to provide a fair level of compensation that will attract and retain needed infrastructure.

A refund effective date on or about May 15, 2007 was established, such that the rate, terms and conditions established in this proceeding could go into effect as of such date regardless of when this proceeding is completed. However, this proceeding and associated litigated hearings, are being held in abeyance to give the parties an opportunity to settle the issues with the assistance of a FERC administrative law judge ("ALJ") and FERC Staff. KeySpan's earnings for the quarter ended March 31, 2007, and for all prior periods, are not subject to refund under this proceeding.

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.

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 the Astoria discrepancy.

On March 15, 2007, FERC issued an order denying the NYISO's complaint against Astoria regarding Astoria's capacity certification prior to the May 2006 installed capacity auctions. Even though FERC denied the complaint, it found that Astoria did not supply its certified capacity in May 2006, and must therefore pay a deficiency charge for its capacity shortfall. The NYISO was directed to pay the affected suppliers for the capacity it supplied in May. On April 16, 2007, the Ravenswood Generating Station sought clarification and rehearing of the order. The NYISO also sought clarification and Astoria requested a rehearing. A decision by the FERC related to the rehearing and clarification requests 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. The case is still pending at FERC and 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.

**Item 3. 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 physical and 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 also has an International SWAP Dealers Association Master Agreement for a fixed for floating unforced capacity financial swap with Morgan Stanley Capital Group Inc.

The following tables set forth selected financial data associated with these derivative financial instruments noted above that were outstanding at March 31, 2007.

| Type of Contract | Year of Maturity | Volumes mmcf | Fixed Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Gas** | | | | | |
| Swaps/Futures - Long Natural Gas | 2007 | 6,490 | 6.84 - 9.82 | 7.89 - 11.21 | 1.3 |
| | 2008 | 680 | 9.08 - 9.82 | 8.55 - 15.55 | (0.1) |
| OTC Swaps - Short Natural Gas | 2007 | 1,826 | 5.86 - 9.98 | 7.73 - 9.16 | (3.8) |
| | 2008 | 1,637 | 6.77 - 6.85 | 8.26 - 10.49 | (3.6) |
| | 2009 | 1,334 | 7.60 - 10.90 | 7.90 - 9.77 | 0.3 |
| | | | | | - |
| | | 11,967 | | | (5.9) |

| Type of Contract | Year of Maturity | Volumes Barrels | Fixed Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Oil** | | | | | |
| Swaps - Long Fuel Oil | 2007 | 183,160 | 48.30 - 67.60 | 51.80 - 58.39 | (0.3) |
| | 2008 | 59,928 | 67.60 | 55.79 - 58.39 | (0.4) |
| | | 243,088 | | | (0.7) |

| Type of Contract | Year of Maturity | MWh | Fixed Margin/ Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Electricity** | | | | | |
| Swaps - Energy | 2007 | 670,036 | 58.25 - 131.25 | 58.25 - 125.75 | (5.2) |
| | 2008 | 35,536 | 70.10 | 62.50 - 88.50 | 0.1 |
| | | 705,572 | | | (5.1) |

| *Change in Fair Value of Derivative Instruments* | 2007 (In $ Millions) |
|---|---|
| Fair value of contracts at January 1, | (5.6) |
| Net (gains) on contracts realized | (6.0) |
| Decrease in fair value of all open contracts | (0.1) |
| Fair value of contracts outstanding at March 31, | (11.7) |

| *(In Millions of Dollars)* | Fair Value of Contracts | | |
|---|---|---|---|
| Sources of Fair Value | Mature Within 12 Months | Thereafter | Total Fair Value |
| Prices actively quoted | $ (1.9) | $ (3.8) | $ (5.7) |
| Local published indicies | (5.6) | (0.4) | (6.0) |
| | $ (7.5) | $ (4.2) | $ (11.7) |

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 March 31, 2007 a 10% increase/decrease in natural gas prices would decrease/increase the value of derivative instruments maturing in one year by $2.3 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. Further, KeySpan has a gas distribution asset optimization contract that employs derivative financial instruments. 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 March 31, 2007.

| Type of Contract | Year of Maturity | Volumes mmcf | Floor ($) | Ceiling ($) | Fixed Price ($) | Current Price ($) | Fair Value (In $ Millions) |
|---|---|---|---|---|---|---|---|
| Options | 2007 | 479 | 5.50 - 6.00 | 7.15 - 8.00 | - | 7.73 - 8.27 | 0.3 |
| Swaps | 2007 | 29,603 | - | - | 6.79 - 11.18 | 7.73 - 9.56 | 1.6 |
| | 2008 | 41,270 | - | - | 7.30 - 11.64 | 8.10 - 9.89 | 6.8 |
| Optimization Contract | 2009 | | | | | | 26.2 |
| | | 71,352 | | | | | 34.9 |

See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for a further description of all our derivative instruments.

### Item 4. Controls and Procedures

We maintain disclosure controls and procedures (as defined under Exchange Act Rule 13a-15(e) and 15d-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 March 31, 2007. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures were effective at the reasonable assurance level in alerting them timely to material information required to be included in KeySpan's periodic SEC reports.

Furthermore, there has been no change in KeySpan's internal control over financial reporting 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.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

See Note 6 to the Consolidated Financial Statements "Financial Guarantees and Contingencies."

**Item 1A. Risk Factors**

Certain statements contained in this Quarterly Report on Form 10-Q concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are other than statements of historical facts, are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Without limiting the foregoing, all statements under the captions "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk" relating to our future outlook, anticipated capital expenditures, future cash flows and borrowings, pursuit of potential future acquisition opportunities and sources of funding, are forward-looking statements. Such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties and actual results may differ materially from those discussed in such statements.

Among the factors that could cause actual results to differ materially are:

- the occurrence of any event, change or other circumstances that could give rise to the termination of the Merger Agreement with National Grid plc or the failure of the Merger to close for any reason;
- volatility of fuel prices 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 manage our cost structure and operate efficiently;
- our ability to successfully contract for natural gas supplies required to meet the needs of our customers;
- implementation of new accounting standards or changes in accounting standards or Generally Accepted Accounting Principles which may require adjustments to financial statements;
- inflationary trends and interest rates;
- the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of such acquisitions;
- available sources and cost of fuel;
- creditworthiness of counterparties to derivative instruments and commodity contracts;
- the resolution of certain disputes with LIPA concerning each party's rights and obligations under various agreements;
- retention of key personnel;

- federal and state regulatory initiatives that threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses and conduct operations;

- the impact of federal, state and local utility regulatory policies, legislation 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 facing our unregulated Energy Services businesses;

- 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;

- a change in the fair market value of our investments that could cause a significant change in the carrying value of such investments or the carrying value of related goodwill;

- timely receipts of payments from LIPA and the NYISO, our two largest customers;

- changes in the unforced capacity financial swap pricing structure;

- receipt of approval for, and the timing thereof, the 2006 LIPA Agreements; and

- other risks detailed from time to time in other reports and other documents filed by KeySpan with the SEC

For any of these statements, KeySpan claims the protection of the safe harbor for forward-looking information contained in the Private Securities Litigation Reform Act of 1995, as amended. For additional discussion on these risks, uncertainties and assumptions, see "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk."

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

31.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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*Filed Herewith

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on behalf of the undersigned there unto duly authorized.

**KEYSPAN CORPORATION**

(Registrant)

By: /s/Gerald Luterman
Name: Gerald Luterman
Title: Executive Vice President and Chief Financial Officer

Date: April 27, 2007

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President and Chief Financial Officer

Date: April 27, 2007

/s/ Theresa A. Balog
Theresa A. Balog
Vice President and
Chief Accounting Officer

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

**ANNUAL REPORT**

**PURSUANT TO SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2007

**[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to _________

**Commission file number 1-14161**

**KEYSPAN CORPORATION**
(Exact Name of Registrant as Specified in its Charter)

| | |
|---|---|
| **NEW YORK** | **11-3431358** |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| **One MetroTech Center, Brooklyn, New York** | **11201** |
| **175 East Old Country Road, Hicksville, New York** | **11801** |
| (Address of Principal Executive Offices) | (Zip Code) |

**(718) 403-1000 (Brooklyn)**
**(516) 755-6650 (Hicksville)**
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes**[X]** No[ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer.

Large accelerated filer **[X]** Accelerated filer **[ ]** Non-accelerated filer **[ ]**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes**[ ]** No**[X]**

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class of Common Stock | Outstanding at July 11, 2007 |
|---|---|
| $.01 par value | 175,936,537 |

KEYSPAN CORPORATION AND SUBSIDIARIES

## INDEX

## CONSOLIDATED BALANCE SHEET

(Unaudited)

| *(In Millions of Dollars)* | **June 30, 2007** | December 31, 2006 |
|---|---|---|
| **ASSETS** | | |
| **Current Assets** | | |
| Cash and temporary cash investments | **$ 496.5** | $ 210.9 |
| Restricted cash | **0.5** | 7.9 |
| Accounts receivable | **1,032.3** | 943.7 |
| Unbilled revenue | **273.8** | 531.2 |
| Allowance for uncollectible accounts | **(84.0)** | (56.9) |
| Gas in storage, at average cost | **533.6** | 646.0 |
| Material and supplies, at average cost | **133.8** | 137.1 |
| Derivative contracts | **37.7** | 54.1 |
| Prepayments | **115.7** | 236.2 |
| Other | **97.6** | 76.8 |
| | **2,637.5** | 2,787.0 |
| **Equity Investments and Other** | **292.7** | 269.7 |
| **Property** | | |
| Gas | **7,825.7** | 7,639.4 |
| Electric | **2,606.4** | 2,575.4 |
| Other | **428.5** | 441.5 |
| Accumulated depreciation | **(3,258.8)** | (3,151.2) |
| Gas production and development, at cost | **188.1** | 186.9 |
| Accumulated depletion | **(116.4)** | (113.7) |
| | **7,673.5** | 7,578.3 |
| **Deferred Charges** | | |
| Regulatory assets: | | |
| Miscellaneous assets | **923.2** | 937.5 |
| Derivative contracts | **94.6** | 196.3 |
| Goodwill and other intangible assets, net of amortization | **1,666.3** | 1,666.3 |
| Derivative contracts | **101.6** | 127.3 |
| Other | **848.5** | 875.1 |
| | **3,634.2** | 3,802.5 |
| **Total Assets** | **$ 14,237.9** | $ 14,437.5 |

See accompanying Notes to the Consolidated Financial Statements.

# CONSOLIDATED BALANCE SHEET

(Unaudited)

| *(In Millions of Dollars)* | **June 30, 2007** | December 31, 2006 |
|---|---|---|
| **LIABILITIES AND CAPITALIZATION** | | |
| **Current Liabilities** | | |
| Accounts payable and other liabilities | $ **759.3** | $ 1,026.0 |
| Commercial paper | **131.5** | 85.0 |
| Current maturities of long-term debt and capital leases | **296.2** | 1.2 |
| Taxes accrued | **202.3** | 200.8 |
| Dividends payable | **83.5** | 83.3 |
| Customer deposits | **36.8** | 33.5 |
| Interest accrued | **58.9** | 58.5 |
| Other current liability, derivative contracts | **89.8** | 219.7 |
| | **1,658.3** | 1,708.0 |
| **Deferred Credits and Other Liabilities** | | |
| Regulatory liabilities: | | |
| Miscellaneous liabilities | **37.2** | 43.4 |
| Removal costs recovered | **587.5** | 556.2 |
| Derivative accounts | **59.3** | 120.6 |
| Asset retirement obligations | **48.7** | 47.3 |
| Deferred income tax | **1,090.7** | 1,176.4 |
| Postretirement benefits and other reserves | **1,657.8** | 1,667.3 |
| Derivative contracts | **88.3** | 43.1 |
| Other | **215.9** | 121.6 |
| | **3,785.4** | 3,775.9 |
| **Commitments and Contingencies (See Note 6)** | **-** | - |
| **Capitalization** | | |
| Common stock - 184,864 shares issued, 175,919 shares outstanding, par value $0.01 | **3,995.9** | 3,994.0 |
| Retained earnings | **1,072.2** | 973.7 |
| Retained earnings - cumulative effect of FIN 48 implementation (See Note 11) | **(5.2)** | - |
| Accumulated other comprehensive loss | **(149.2)** | (175.3) |
| Treasury stock | **(258.7)** | (273.6) |
| Total common shareholders' equity | **4,655.0** | 4,518.8 |
| Long-term debt and capital leases | **4,123.1** | 4,419.1 |
| **Total Capitalization** | **8,778.1** | 8,937.9 |
| **Minority Interest in Consolidated Companies** | **16.1** | 15.7 |
| **Total Liabilities and Capitalization** | $ **14,237.9** | $ 14,437.5 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED STATEMENT OF INCOME

(Unaudited)

| *(In Millions of Dollars, Except Per Share Amounts)* | Three Months Ended June 30, **2007** | **2006** | Six Months Ended June 30, **2007** | **2006** |
|---|---|---|---|---|
| **Revenues** | | | | |
| Gas Distribution | $ **1,011.1** | $ 873.2 | $ **3,426.6** | $ 3,053.3 |
| Electric Services | **457.7** | 444.2 | **842.2** | 869.0 |
| Energy Services | **52.4** | 50.4 | **104.9** | 98.7 |
| Energy Investments | **9.2** | 9.9 | **19.2** | 17.8 |
| Total Revenues | **1,530.4** | 1,377.7 | **4,392.9** | 4,038.8 |
| **Operating Expenses** | | | | |
| Purchased gas for resale | **649.4** | 539.8 | **2,322.1** | 2,051.2 |
| Fuel and purchased power | **138.1** | 115.7 | **266.3** | 245.7 |
| Operations and maintenance | **411.4** | 420.6 | **842.3** | 826.7 |
| Depreciation, depletion and amortization | **104.6** | 101.2 | **216.9** | 211.4 |
| Operating taxes | **98.7** | 95.8 | **221.2** | 214.0 |
| Total Operating Expenses | **1,402.2** | 1,273.1 | **3,868.8** | 3,549.0 |
| Income from equity investments | **4.9** | 2.9 | **8.5** | 6.3 |
| Sale of assets | **0.3** | - | **0.3** | 0.5 |
| **Operating Income** | **133.4** | 107.5 | **532.9** | 496.6 |
| **Other Income and (Deductions)** | | | | |
| Interest charges | **(69.6)** | (59.4) | **(131.1)** | (125.6) |
| Other | **18.3** | 6.2 | **26.4** | 17.6 |
| Total Other Income and (Deductions) | **(51.3)** | (53.2) | **(104.7)** | (108.0) |
| **Income Taxes** | | | | |
| Current | **63.7** | (37.3) | **240.9** | 122.2 |
| Deferred | **(33.8)** | 42.2 | **(78.3)** | 9.0 |
| Total Income Taxes | **29.9** | 4.9 | **162.6** | 131.2 |
| **Earnings for Common Stock** | $ **52.2** | $ 49.4 | $ **265.6** | $ 257.4 |
| **Basic Earnings Per Share** | $ **0.30** | $ 0.28 | $ **1.51** | $ 1.47 |
| **Diluted Earnings Per Share** | $ **0.29** | $ 0.28 | $ **1.50** | $ 1.46 |
| **Average Common Shares Outstanding (000)** | **175,845** | 174,989 | **175,733** | 174,846 |
| **Average Common Shares Outstanding - Diluted (000)** | **177,220** | 176,121 | **177,048** | 175,848 |

See accompanying Notes to the Consolidated Financial Statements.

## CONSOLIDATED STATEMENT OF CASH FLOWS

(Unaudited)

| *(In Millions of Dollars)* | Six Months Ended June 30, **2007** | 2006 |
|---|---|---|
| ***Operating Activities*** | | |
| Net income | $ **265.6** | $ 257.4 |
| **Adjustments to reconcile net income to net cash provided by (used in) operating activities** | | |
| Depreciation, depletion and amortization | **216.9** | 211.4 |
| Deferred income tax | **(78.3)** | 9.0 |
| Income from equity investments | **(8.5)** | (6.3) |
| Dividends from equity investments | **2.3** | 6.5 |
| Amortization of financing fees / interest rate swap | **4.4** | 4.1 |
| Amortization of property taxes | **52.0** | 66.7 |
| Net pension and other postretirement expense/cash payment | **52.2** | 83.2 |
| **Changes in assets and liabilities** | | |
| Accounts receivable | **69.4** | 524.3 |
| Materials and supplies, fuel oil and gas in storage | **168.7** | 89.6 |
| Accounts payable and other liabilities | **(171.6)** | (399.0) |
| Taxes accrued | **60.6** | (15.1) |
| Interest accrued | **0.3** | 2.2 |
| Environmental payments | **(23.5)** | (24.8) |
| Other | **(4.6)** | (19.7) |
| **Net Cash Provided by Operating Activities** | **605.9** | 789.5 |
| ***Investing Activities*** | | |
| Construction expenditures | **(246.1)** | (247.0) |
| Cost of removal | **(14.0)** | (15.7) |
| Derivative margin call | **42.7** | - |
| Return of investment | **7.6** | - |
| **Net Cash Used in Investing Activities** | **(209.8)** | (262.7) |
| ***Financing Activities*** | | |
| Common/treasury stock issued | **10.4** | 18.8 |
| Issuance (payment) of commercial paper | **46.5** | (467.6) |
| Payment of long-term debt | **(0.6)** | - |
| Common stock dividends paid | **(166.8)** | (162.4) |
| **Net Cash Used in Financing Activities** | **(110.5)** | (611.2) |
| Net Increase (Decrease) in Cash and Cash Equivalents | **285.6** | (84.4) |
| Cash and Cash Equivalents at Beginning of Period | **210.9** | 124.5 |
| Cash and Cash Equivalents at End of Period | $ **496.5** | $ 40.1 |
| Interest Paid | $ **135.5** | $ 126.8 |
| Income Tax Paid | $ **131.6** | $ 178.2 |

Cash equivalents are short-term marketable securities purchased with maturities of three months or less that were carried at cost which approximates fair value.

See accompanying Notes to the Consolidated Financial Statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

INTRODUCTION TO THE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

KeySpan Corporation (referred to in the Notes to the Financial Statements as "KeySpan," "we," "us" and "our") is a holding company under the Public Utility 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 "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 of KeySpan (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. As contemplated in the Merger Agreement, National Grid plc has provided notice extending the termination date of the Merger Agreement through August 25, 2007.

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. Specifically, we filed our application for approval of the Merger pursuant to the Federal Power Act in May 2006 and in October 2006 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 ("HSR"), which provides a one year period to complete the Merger. In May 2007, we re-filed an application under HSR and in June 2007 we received notice that early termination of the HSR waiting period was granted. We also 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.

In late June 2007, KeySpan and National Grid plc reached an agreement in principle with the Staff of the New York State Public Service Commission ("NYPSC"), the New York State Consumer Protection Board and certain other parties that would, upon NYPSC approval, resolve all issues in the pending Merger application before the NYPSC. On July 6, 2007, the Merger and Gas Revenue Requirement Joint Proposal (the "Merger JP") was filed with the NYPSC and the Administrative Law Judges presiding over the Merger proceeding.

The Merger JP supersedes the proposed ten-year rate plan included with the merger application filed with the NYPSC on July 20, 2006. If adopted by the NYPSC, the Merger JP would provide for five-year rate plans for KeySpan's two gas distribution utility companies located in New York, KeySpan Energy Delivery of New York ("KEDNY") and KeySpan Energy Delivery of Long Island ("KEDLI"), that would go into effect on January 1, 2008. The Merger JP provides for no increase in gas delivery rates in each of the five years of KEDNY's merger rate plan and an increase of $60 million in gas delivery rates in the first year of the KEDLI merger rate plan and no further increase in years two through five. The individual KEDNY and KEDLI rate plan applications filed with the NYPSC on October 3, 2006 will supplement the Merger JP. If the Merger JP is approved by the NYPSC, the merger rate plans, as they may be supplemented by KEDNY's and KEDLI's individual rate cases, will go into effect on January 1, 2008. For more information on the Merger JP, see KeySpan's Report on Form 8-K filed on July 12, 2007, incorporated herein by reference.

NYPSC action on the Merger JP is contemplated at its August 22, 2007 session, and, subject to and upon receipt of NYPSC approval, it is anticipated that the Merger would close shortly thereafter. We are, however, 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.

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. KeySpan also sought approval of the Merger from the New Hampshire Public Utility Commission ("NHPUC") and in July 2007, the NHPUC issued an Order providing final approval of the Merger in New Hampshire.

On April 6, 2007, the Attorney General of the Commonwealth of Massachusetts filed a petition with the Massachusetts Department of Telecommunications and Energy ("MADTE") to initiate an oversight investigation related to the Merger between KeySpan and National Grid plc. The petition does not specifically seek MADTE approval of the Merger, which under current law has been interpreted as not being required in connection with mergers of utility holding companies which only indirectly affect the ownership of utility subsidiaries operating within the Commonwealth of Massachusetts. Rather, the petition requests that the MADTE investigate the impact of the Merger on rates and service quality of the utility subsidiaries owned and operated by KeySpan and National Grid plc in the Commonwealth of Massachusetts. On April 13, 2007 KeySpan and National Grid plc filed a response to the Attorney General's petition agreeing to cooperate in such a proceeding and recommending a proposed procedural schedule. A public hearing and procedural conference was held on July 12, 2007. KeySpan cannot predict the outcome of this proceeding.

In connection with the Merger, KeySpan expects to continue to incur significant expenses, including without limitation, expenses for legal and consulting services, the vesting of performance shares and stock options, as well as expenses associated with change of control payments and "stay-on" bonuses. KeySpan is currently in the process of quantifying the financial impact of the aforementioned items. (For additional information on outstanding performance shares and stock options see Note 7 "Stock Based Compensation.")

For a discussion on the impact of the Merger on KeySpan's service agreements with LIPA, see Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement."

## 1. BASIS OF PRESENTATION

In our opinion, the accompanying unaudited Consolidated Financial Statements contain all adjustments necessary to present fairly KeySpan's financial position as of June 30, 2007, and the results of operations for the three and six months ended June 30, 2007 and June 30, 2006, as well as cash flows for the six months ended June 30, 2007 and June 30, 2006. The accompanying unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006. The December 31, 2006 financial statement information has been derived from the 2006 audited consolidated financial statements.

Income from interim periods may not be indicative of future results. Consolidated earnings are seasonal in nature primarily due to the significant contributions to earnings of the gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters.

Basic earnings per share ("EPS") is calculated by dividing earnings available 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 available 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 Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share" our basic and diluted EPS are as follows:

| *(In Millions of Dollars, Except Per Share Amounts)* | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| Earnings for common stock | $ 52.2 | $ 49.4 | $ 265.6 | $ 257.4 |
| Weighted average shares outstanding (000) | 175,845 | 174,989 | 175,733 | 174,846 |
| Add dilutive securities: | | | | |
| Options | 1,107 | 1,038 | 1,079 | 933 |
| Performance shares | 268 | 94 | 236 | 69 |
| Total weighted average shares outstanding - assuming dilution | 177,220 | 176,121 | 177,048 | 175,848 |
| Basic earnings per share | $ 0.30 | $ 0.28 | $ 1.51 | $ 1.47 |
| Diluted earnings per share | $ 0.29 | $ 0.28 | $ 1.50 | $ 1.46 |

## 2. BUSINESS SEGMENTS

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

The Gas Distribution segment consists of 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, Boston Gas Company, Colonial Gas Company, Essex Gas Company and EnergyNorth Natural Gas, Inc., collectively referred to as KeySpan Energy Delivery New England ("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 10, "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 New York Independent Systems Operator ("NYISO") energy markets. To finance the purchase and/or construction of the Ravenswood Generating Station, KeySpan entered into a leasing arrangement for each facility. The Electric Services segment also conducts retail marketing of electricity to commercial customers. (See Note 6 “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.

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.

This segment is also engaged in pipeline development activities. KeySpan and Spectra 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.

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. At June 30, 2007, the total assets of each reportable segment have not changed materially from those levels reported at December 31, 2006. The reportable segment information is as follows:

| *(In Millions of Dollars)* | Gas Distribution | Electric Services | Energy Services | Energy Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|
| **Three Months Ended June 30, 2007** | | | | | | |
| Unaffiliated revenue | 1,011.1 | 457.7 | 52.4 | 9.2 | - | 1,530.4 |
| Intersegment revenue | - | - | 2.5 | 1.3 | (3.8) | - |
| Operating Income | 61.4 | 44.3 | 2.0 | 5.5 | 20.2 | 133.4 |
| **Three Months Ended June 30, 2006** | | | | | | |
| Unaffiliated revenue | 873.2 | 444.2 | 50.4 | 9.9 | - | 1,377.7 |
| Intersegment revenue | - | - | 2.2 | 1.3 | (3.5) | - |
| Operating Income | 39.5 | 62.4 | 2.0 | 3.7 | (0.1) | 107.5 |

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

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of $398.1 million and $389.1 million for the three months ended June 30, 2007 and 2006, respectively, represent approximately 26% and 28%, respectively of our consolidated revenues in these periods.

| *(In Millions of Dollars)* | Gas Distribution | Electric Services | Energy Services | Energy Investments | Eliminations | Consolidated |
|---|---|---|---|---|---|---|
| **Six Months Ended June 30, 2007** | | | | | | |
| Unaffiliated revenue | 3,426.6 | 842.2 | 104.9 | 19.2 | - | 4,392.9 |
| Intersegment revenue | - | 3.9 | 4.7 | 2.6 | (11.2) | - |
| Operating Income | 464.0 | 42.8 | 3.4 | 10.5 | 12.2 | 532.9 |
| **Six Months Ended June 30, 2006** | | | | | | |
| Unaffiliated revenue | 3,053.3 | 869.0 | 98.7 | 17.8 | - | 4,038.8 |
| Intersegment revenue | - | - | 4.7 | 2.6 | (7.3) | - |
| Operating Income | 376.0 | 127.3 | 1.6 | 6.7 | (15.0) | 496.6 |

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

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of $736.0 million and $705.9 million for the six months ended June 30, 2007 and 2006, respectively, represent approximately 17% of our consolidated revenues in both periods.

## 3. COMPREHENSIVE INCOME

The table below indicates the components of comprehensive income:

| (In Millions of Dollars) | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| Net Income | $ 52.2 | $ 49.4 | $ 265.6 | $ 257.4 |
| Other comprehensive income (loss), net of tax | | | | |
| Reclassification of (gains) losses included in net income | 3.1 | (3.2) | 9.6 | (38.9) |
| Unrealized (losses) gains on derivative financial instruments | 5.9 | (5.0) | 2.8 | 40.9 |
| Unrealized gains (losses) on marketable securities | 0.7 | (0.1) | 0.6 | 0.3 |
| Accrued underfunded pension and other postretirement obligation | - | - | 13.1 | - |
| Other comprehensive income (loss), net of tax | 9.7 | (8.3) | 26.1 | 2.3 |
| Comprehensive Income | $ 61.9 | $ 41.1 | $ 291.7 | $ 259.7 |
| Related tax (benefit) expense | | | | |
| Reclassification of (gains) losses included in net income | 2.6 | (1.7) | 6.8 | (20.9) |
| Unrealized (losses) gains on derivative financial instruments | 2.9 | (2.4) | 1.0 | 22.9 |
| Unrealized gains (losses) on marketable securities | 0.4 | (0.1) | 0.3 | 0.2 |
| Total Tax (Benefit) Expense | $ 5.9 | $ (4.2) | $ 8.1 | $ 2.2 |

## 4. HEDGING AND DERIVATIVE FINANCIAL INSTRUMENTS

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 and receive hedge accounting treatment 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. Certain derivative financial instruments employed by our Gas Distribution operations are subject to SFAS 71 “Accounting for the Effects of Certain Types of Regulation.” In addition, with regard to the Ravenswood Generating Station, our strategy, for the period April 2007 through September 2007, is to economically hedge up to 37% of the Ravenswood Generating Station’s on-peak electric capacity. To accomplish this strategy, KeySpan uses derivative financial instruments that receive hedge accounting treatment, as well as derivative financial instruments that do not receive hedge accounting treatment. Due to the pending Merger with National Grid plc and the Proposed Merger JP, KeySpan is currently considering alternatives to its risk management strategy regarding the use of derivative financial instruments associated with the Ravenswood Generating Station for periods beyond September 2007. Accordingly, only a minor number of derivative instruments outstanding at June 30, 2007 extend beyond September 2007. For more information on the Merger JP, see KeySpan’s Report on Form 8-K filed on July 12,2007.

*Commodity Derivative Instruments – Hedge Accounting:* Our Energy Investments subsidiary,

Seneca-Upshur, utilizes OTC natural gas swaps to hedge the cash flow variability associated with the forecasted sales of a portion of its natural gas production. At June 30, 2007, Seneca-Upshur has hedge positions in place for approximately 70% of its estimated 2007 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 June 30, 2007 was a liability of $4.9 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 $3.2 million. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial for the six months ended June 30, 2007.
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 July 2008. The fair value of these derivative instruments at June 30, 2007 was a liability of $0.4 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 $0.4 million. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial as of June 30, 2007.

As mentioned earlier, the Ravenswood Generating Station economically hedges the cash flow variability associated with a portion of electric energy sales and fuel purchases. KeySpan employs financially-settled electric-power swap contracts, financially-settled oil swap contracts, physical natural gas forward contracts and OTC natural gas swaps in its hedging strategy. The maximum length of time over which derivative financial instruments that receive hedge accounting treatment are in-place is through December 2008. We use market quoted forward prices to value the electric-power swap contracts. The fair value of the electric power derivative instruments at June 30, 2007 was $2.3 million. We use market quoted forward prices to value the oil swap contracts and natural gas contracts. The fair value of these derivative instruments at June 30, 2007 was a net liability of $2.8 million. These derivative instruments are reported in accumulated other comprehensive income and the majority of these derivative instruments are expected to be reclassified into earnings in the next twelve months. Ineffectiveness associated with these outstanding derivative financial instruments was immaterial for the six months ended June 30, 2007.

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 fair value of the electric power derivative instruments associated with the Ravenswood Generating Station that do not qualify for hedge accounting treatment at June 30, 2007 was $9.6 million. We use market quoted forward prices to value the electric-power swap contracts. The fair value of the natural gas contracts associated with the Ravenswood Generating Station that do not qualify for hedge accounting treatment at June 30, 2007 was a liability of $8.3 million. We use market quoted forward prices to value these natural gas contracts. The maximum length of time over which derivative financial instruments are in-place is through December 2008.

KeySpan also employs a limited number of unleaded gas swaps to hedge a small portion of its risk associated with changing prices for fleet fuel. These financial derivative instruments do not qualify for hedge accounting treatment. The maximum length of time over which derivative financial instruments are in-place is through March 2008. The fair value of these contracts is $0.3 million. We use market quoted forward prices to value these contracts.

Based upon KeySpan's experience in the New York City electric capacity market and management's assessment that a financial opportunity existed related to this market, KeySpan entered into an International SWAP Dealers Association Master Agreement for a fixed for float unforced capacity financial swap (the "Swap Agreement") with Morgan Stanley Capital Group Inc. ("Morgan Stanley") on January 18, 2006 in an effort to enhance shareholder value. The Swap Agreement involves a financial transaction and is not intended to be an economic hedge of our physical generation assets or a contract for the physical delivery of capacity or energy. However, the same market dynamics that are expected to enhance KeySpan's physical generation business are expected to enhance the value of the financial Swap Agreement.

The Swap Agreement has a three year term that began on May 1, 2006. The notional quantity was 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 occurs on a monthly 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. At contract inception, the initial fair value of the Swap Agreement was fully reserved under the provision of EITF 02-3 "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," due to KeySpan's assessment that market prices for the underlying capacity were unobservable. Accordingly, no fair value was recorded on the Consolidated Balance Sheet at the inception of the contract. Subsequent changes in fair value have resulted in the recognition of a $1.0 million liability at June 30, 2007, while the remainder of the fair value associated with the contract remained reserved under EITF 02-3 guidance.

The NYPSC, Consolidated Edison and other load serving entities ("LSEs") have proposed price mitigation measures for In-City capacity that would apply to the Ravenswood Generating Station. These price mitigation measures essentially proposed to reduce the capacity bid price that the Ravenswood Generating Station could bid into the NYISO energy market. However, the FERC found that the NYISO filing failed to meet the burden of proof required to support revisions to market rules. Nevertheless, on its own motion, FERC initiated a proceeding to investigate and consider the justness and reasonableness of the NYISO's In-City capacity market, including whether and how market rules should be revised to provide a fair level of compensation that will attract and retain needed infrastructure. The FERC has established a procedure for a "paper hearing" that would involve our NYISO proposal to be filed in October 2007. Comments on that proposal will be filed in November 2007 and reply comments will be filed in December 2007. In connection with this proceeding, in July 2007 KeySpan received notice that the FERC Office of Enforcement is conducting a formal investigation into matters regarding the offering practices of generating units servicing New York City's In-City capacity market. At this time, we are unable to predict the outcome of these proceedings and what effect, if any, they may have on the potential revenue that could be realized from physical sales of In-City capacity or on the 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 purchases 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 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 June 30, 2007 the fair value of these derivative instruments was a liability of $68.2 million.

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 qualify for the normal purchases and sales exception. Certain contracts for the 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 71. At June 30, 2007, these derivatives had a net fair value of $71.4 million.

KeySpan has a management contract with Merrill Lynch Commodities, under which KeySpan and Merrill Lynch Commodities will share the responsibilities for managing KeySpan's upstream gas distribution assets associated with its Massachusetts gas distribution subsidiaries, as well as providing city-gate delivered supply. This contract allows for both KeySpan and Merrill Lynch Commodities to employ derivative instruments to maximize the profitability of KeySpan's portfolio of gas distribution assets. Profits associated with these activities are shared between KeySpan, Merrill Lynch Commodities and KeySpan's Massachusetts ratepayers. The accounting for this contract is subject to SFAS 71 since the contract was executed by KeySpan's regulated gas distribution utilities. At June 30, 2007, KeySpan's proportionate share of the fair value associated with these derivative instruments amounted to $15.0 million, $14.3 million of which has been deferred for future sharing among the alliance members and Massachusetts ratepayers. The remaining amount was recorded as a benefit to revenues. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

The table below summarizes the fair value of all of the above outstanding derivative instruments at June 30, 2007 and December 31, 2006 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)* | June 30, 2007 | December 31, 2006 |
|---|---|---|
| **Gas Contracts:** | | |
| Other current assets | 22.0 | 30.7 |
| Other deferred charges | 101.5 | 127.1 |
| Regulatory asset | 94.6 | 196.3 |
| Other current liability | (87.9) | (211.7) |
| Other deferred liabilities | (87.1) | (42.1) |
| Regulatory liability | (59.3) | (120.6) |
| | | |
| **Oil Contracts:** | | |
| Other current assets | 1.4 | 0.3 |
| Other current liability | (0.6) | (7.2) |
| Other deferred liabilities | - | (0.5) |
| | | |
| **Electric Contracts:** | | |
| Other current assets | 14.3 | 23.2 |
| Other deferred charges | 0.1 | 0.3 |
| Other current liability | (1.4) | (0.8) |
| Other deferred liabilities | (1.1) | (0.6) |

*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 would have paid KeySpan $37,500 per heating degree day when the actual temperature was 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 would have received on these purchased put options was $15 million. The net premium cost for these options was $1.7 million and was 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. However, weather for the first quarter of 2007 was colder than normal. Therefore, for the entire winter heating season –November 2006 through March 2007 – weather was slightly colder than normal. As a result, in the first quarter of 2007 KeySpan reversed the $9.1 million accrual recorded in the fourth quarter of 2006. 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.

*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 June 30, 2007, KeySpan has received $0.5 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.

## 5. RECENT ACCOUNTING PRONOUNCEMENTS

In February 2007, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 159 "The Fair Value Option for Financial Assets and Financial Liabilities." This Statement permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement requires a business entity to report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. An entity may decide whether to elect the fair value option for each eligible item on its election date, subject to certain requirements described in the Statement. This Statement shall be effective as of the beginning of each reporting entity's first fiscal year that begins after November 15, 2007. KeySpan is currently reviewing the requirements of this Statement and, at this point in time, we cannot determine the impact, if any, that this Statement may have on results of operations and financial position.

In September 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.

In July 2006, the FASB issued Interpretation No. 48 "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes" and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. KeySpan adopted the provisions of FIN 48 on January 1, 2007. See Note 11, "Adoption of FASB Interpretation Number 48" for additional details on the impact of this implementation on KeySpan's financial statements.

## 6. FINANCIAL GUARANTEES AND CONTINGENCIES

*Variable Interest Entity:* 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 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 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.

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 $300 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 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."

*Asset Retirement Obligations:* KeySpan has various asset retirement obligations primarily associated with its gas distribution and electric generation activities. These obligations have remained substantially unchanged from December 31, 2006, except for normal accretion adjustments and costs incurred. Generally, KeySpan's largest asset retirement obligations relate to: (i) legal requirements 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; or dispose of sections of gas main when removed from the pipeline system; (ii) cleaning and removal requirements associated with storage tanks containing waste oil and other waste contaminants; and (iii) legal requirements to remove asbestos upon major renovation or demolition of structures and facilities. At June 30, 2007, these obligations total $48.7 million. See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Note 7 to the Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for additional information regarding these obligations.

Environmental Matters

*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 KeySpan, have been identified to the Department of Environmental Conservation ("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/or remediation activities associated with certain sites and one waterway. In February 2007, KeySpan entered into an ACO for fourteen 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 $88.1 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 $70.5 million.

KeySpan presently estimates the remaining cost of its KEDNY and KEDLI MGP-related environmental remediation activities will be $309.5 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.

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 June 30, 2007, we have reflected a regulatory asset of $361.9 million for KEDNY/KEDLI MGP sites. KeySpan has 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. Among other things, these filings seek recovery of deferred expenses associated with remediation of MGP sites, as well as recovery of ongoing remediation expenses.

KeySpan is 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. KeySpan is 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 $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, 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.

KeySpan presently estimates the remaining cost of the Massachusetts KEDNE MGP-related environmental cleanup activities will be $6.0 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 acquisition date of these subsidiaries, with respect to these MGP-related activities total $37.5 million.

KeySpan 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 in New Hampshire. At four of these sites, KeySpan has entered into cost sharing agreements with other parties who share responsibility for remediation of these sites. EnergyNorth also 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. The Nashua River Asbestos Site now has been fully remediated.

KeySpan presently estimates the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be $23.5 million, which amount has been accrued 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 acquisition date of this subsidiary, with respect to the MGP-related activities total $24.9 million.

By rate orders, the Massachusetts Department of Telecommunications and Energy ("MADTE") and the New Hampshire Public Utility Commission ("NHPUC") provide for the recovery of site investigation and remediation costs and, accordingly, at June 30, 2007, we have reflected a regulatory asset of $38.5 million for the KEDNE MGP sites. Colonial Gas Company and Essex Gas Company are not subject to the provisions of SFAS 71, "Accounting for the Effects of Certain Types of Regulation" 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*: KeySpan is aware of three non-utility sites associated with KeySpan New England, LLC, a successor company to Eastern Enterprises, for which it 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 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 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 sought a judicial determination on the allocation of liability for the Everett Facility. A confidential settlement agreement was executed on terms favorable to KeySpan and the Beazer lawsuit has been discontinued.

KeySpan presently estimates the remaining cost of the environmental cleanup activities for these three non-utility sites will be approximately $8.7 million, which amount has been accrued 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 $24.1 million.

KeySpan believes 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.

See KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006 Note 7, to those Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies" for further information on environmental matters.

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. 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. In January 2007, the Court issued an order preliminarily approving the settlement, authorizing the parties to notify KeySpan shareholders of the settlement. Mailing of the notices began on February 6, 2007. On June 28, 2007, a written Decision was issued and a Final Judgment approving the settlement, awarding the requested attorney's fees of $350,000 and dismissing the action with prejudice. Payment of the attorney's fees in the amount of $350,000 by National Grid plc is contingent on the closing of the Merger.

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. On November 27, 2006, December 28, 2006 and May 24, 2007, three 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 the Electric Services segment from a series of agreements with LIPA pursuant to which we manage LIPA's transmission and distribution system and supply approximately one half of LIPA's customers' electricity needs. KeySpan and LIPA have entered into agreements to extend, amend, and restate these contractual arrangements. Further, following the announcement of the proposed Merger of KeySpan and National Grid plc, LIPA, National Grid plc and KeySpan engaged in discussions concerning the impact of the transaction on LIPA's operations. See Note 10 "2006 LIPA Settlement" for further details of these agreements and discussions.

On May 31, 2007, KeySpan received a Civil Investigative Demand ("CID") from the United States Department of Justice, Antitrust Division, requesting the production of documents and information relating to its investigation of competitive issues in the New York City electric energy capacity market. The CID is a request for information in the course of an investigation and does not constitute the commencement of legal proceedings, and no specific allegations have been made against KeySpan. KeySpan intends to fully cooperate with this investigation.

Financial Guarantees

KeySpan has issued financial guarantees in the normal course of business, on behalf of its subsidiaries, to various third party creditors. At June 30, 2007, 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:

| *Nature of Guarantee (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) | 66.2 | 2007 - 2010 |
| Commodity Guarantees and Other | (vi) | 95.9 | 2007 - 2009 |
| Letters of Credit | (vii) | 76.6 | 2007 - 2010 |
| | | $ 1,720.5 | |

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 current maturities of long-term debt and capital leases, and long-term debt on the Consolidated Balance Sheet as appropriate.

(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 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 of the lease has been extended to 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 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 and 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 June 30, 2007, the total cost to complete such remaining bonded projects is estimated to be approximately $24.2 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 June 30, 2007.

(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.

As noted previously, KeySpan owns a 26.25% ownership interest in the Millennium Pipeline Company LLC ("Millennium"), the developer of the Millennium Pipeline project. The Millennium Pipeline project is anticipated to have the capacity to transport up to 525,000 DTH of natural gas a day from Corning, New York to Ramapo, New York, interconnecting with the pipeline systems of various other utilities in New York. Subject to the receipt of certain remaining permits and financing, Millennium expects that the first phase of the project will be in service by November 2008.

Consolidated Edison, KEDLI and Columbia Transmission have each entered into precedent agreements to purchase capacity on the pipeline. Upon and subject to the terms and conditions set forth in Precedent Agreements, KeySpan has agreed to guarantee the full and prompt payment of $15.8 million (the "Guaranteed Amount") of the contingent $60 million financial obligation that Millennium may incur for liquidated damages under the Precedent Agreements to Consolidated Edison and KEDLI. The liquidated damages are intended to reimburse Consolidated Edison and KEDLI for costs incurred to secure additional capacity if Millennium is unable to provide the contracted capacity. The $15.8 million guaranteed amount reflects KeySpan's proportionate share of the $60 million of financial security that is required to be provided to Consolidated Edison and KEDLI pursuant to the Precedent Agreements based on KeySpan's proportionate ownership interest in the Millennium Pipeline project. This guarantee has been accounted for in accordance with FIN 45 "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtness of Others." At June 30, 2007, the fair value of this guarantee was $0.7 million and is reflected as a component of equity investments, and other deferred credits and other liabilities on the Consolidated Balance Sheet.

## 7. 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 this 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 June 30, 2007, 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 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. All stock option awards previously accounted for under APB 25 were fully vested by December 31, 2006.

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)* | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|
| Performance shares | $ 3.6 | $ 4.6 |
| Restricted stock | 1.4 | 3.8 |
| Stock options | 1.4 | 3.1 |
| EDSPP discount | 2.3 | 2.7 |
| Total stock-based compensation included in operations and maintenance expense | 8.7 | 14.2 |
| Income tax benefit | (3.0) | (5.0) |
| Total stock based compensation expense, net of tax | $ 5.7 | $ 9.2 |

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. During the six months ended June 30, 2007 and 2006 cash received from stock options exercised was $10.8 million and $18.1 million, respectively. The tax benefit realized for tax deductions from stock options exercised during the six months ended June 30, 2007 and 2006 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 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 2005 award is being expensed ratably over its remaining performance period.

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 June 30, 2007, associated with all of the performance share awards was $8.1 million.

There were no performance share awards granted during the six months ended June 30, 2007.

*Restricted Stock Awards*

KeySpan has made certain grants of restricted stock to officers, directors and certain other management employees under the Incentive Plan. Awards of restricted stock were made in 2002, 2005, 2006 and 2007. These awards may not be sold or otherwise transferred until certain restrictions have lapsed. The unearned stock-based compensation related to these awards is being amortized to compensation expense over the period in which the awards vest. 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. Upon a change of control, all restricted stock awards will vest immediately. The unearned compensation as of June 30, 2007, associated with restricted stock was $6.1 million.

*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 245,532 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 2007 or 2006.

A summary of the status of our fixed stock option plans and changes is presented below for the six months ended June 30, 2007:

| Fixed Options | Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value *(In Millions)* |
|---|---|---|---|
| Outstanding at beginning of period | 9,403,104 | $ 33.82 | |
| Exercised | (305,337) | $ 34.47 | |
| Forfeited | (7,610) | $ 38.27 | |
| Outstanding at end of period | 9,090,157 | $ 33.79 | $ 70.8 |
| Exercisable at end of period | 7,762,938 | $ 33.13 | $ 65.6 |

The total intrinsic value of the options exercised during the six months ended June 30, 2007 and 2006 was approximately $2.1 million and $4.5 million, respectively.

| Remaining Contractual Life | Options Outstanding at June 30, 2007 | Weighted Average Exercise Price | Range of Exercise Price | Options Exercisable at June 30, 2007 | Weighted Average Exercise Price | Range of Exercise Price |
|---|---|---|---|---|---|---|
| 1 years | 185,000 | $ 32.63 | $32.63 | 185,000 | $ 32.63 | $32.63 |
| 2 years | 670,108 | $ 28.02 | $24.73 - $29.38 | 670,108 | $ 28.02 | $24.73 - $29.38 |
| 3 years | 381,741 | $ 26.98 | $21.99 - $27.06 | 381,741 | $ 26.98 | $21.99 - $27.06 |
| 4 years | 936,427 | $ 22.70 | $22.50 - $32.76 | 936,427 | $ 22.70 | $22.50 - $32.76 |
| 5 years | 1,437,433 | $ 39.50 | $39.50 | 1,437,433 | $ 39.50 | $39.50 |
| 6 years | 1,669,525 | $ 32.66 | $32.66 | 1,669,525 | $ 32.66 | $32.66 |
| 7 years | 1,118,988 | $ 32.40 | $32.40 | 919,708 | $ 32.40 | $32.40 |
| 8 years | 1,370,165 | $ 37.54 | $37.54 | 948,405 | $ 37.54 | $37.54 |
| 9 years | 1,320,770 | $ 39.25 | $39.25 | 614,591 | $ 39.25 | $39.25 |
| | 9,090,157 | | | 7,762,938 | | |

As of June 30, 2007, there are approximately 1.3 million options which have not yet vested. The unearned compensation cost related to these stock option awards is $1.8 million which is expected to be recognized over the next two years.

## 8. POSTRETIREMENT BENEFITS

*Pension Plans:* The following information represents the consolidated net periodic pension cost for the three and six months ended June 30, 2007 and 2006, 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 the 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) | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| Service cost, benefits earned during the period | $ 14.8 | $ 16.0 | $ 30.5 | $ 32.1 |
| Interest cost on projected benefit obligation | 39.1 | 38.6 | 79.7 | 77.2 |
| Expected return on plan assets | (52.0) | (47.0) | (104.1) | (94.0) |
| Net amortization and deferral | 13.0 | 21.9 | 28.9 | 43.8 |
| Total pension cost | $ 14.9 | $ 29.5 | $ 35.0 | $ 59.1 |

*Other Postretirement Benefits:* The following information represents the consolidated net periodic other postretirement benefit cost for the three and six months ended June 30, 2007 and 2006 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 Millions of Dollars) | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| Service cost, benefits earned during the period | $ 5.2 | $ 7.0 | $ 11.3 | $ 13.9 |
| Interest cost on accumulated postretirement benefit obligation | 18.0 | 20.1 | 37.4 | 40.3 |
| Expected return on plan assets | (9.5) | (9.2) | (19.3) | (18.3) |
| Net amortization and deferral | 10.0 | 16.7 | 22.2 | 33.3 |
| Other postretirement cost | $ 23.7 | $ 34.6 | $ 51.6 | $ 69.2 |

During the first six months of 2007, KeySpan contributed $28.0 million to its pension plans. KeySpan anticipates contributing an additional $103.0 million to its other postretirement benefit plans during the remainder of 2007. Estimated contribution levels are subject to change based on future market returns, interest rates and certain other measurements. Actual contributions, therefore, may vary from these levels.

## 9. COMMERCIAL PAPER

At June 30, 2007, KeySpan had two credit facilities totaling $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 June 30, 2007, KeySpan's consolidated indebtedness was 49.4% 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 June 30, 2007, we had cash and temporary cash investments of $496.5 million. During the first six months of 2007, we borrowed $46.5 million of commercial paper and, at June 30, 2007, $131.5 million of commercial paper was outstanding. At June 30, 2007, KeySpan had the ability to issue up to an additional $1.4 billion, under its commercial paper program.

10. 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 the Long Island Lighting Company's ("LILCO's") business units were merged with KeySpan and LILCO's common stock and remaining assets were acquired by LIPA. Also effective on that date, 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 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 retroactive to 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. 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 pending Merger of KeySpan and National Grid plc, LIPA, National Grid plc and KeySpan engaged in discussions concerning the impact of the transaction on LIPA's operations. KeySpan, National Grid plc and LIPA have reached an agreement pursuant to which LIPA agreed to waive its contractual right to terminate the 1998 LIPA Agreements and the 2006 LIPA Agreements upon consummation of the Merger between KeySpan and National Grid plc, in exchange for enhancements to certain of the 2006 LIPA Agreements and certain other considerations. The amended and enhanced agreements become effective upon completion of the Merger between KeySpan and National Grid plc and are subject to approval by the New York State Attorney General and the New York State Comptroller.

*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 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 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 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 KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006 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 the steam generating units at KeySpan's Far Rockaway and/or E.F. Barrett Generating Stations (and certain related assets) at a price equal to the net book value of each facility. In December 2006, KeySpan and LIPA entered into an amendment to the 2006 Option Agreement whereby the parties agreed to extend the expiration of the option period to the later of (i) December 31, 2007 or (ii) 180 days following the effective date of the 2006 Option Agreement. Pursuant to the National Grid plc, KeySpan and LIPA negotiations, the parties further amended the 2006 Option Agreement to extend the expiration of the option period to May 31, 2008. The 2006 Option

Agreement, as amended, 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 remains unchanged for three years and then increase annually by 1.7%, plus inflation. The variable component, which comprises no more than 20% of KeySpan's compensation under the 2006 MSA, 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 receives 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 retains 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 the three and six months ended June 30, 2007 and 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.

11. ADOPTION OF FASB INTERPRETATION NUMBER 48

On July 13, 2006 the FASB issued Interpretation No. 48 "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement No. 109, "Accounting for Income Taxes" and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on: the classification of unrecognized tax benefits; disclosures for interest and penalties; accounting and disclosures for interim reporting periods; and transition requirements. FIN 48 was effective for fiscal years beginning after December 15, 2006.

KeySpan adopted the provisions of FIN 48 on January 1, 2007. The total amount of unrecognized tax benefits as of the date of adoption was \$79.6 million. As a result of the implementation of FIN 48, we recognized a \$20.5 million increase in the liability for unrecognized tax benefits which was accounted for as a reduction in retained earnings of \$5.2 million and an increase to deferred tax assets of \$15.3 million.

Included in the balance of unrecognized tax benefits at January 1, 2007, are \$55.3 million of tax benefits that, if recognized, would affect the effective tax rate.

KeySpan recognizes interest accrued related to unrecognized tax benefits in tax expense on the Consolidated Statement of Income. During the years ended December 31, 2006, 2005 and 2004, we recognized approximately \$0.9 million, \$7.6 million and \$0.4 million in interest, respectively. KeySpan had accrued interest payable of \$8.9 million and \$8.0 million at December 31, 2006 and 2005, respectively. Upon adoption of FIN 48, on January 1, 2007, KeySpan increased its accrued interest payable to \$24.3 million, which is included in the total of unrecognized benefits as of the date of adoption. KeySpan recorded an additional \$ 2.3 million and \$4.7 million of accrued interest during the three and six months ended June 30, 2007, respectively. We do not anticipate that the total amounts of unrecognized tax benefits will significantly increase or decrease within the next twelve months.

KeySpan is subject to federal, state and local income tax. Through its various subsidiaries, KeySpan operates predominately in New York, Massachusetts and New Hampshire. The following table summarizes the open tax years for each major jurisdiction:

| Jurisdiction | Open Tax Years |
|---|---|
| Federal | 2000 - 2006 |
| New York State | 2000 - 2006 |
| New York City | 2000 - 2006 |
| Massachusetts | 2000 - 2006 |
| New Hampshire | 2003 - 2006 |

The Internal Revenue Service has recently commenced the examination of KeySpan's tax returns for the years ended December 31, 2000 through December 31, 2004. In addition, several of our subsidiaries are currently under audit by New York State and New York City for the tax years ended December 31, 2000 through December 31, 2005. Although the tax years ended December 31, 2003 through December 31, 2005 are open in Massachusetts and New Hampshire, none of our subsidiaries in these states are currently being audited by the income tax authorities. At this time, we do not believe that the outcome of any examination will have a material impact on KeySpan's financial statements.

12. KEYSPAN GAS EAST CORPORATION SUMMARY FINANCIAL INFORMATION

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)* | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Three Months Ended June 30, 2007 | | | | |
| **Revenues** | $ 0.2 | $ 276.5 | $ 1,253.9 | $ (0.2) | $ 1,530.4 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 175.1 | 474.3 | - | 649.4 |
| Fuel and purchased power | - | - | 138.1 | - | 138.1 |
| Operations and maintenance | (7.3) | 36.5 | 382.2 | - | 411.4 |
| Intercompany expense | - | 1.5 | (1.3) | (0.2) | - |
| Depreciation and amortization | - | 21.2 | 83.4 | - | 104.6 |
| Operating taxes | - | 15.6 | 83.1 | - | 98.7 |
| Total Operating Expenses | (7.3) | 249.9 | 1,159.8 | (0.2) | 1,402.2 |
| Income from equity investments | 52.9 | - | 4.9 | (52.9) | 4.9 |
| Gain on sale of assets | - | - | 0.3 | - | 0.3 |
| **Operating Income** | 60.4 | 26.6 | 99.3 | (52.9) | 133.4 |
| Interest charges | (46.5) | (15.4) | (23.8) | 16.1 | (69.6) |
| Other income and (deductions) | 35.4 | 1.9 | (2.9) | (16.1) | 18.3 |
| **Total Other Income and (Deductions)** | (11.1) | (13.5) | (26.7) | - | (51.3) |
| **Income Taxes (Benefit)** | (2.9) | 5.6 | 27.2 | - | 29.9 |
| **Net Income** | $ 52.2 | $ 7.5 | $ 45.4 | $ (52.9) | $ 52.2 |

**Statement of Income**

| *(In Millions of Dollars)* | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Three Months Ended June 30, 2006 | | | | |
| **Revenues** | $ 0.2 | $ 245.9 | $ 1,131.8 | $ (0.2) | $ 1,377.7 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 153.8 | 386.0 | - | 539.8 |
| Fuel and purchased power | - | - | 115.7 | - | 115.7 |
| Operations and maintenance | 9.3 | 34.5 | 376.8 | - | 420.6 |
| Intercompany expense | - | 1.4 | (1.4) | - | - |
| Depreciation and amortization | - | 18.7 | 82.5 | - | 101.2 |
| Operating taxes | - | 15.3 | 80.5 | - | 95.8 |
| Total Operating Expenses | 9.3 | 223.7 | 1,040.1 | - | 1,273.1 |
| Income from equity investments | 49.3 | - | 2.9 | (49.3) | 2.9 |
| **Operating Income (Loss)** | 40.2 | 22.2 | 94.6 | (49.5) | 107.5 |
| Interest charges | (39.9) | (13.2) | (14.3) | 8.0 | (59.4) |
| Other income and (deductions) | 26.5 | 0.9 | (13.4) | (7.8) | 6.2 |
| **Total Other Income and (Deductions)** | (13.4) | (12.3) | (27.7) | 0.2 | (53.2) |
| **Income Taxes (Benefit)** | (22.6) | 5.5 | 22.0 | - | 4.9 |
| **Net Income** | $ 49.4 | $ 4.4 | $ 44.9 | $ (49.3) | $ 49.4 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Six Months Ended June 30, 2007 | | | | |
| **Revenues** | $ 0.3 | $ 871.0 | $ 3,521.8 | $ (0.2) | $ 4,392.9 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 569.4 | 1,752.7 | - | 2,322.1 |
| Fuel and purchased power | - | - | 266.3 | - | 266.3 |
| Operations and maintenance | (5.9) | 74.4 | 773.8 | - | 842.3 |
| Intercompany expense | - | 2.8 | (2.6) | (0.2) | - |
| Depreciation and amortization | - | 49.6 | 167.3 | - | 216.9 |
| Operating taxes | - | 34.3 | 186.9 | - | 221.2 |
| Total Operating Expenses | (5.9) | 730.5 | 3,144.4 | (0.2) | 3,868.8 |
| Income from equity investments | 273.1 | - | 8.5 | (273.1) | 8.5 |
| Gain on sale of assets | - | - | 0.3 | - | 0.3 |
| **Operating Income** | 279.3 | 140.5 | 386.2 | (273.1) | 532.9 |
| Interest charges | (87.4) | (28.1) | (43.5) | 27.9 | (131.1) |
| Other income and (deductions) | 66.1 | 3.7 | (15.5) | (27.9) | 26.4 |
| **Total Other Income and (Deductions)** | (21.3) | (24.4) | (59.0) | - | (104.7) |
| **Income Taxes (Benefit)** | (7.6) | 43.5 | 126.7 | - | 162.6 |
| **Net Income** | $ 265.6 | $ 72.6 | $ 200.5 | $ (273.1) | $ 265.6 |

**Statement of Income**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | Six Months Ended June 30, 2006 | | | | |
| **Revenues** | $ 0.3 | $ 789.6 | $ 3,249.2 | $ (0.3) | $ 4,038.8 |
| **Operating Expenses** | | | | | |
| Purchased gas | - | 518.7 | 1,532.5 | - | 2,051.2 |
| Fuel and purchased power | - | - | 245.7 | - | 245.7 |
| Operations and maintenance | 17.3 | 70.9 | 738.5 | - | 826.7 |
| Intercompany expense | - | 2.6 | (2.6) | - | - |
| Depreciation and amortization | - | 43.8 | 167.6 | - | 211.4 |
| Operating taxes | - | 33.0 | 181.1 | - | 214.0 |
| Total Operating Expenses | 17.3 | 669.0 | 2,862.8 | - | 3,549.0 |
| Income from equity investments | 265.9 | - | 6.3 | (265.9) | 6.3 |
| Gain on sale of assets | - | 0.1 | 0.4 | - | 0.5 |
| **Operating Income (Loss)** | 248.9 | 120.7 | 393.2 | (266.2) | 496.6 |
| Interest charges | (79.7) | (27.4) | (31.0) | 12.4 | (125.6) |
| Other income and (deductions) | 59.3 | 1.0 | (30.6) | (12.1) | 17.6 |
| **Total Other Income and (Deductions)** | (20.4) | (26.4) | (61.6) | 0.3 | (108.0) |
| **Income Taxes (Benefit)** | (28.9) | 35.4 | 124.7 | - | 131.2 |
| **Net Income** | $ 257.4 | $ 59.0 | $ 206.9 | $ (265.9) | $ 257.4 |

| Balance Sheet | | | | | |
|---|---|---|---|---|---|
| | | | June 30, 2007 | | |
| *(In Millions of Dollars)* | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & temporary cash investments | $ 0.1 | $ 227.6 | $ 268.8 | $ - | $ 496.5 |
| Accounts receivable, net | 0.6 | 197.9 | 749.8 | - | 948.3 |
| Other current assets | 1.0 | 234.6 | 957.1 | - | 1,192.7 |
| | 1.7 | 660.1 | 1,975.7 | - | 2,637.5 |
| **Equity Investments and Other** | 5,147.7 | - | 159.3 | (5,014.3) | 292.7 |
| **Property** | | | | | |
| Gas | - | - | 7,825.7 | - | 7,825.7 |
| Electric | - | 2,252.0 | 354.4 | - | 2,606.4 |
| Other | - | 1.3 | 615.3 | - | 616.6 |
| Accumulated depreciation and depletion | - | (452.2) | (2,923.0) | - | (3,375.2) |
| | - | 1,801.1 | 5,872.4 | - | 7,673.5 |
| **Intercompany Accounts Receivable** | 964.9 | 257.0 | 2,013.8 | (3,235.7) | - |
| **Deferred Charges** | 1,959.2 | 448.8 | 1,226.2 | - | 3,634.2 |
| **Total Assets** | $ 8,073.5 | $ 3,167.0 | $ 11,247.4 | $ (8,250.0) | $ 14,237.9 |
| **LIABILITIES AND CAPITALIZATION** | | | | | |
| **Current Liabilities** | | | | | |
| Accounts payable and other liabilities | $ 49.8 | $ 75.5 | $ 634.0 | $ - | $ 759.3 |
| Commercial paper | 131.5 | - | - | - | 131.5 |
| Other current liabilities | 356.8 | 171.0 | 239.7 | - | 767.5 |
| | 538.1 | 246.5 | 873.7 | - | 1,658.3 |
| **Intercompany Accounts Payable** | 11.1 | 623.2 | 1,013.7 | (1,648.0) | - |
| **Deferred Credits and Other Liabilities** | | | | | |
| Deferred income tax | 4.6 | 420.4 | 665.7 | - | 1,090.7 |
| Postretirement benefits and other reserves | 1,067.2 | 143.4 | 447.2 | - | 1,657.8 |
| Other deferred credits and liabilities | 148.0 | 37.6 | 851.3 | - | 1,036.9 |
| | 1,219.8 | 601.4 | 1,964.2 | - | 3,785.4 |
| **Capitalization** | | | | | |
| Common shareholders' equity | 4,603.2 | 1,070.0 | 3,996.1 | (5,014.3) | 4,655.0 |
| Long-term debt and capital leases | 1,701.3 | 625.9 | 3,383.6 | (1,587.7) | 4,123.1 |
| **Total Capitalization** | 6,304.5 | 1,695.9 | 7,379.7 | (6,602.0) | 8,778.1 |
| **Minority Interest in Subsidiary Companies** | - | - | 16.1 | - | 16.1 |
| **Total Liabilities & Capitalization** | $ 8,073.5 | $ 3,167.0 | $ 11,247.4 | $ (8,250.0) | $ 14,237.9 |

**Balance Sheet**

| (In Millions of Dollars) | Guarantor | KEDLI | Other Subsidiaries | Eliminations | Consolidated |
|---|---|---|---|---|---|
| | | | December 31, 2006 | | |
| **ASSETS** | | | | | |
| **Current Assets** | | | | | |
| Cash & 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 |
| **Equity Investments and Other** | 4,837.5 | - | 144.0 | (4,711.8) | 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** | $ 7,891.4 | $ 2,869.1 | $ 11,121.6 | $ (7,444.6) | $ 14,437.5 |
| **LIABILITIES AND CAPITALIZATION** | | | | | |
| **Current Liabilities** | | | | | |
| Accounts payable and other liabilities | $ 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 | 4,461.2 | 996.8 | 3,772.6 | (4,711.8) | 4,518.8 |
| Long-term debt and capital leases | 1,861.8 | 750.9 | 3,320.2 | (1,513.8) | 4,419.1 |
| **Total Capitalization** | 6,323.0 | 1,747.7 | 7,092.8 | (6,225.6) | 8,937.9 |
| **Minority Interest in Subsidiary Companies** | - | - | 15.7 | - | 15.7 |
| **Total Liabilities & Capitalization** | $ 7,891.4 | $ 2,869.1 | $ 11,121.6 | $ (7,444.6) | $ 14,437.5 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Six Months Ended June 30, 2007 | | | |
|---|---|---|---|---|
| | Guarantor | KEDLI | Other Subsidiaries | Consolidated |
| **Operating Activities** | | | | |
| Net Cash Provided by Operating Activities | $ 25.7 | $ 224.4 | $ 355.8 | $ 605.9 |
| **Investing Activities** | | | | |
| Construction expenditures | - | (42.4) | (203.7) | (246.1) |
| Cost of removal | - | (3.9) | (10.1) | (14.0) |
| Derivative margin calls | - | 15.2 | 27.5 | 42.7 |
| Return of investment | - | - | 7.6 | 7.6 |
| Net Cash (Used in) Investing Activities | - | (31.1) | (178.7) | (209.8) |
| **Financing Activities** | | | | |
| Treasury stock issued | 10.4 | - | - | 10.4 |
| Issuance (payment) of debt, net | 46.5 | - | (0.6) | 45.9 |
| Common stock dividends paid | (166.8) | - | - | (166.8) |
| Intercompany dividend payments | 2.0 | - | (2.0) | - |
| Net intercompany accounts | (58.2) | (0.4) | 58.6 | - |
| Net Cash (Used in) Provided by Financing Activities | (166.1) | (0.4) | 56.0 | (110.5) |
| Net (Decrease) Increase in Cash and Cash Equivalents | $ (140.4) | $ 192.9 | $ 233.1 | $ 285.6 |
| Cash and Cash Equivalents at Beginning of Period | 140.5 | 34.7 | 35.7 | 210.9 |
| Cash and Cash Equivalents at End of Period | $ 0.1 | $ 227.6 | $ 268.8 | $ 496.5 |

**Statement of Cash Flows**

| *(In Millions of Dollars)* | Six Months Ended June 30, 2006 | | | |
|---|---|---|---|---|
| | Guarantor | KEDLI | Other Subsidiaries | Consolidated |
| **Operating Activities** | | | | |
| Net Cash (Used in) Provided by Operating Activities | $ (56.0) | $ 263.9 | $ 581.6 | $ 789.5 |
| **Investing Activities** | | | | |
| Capital expenditures | - | (41.2) | (205.8) | (247.0) |
| Cost of removal | - | (3.8) | (11.9) | (15.7) |
| Net Cash Provided by (Used in) Investing Activities | - | (45.0) | (217.7) | (262.7) |
| **Financing Activities** | | | | |
| Treasury stock issued | 18.8 | - | - | 18.8 |
| Payment of debt, net | (467.6) | - | - | (467.6) |
| Common and preferred stock dividends paid | (162.4) | - | - | (162.4) |
| Net intercompany accounts | 602.2 | (219.3) | (382.9) | - |
| Net Cash Provided by (Used in) Financing Activities | (9.0) | (219.3) | (382.9) | (611.2) |
| Net Increase (Decrease) in Cash and Cash Equivalents | $ (65.0) | $ (0.4) | $ (19.0) | $ (84.4) |
| Cash and Cash Equivalents at Beginning of Period | 79.5 | 3.5 | 41.5 | 124.5 |
| Cash and Cash Equivalents at End of Period | $ 14.5 | $ 3.1 | $ 22.5 | $ 40.1 |

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Consolidated Review of Results**

The following is a summary of transactions affecting comparative earnings for the three and six months ended June 30, 2007, compared to the three and six months ended June 30, 2006. Capitalized terms used in the following discussion, but not otherwise defined, have the same meaning as when used in the Notes to the Consolidated Financial Statements included under Item 1. References to "KeySpan," "we," "us," and "our" mean KeySpan Corporation, together with its consolidated subsidiaries.

Operating income by segment, as well as consolidated earnings for common stock is set forth in the following table for the periods indicated.

| *(In Millions of Dollars, Except per Share)* | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2007 | 2006 | 2007 | 2006 |
| Gas Distribution | $ 61.4 | $ 39.5 | $ 464.0 | $ 376.0 |
| Electric Services | 44.3 | 62.4 | 42.8 | 127.3 |
| Energy Services | 2.0 | 2.0 | 3.4 | 1.6 |
| Energy Investments | 5.5 | 3.7 | 10.5 | 6.7 |
| Eliminations and other | 20.2 | (0.1) | 12.2 | (15.0) |
| **Operating Income** | 133.4 | 107.5 | 532.9 | 496.6 |
| **Other Income and (Deductions)** | | | | |
| Interest charges | (69.6) | (59.4) | (131.1) | (125.6) |
| Other income and (deductions) | 18.3 | 6.2 | 26.4 | 17.6 |
| | (51.3) | (53.2) | (104.7) | (108.0) |
| Income taxes | 29.9 | 4.9 | 162.6 | 131.2 |
| **Earnings for Common Stock** | $ 52.2 | $ 49.4 | $ 265.6 | $ 257.4 |
| **Basic Earnings per Share** | $ 0.30 | $ 0.28 | $ 1.51 | $ 1.47 |

**Results of Operations Quarter Ended June 30, 2007 vs 2006**

KeySpan's earnings for common stock for the three months ended June 30, 2007 were $52.2 million, or $0.30 per share, compared to $49.4 million or $0.28 per share realized during the three months ended June 30, 2006, an increase of $2.8 million, or $0.02 per share. The favorable comparative operating results reflect: (i) an increase in operating income; offset by (ii) higher interest expense and (iii) an increase in comparative income tax expense due, in part, to the benefits recorded in 2006 related to the settlement of certain outstanding issues with the New York City Department of Taxation and Finance and the Internal Revenue Service ("IRS").

As indicated in the above table, operating income increased $25.9 million, or 24% for the quarter ended June 30, 2007, compared to the corresponding quarter last year. The Gas Distribution segment realized an increase in operating income of $21.9 million, which was, for the most part, offset by a decrease in operating income associated with KeySpan's electric operations of $18.1 million. Operating income from the Gas Distribution segment benefited from load growth additions and an increase in usage per customer which resulted in an increase to net gas revenues. The Electric Services segment results were adversely impacted by a decrease in electric revenues from KeySpan's merchant electric generating facilities and an increase in operating expenses.

The favorable operating income variation reflected in "eliminations and other" of $20.3 million is primarily due to a decrease in costs recorded at KeySpan's holding company level that are not allocated to the operating segments - primarily costs related to KeySpan's pending Merger with National Grid plc and certain employee benefit costs. (See the discussion under the caption "Review of Operating Segments" for further details on each segment.)

Other income and (deductions) reflects interest charges and other miscellaneous items. For the second quarter of 2007, other income and (deductions) reflects a net expense of $51.3 million compared to a net expense of $53.2 million for the second quarter of 2006. The favorable variation of $1.9 million is primarily due to an increase in interest income on temporary cash investments and certain other investments amounting to $12.1 million, partially offset by higher interest charges of $10.2 million.

The increase in comparative interest expense year-over-year reflects, in part, a $6 million benefit recorded in 2006 related to the settlement of certain outstanding issues with the New York City Department of Taxation and Finance. During the second quarter of 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. During the three months ended June 30, 2006, KeySpan reversed a previously recorded $6 million interest reserve established in connection with that dispute. Further, interest expense in 2007 reflects a higher level of outstanding long-term debt. Long-term debt at June 30, 2007 was $486 million higher than last year reflecting the November 2006 issuance of $500 million Senior Unsecured Notes. Partially offsetting these adverse impacts to comparative interest expense is the favorable impact associated with a lower level of outstanding commercial paper. During the second quarter of 2007, KeySpan's average outstanding commercial paper borrowings were $91.5 million compared to $217.9 million in average outstanding borrowings during the second quarter of 2006.

The increase in income tax expense of $25.0 million for the second quarter of 2007 compared to the second quarter of 2006 reflects, in part, the favorable resolution reached in June 2006 between KeySpan and the IRS regarding certain issues associated with the Long Island Lighting Company's ("LILCO") 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 ended September 30, 1997 through December 31, 1998. In addition, as noted above, KeySpan resolved its dispute with the New York City Department of Taxation and Finance with respect to income taxes relating to its merchant electric generating facility. As a result of settling these issues, KeySpan realized a tax benefit of $16.4 million during the three months ended June 30, 2006. The remaining increase in income tax expense generally reflects a higher level of pre-tax income in the second quarter of 2007 compared to the second quarter of 2006.

**Results of Operations Six Months Ended June 30, 2007 vs 2006**

KeySpan's earnings for common stock for the six months ended June 30, 2007, were $265.6 million, or $1.51 per share, compared to $257.4 million, or $1.47 per share, realized during the same period last year, an increase of $8.2 million, or $0.04 per share. Similar to the comparison for the quarter, the favorable comparative operating results for the period also reflect: (i) an increase in operating income; offset by (ii) higher interest expense and (iii) an increase in comparative income tax expense due to tax benefits recorded in 2006.

As indicated in the above table, operating income increased $36.3 million, or 7% for the six months ended June 30, 2007, compared to the corresponding period last year. The Gas Distribution segment realized an increase in operating income of $88.0 million, which was substantially offset by a decrease in operating income associated with KeySpan's electric operations of $84.5 million. Operating income from the Gas Distribution segment benefited from the comparatively colder winter-heating season weather during the first quarter of 2007 compared to the first quarter of 2006, as well as from load growth additions which, combined, resulted in an increase to net gas revenues for the first six months of 2007. The Electric Services segment results were adversely impacted by a decrease in electric revenues from KeySpan's merchant electric generating facilities and higher operating expenses. Further, an outstanding fixed for floating unforced capacity financial swap resulted in lower operating income for the six months ended June 30, 2007, compared to the same period last year.

Operating income for the first six months of 2007 from KeySpan's two other operating segments – Energy Services and Energy Investments - increased $1.8 million and $3.8 million, respectively, compared to the first six months of 2006. The increase in operating income from the Energy Services segment reflects lower administrative and general expenses, as well as higher bandwidth sales associated with KeySpan's fiber optic subsidiary, while the increase in operating income from the Energy Investments segment was due to higher revenues related to KeySpan's Liquefied Natural Gas ("LNG") transportation subsidiary and higher equity earnings on certain investments.

The operating income variation reflected in "eliminations and other" of $27.2 million is due primarily to a decrease in costs residing at KeySpan's holding company level such as costs associated with KeySpan's pending Merger with National Grid plc, corporate advertising expenses, sponsorship fees and certain employee benefit costs that are not allocated to KeySpan's operating segments. (See the discussion under the caption “Review of Operating Segments” for further details on each segment.)

Other income and (deductions) reflects interest charges and other miscellaneous items. For the six months ended June 30, 2007, other income and (deductions) reflects a net expense of $104.7 million compared to a net expense of $108.0 million for the same period of 2006. The favorable variation of $3.3 million is primarily due to an increase in interest income on temporary cash investments and certain other investments amounting to $8.8 million, partially offset by higher interest charges of $5.5 million.

The increase in comparative interest expense year-over-year reflects, in part, the $6 million benefit recorded in 2006 related to the settlement with the New York City Department of Taxation and Finance as previously mentioned. Further, interest expense in 2007 reflects a higher level of outstanding long-term debt. Long-term debt at June 30, 2007 was $486 million higher than last year reflecting the November 2006 issuance of $500 million Senior Unsecured Notes. Partially offsetting these adverse impacts to comparative interest expense is the favorable impact associated with a lower level of outstanding commercial paper. During the first six months of 2007, KeySpan’s average outstanding commercial paper borrowings were $80.8 million compared to $397.0 million in average outstanding borrowings during the first six months of 2006. Additionally, regulatory carrying charges were lower year-over-year.

The increase in income tax expense of $31.4 million for the six months ended June 30, 2007 compared to the six months ended June 30, 2006 reflects, in part, an increase in pre-tax income in 2007. Further, as noted previously, in the second quarter of 2006 KeySpan and the IRS reached a resolution on certain then outstanding issues. Additionally, KeySpan resolved its dispute with New York City Department of Taxation and Finance with respect to income taxes relating to its merchant electric generating facility. As a result of settling these issues, KeySpan realized a tax benefit of $16.4 million during the six months ended June 30, 2006.

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 reports its segment results 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.

| | Three Months Ended June 30, | | Six Months Ended June30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 | 2007 | 2006 |
| Revenues | $ 1,011.1 | $ 873.2 | $ 3,426.6 | $ 3,053.3 |
| Cost of gas | 650.7 | 541.1 | 2,324.3 | 2,053.7 |
| Revenue taxes | 12.7 | 10.0 | 41.5 | 36.2 |
| Net Revenues | 347.7 | 322.1 | 1,060.8 | 963.4 |
| Operating Expenses | | | | |
| Operations and maintenance | 177.5 | 176.5 | 368.7 | 366.9 |
| Depreciation and amortization | 72.1 | 69.2 | 151.9 | 145.1 |
| Operating taxes | 37.4 | 36.9 | 76.9 | 75.4 |
| Total Operating Expenses | 287.0 | 282.6 | 597.5 | 587.4 |
| Gain on Sale of Assets | 0.7 | - | 0.7 | - |
| Operating Income | $ 61.4 | $ 39.5 | $ 464.0 | $ 376.0 |
| Firm gas sales and transportation (MDTH) | 55,484 | 48,851 | 205,514 | 175,755 |
| Transportation - Electric Generation (MDTH) | 13,412 | 20,709 | 18,621 | 27,180 |
| Other Sales (MDTH) | 45,563 | 45,539 | 94,120 | 97,871 |
| Warmer (Colder) than Normal - New York | (11%) | 18% | (4%) | 14% |
| Warmer (Colder) than Normal - New England | (14%) | (6%) | (5%) | 5% |

A MDTH is 10,000 therms (British Thermal Units) 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 $21.9 million, or 55%, for the second quarter of 2007 compared to the same quarter last year, due to an increase in net gas revenues (revenues less the cost of gas and associated revenue taxes) of $25.6 million, partially offset by an increase in operating expenses.

For the six months ended June 30, 2007, operating income increased $88.0 million compared to the same period last year, primarily due to an increase in net gas revenues of $97.4 million, partially offset by an increase in operating expenses.

*Net Revenues*

Net gas revenues from our gas distribution operations increased $97.4 million, or 10%, in the first six months of 2007 compared to the same period last year. Both the New York and New England based gas distribution operations benefited from the significantly colder weather experienced throughout the northeastern United States during the first six months of 2007 and from load growth additions. As measured in heating degree days, weather during the first six months of 2007 in all of our service territories was approximately 4%-5% colder than normal and approximately 18% and 9% colder than last year in our New York and New England service territories, respectively.

Net revenues from firm gas customers (residential, commercial and industrial customers) increased $74.7 million in the first six months of 2007 compared to the same period last year. The combination of an increase in usage per customer due to the comparatively colder winter-heating season weather, as well as load growth additions from oil-to-gas conversions, primarily for space heating purposes and new construction in 2006, resulted in a beneficial impact to net gas revenues of $72.5 million, net of the weather normalization adjustments and weather derivatives discussed below. (Approximately 11% of this increase is from load growth.)

Also included in net gas revenues is the recovery of property taxes that added $5.6 million to net revenues during the first six months of 2007. 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. Additionally, we have a management contract with Merrill Lynch Commodities under which KeySpan and Merrill Lynch Commodities share the responsibilities for managing KeySpan's upstream gas contracted assets associated with its Massachusetts gas distribution subsidiaries. KeySpan, Merrill Lynch Commodities and KeySpan's Massachusetts gas sales customers share in the profits generated from the optimization of these assets. For the six months ended June 30, 2007, KeySpan recognized $5.7 million of operating income on this contract, after sharing with Merrill Lynch Commodities and KeySpan's Massachusetts gas sales customers.

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. Since weather was colder than normal during the first six months of 2007, KeySpan refunded $5.3 million to its firm gas heating sales customers in 2007. 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 2006/2007 winter heating season - November 2006 through March 2007. These financial derivatives afford KeySpan some protection against warmer than normal weather. Weather during the fourth quarter of 2006 was warmer than normal; accordingly KeySpan recorded a $9.1 million benefit to earnings in the fourth quarter of 2006 to reflect the accrual for the weather hedges. However, as noted, weather for the first quarter of 2007 was colder than normal in KeySpan's New England service territory. Therefore, for the entire winter heating season –November 2006 through March 2007 – weather was slightly colder than normal. As a result, in 2007 KeySpan reversed the

$9.1 million accrual recorded in the fourth quarter of 2006. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for further information.)

Firm gas distribution rates for KEDNY, KEDLI and KEDNE in 2007, other than for the recovery of gas costs, have remained substantially unchanged from rates charged in 2006.

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 $22.7 million during the first six months of 2007 compared to the same period last year reflecting higher pricing.

*Firm Sales, Transportation and Other Quantities*

Firm gas sales and transportation quantities for the six months ended June 30, 2007, increased 17% compared to the same period in 2006 due primarily to the colder weather this year compared to last year during the winter-heating season and to customer additions and oil-to-gas conversions. 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. As mentioned previously, we have a management contract with Merrill Lynch Commodities under which KeySpan and Merrill Lynch Commodities 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 Commodities and KeySpan's Massachusetts gas sales customers share in the profits generated from the optimization of these assets. KeySpan provides these services internally for its New York and New Hampshire gas distribution subsidiaries.

*Purchased Gas for Resale*

The increase in gas costs for the first six months of 2007 compared to the same period of 2006 of $270.6 million, or 13%, is reflective of an 8% increase in the quantity of gas purchased due to the comparatively colder winter heating season weather and a 5% increase in the price per dekatherm of gas purchased for firm gas sales 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*

Operating expenses during the second quarter of 2007 compared to the same quarter of 2006 increased \$4.4 million, or 2% in total. Operations and maintenance expense increased slightly - \$1.0 million. Although this variation is not large, the components are varied. Repair and maintenance costs, corporate overhead charges, insurance and regulatory fees increased \$11.5 million in total. In addition, the provision for uncollectible accounts receivable increased \$1.6 million due to the increase, year-over-year, in net gas revenues. On the other hand, employee benefit costs, primarily postretirement expenses, decreased \$12.1 million as a result of favorable asset returns, an increase in the discount rate and favorable health care insurance claims experience.

Depreciation and amortization charges increased \$2.9 million due mostly to an increase of \$2.2 million for the amortization of deferred property taxes. As noted previously, the amortization of these deferred taxes does not impact net income since we recovered a similar amount from our ratepayers in revenues. Finally, operating taxes, primarily property taxes, increased \$0.5 million.

For the six months ended June 30, 2007, operating expenses increased \$10.1 million, or 2% compared to the same period last year. Operations and maintenance expense increased \$1.8 million. Similar to the quarterly explanation, this variation is not large, but the components are varied. Repair and maintenance costs, corporate overhead charges, insurance and regulatory fees increased \$15.2 million in total. Additionally, the provision for uncollectible accounts receivable increased \$3.0 million due to the increase, year-over-year, in net gas revenues. On the other hand, employee benefit costs, primarily postretirement expenses decreased \$16.4 million as a result of favorable asset returns, an increase in the discount rate and favorable health care insurance claims experience.

Depreciation and amortization charges increased \$6.8 million due, in part, to an increase of \$5.6 million for the amortization of deferred property taxes. As noted previously, the amortization of these deferred taxes does not impact net income since we recovered a similar amount from our ratepayers in revenues. The remaining increase reflects an increase in depreciation charges of \$1.2 million due to the continued expansion of the gas distribution system. Finally, operating taxes, primarily property taxes in KeySpan's New York territory, increased \$1.5 million.

*Gas Supply and Pricing*

KeySpan had adequate gas supply available to meet its gas load demand in its service territories for the 2006/2007 winter heating season as KeySpan's gas storage was 100% full at the start of the winter heating season. The current gas rate structure of each of our gas distribution utilities includes 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 Massachusetts Department of Telecommunications and Energy ("MADTE") order, received in the fourth quarter of 2005, permitting Boston Gas Company 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 financial derivatives, KeySpan 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 mitigated 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. 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 our market segments through the expansion of our gas distribution system for new 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 where natural gas is already in the home for other uses 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 each have a 50% ownership interest in Islander East Pipeline Company, LLC ("Islander East"). Once in service, the pipeline is expected to have the capacity to transport up to 260,000 DTH of natural gas to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. In addition, KeySpan has a 26.25% interest in the Millennium Pipeline development project which is anticipated to transport up to 525,000 DTH of natural gas a day to a point of interconnection with the Algonquin pipeline in Ramapo, New York. KEDLI has executed a Precedent Agreement for 175,000 DTH of 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 Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement"). The Electric Services segment also provides retail marketing of electricity to commercial customers.

Following the announcement of the pending Merger of KeySpan and National Grid plc, LIPA, National Grid plc and KeySpan engaged in discussions concerning the impact of the transaction on LIPA's operations. KeySpan, National Grid plc and LIPA have reached an agreement pursuant to which LIPA agreed to waive its contractual right to terminate the 1998 LIPA Agreements and the 2006 LIPA Agreements upon consummation of the Merger between KeySpan and National Grid plc, in exchange for enhancements to certain of the 2006 LIPA Agreements and certain other considerations. The amended and enhanced agreements become effective upon completion of the Merger between KeySpan and National Grid plc and are subject to approval by the New York State

Attorney General and the New York State Comptroller.

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

| *(In Millions of Dollars)* | Three Months Ended June 30, 2007 | Three Months Ended June 30, 2006 | Six Months Ended June 30, 2007 | Six Months Ended June 30, 2006 |
|---|---|---|---|---|
| Revenues | $ 443.2 | $ 426.5 | $ 841.5 | $ 851.3 |
| Purchased fuel | 137.9 | 115.5 | 270.2 | 245.5 |
| Net Revenues from Operations | 305.3 | 311.0 | 571.3 | 605.8 |
| Derivative Financial Instrument | 14.5 | 17.7 | 4.6 | 17.7 |
| Net Electric Revenues | 319.8 | 328.7 | 575.9 | 623.5 |
| Operating Expenses | | | | |
| Operations and maintenance | 199.8 | 195.2 | 385.2 | 350.5 |
| Depreciation | 25.4 | 25.1 | 50.5 | 52.2 |
| Operating taxes | 50.3 | 46.0 | 97.4 | 93.5 |
| Total Operating Expenses | 275.5 | 266.3 | 533.1 | 496.2 |
| Operating Income | $ 44.3 | $ 62.4 | $ 42.8 | $ 127.3 |
| Electric sales (MWH)* | 1,102,021 | 1,080,775 | 1,980,330 | 1,887,452 |
| Capacity(MW)* | 2,450 | 2,450 | 2,450 | 2,450 |
| Cooling degree days | 323 | 276 | 323 | 276 |

*Reflects the operations of the Ravenswood Generating Station only.

*Executive Summary*

Operating income decreased $18.1 million, or 29%, for the three months ended June 30, 2007, compared to the same quarter last year, due, in part, to a decrease in net revenues from the Ravenswood Generating Station of $7.6 million primarily resulting from the comparative impact associated with derivative financial instruments. Further, an outstanding fixed for floating unforced capacity financial swap resulted in lower comparative operating income of $3.2 million. The remaining decrease in operating income reflects higher operating expenses.

For the six months ended June 30, 2007, operating income decreased $84.5 million, or 66%, compared to the same period last year, due in part, to a decrease in net revenues from the Ravenswood Generating Station of $61.0 million primarily resulting from the comparative impact associated with derivative financial instruments. Although KeySpan's hedging strategies during the first six months of 2007 were consistent with past KeySpan policy to hedge the cash flow variability associated with a portion of forecasted fuel purchases and electric energy sales associated with the Ravenswood Generating Station, the results from these strategies were significantly lower year-over-year. Further, an outstanding fixed for floating unforced capacity financial swap resulted in lower comparative operating income of $13.1 million. The remaining decrease in operating income reflects higher operating expenses.

*Net Revenues*

Total electric net revenues realized during the second quarter of 2007 were \$8.9 million, or 3%, lower than such revenues realized during the corresponding quarter last year.

Net revenues from the Ravenswood Generating Station decreased \$7.6 million for the three months ended June 30, 2007, compared to the same quarter last year due, in part, to lower capacity margins of \$3.9 million as a result of additional capacity installed in New York City last year. Further, energy margins decreased \$3.7 million in the second quarter of 2007 compared to the second quarter of 2006.

The decrease in energy margins associated with the Ravenswood Generating Station was due to the comparative impact of KeySpan's hedging activities. We employ derivative financial instruments to economically hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil consumed at the Ravenswood Generating Station, as well as for a portion of forecasted electric energy sales. For the second quarter of 2007, KeySpan's hedging strategies, which are reflected in net electric revenues, resulted in a gain of \$1.4 million compared to hedging gains of \$7.1 million realized during the same period last year, resulting in a net comparative reduction in operating income of \$5.7 million.

Offsetting, to some extent, the adverse impact of the comparative hedging results, was an increase in physical "spark-spreads" (the selling price of electricity less the cost of fuel, exclusive of hedging gains or losses), which resulted in a benefit of \$2.0 million to energy margins for the second quarter 2007 compared to the same quarter of 2006. (See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for further information on KeySpan's hedging strategy.)

The rules and regulations for capacity, energy sales and the sale of certain ancillary services to the New York Independent System Operator ("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 "Market and Credit Risk Management Activities" for further details on these matters.

KeySpan has 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 second quarter of 2007, KeySpan realized a gain of \$14.5 million from this derivative financial instrument compared to a gain of \$17.7 million realized last year. This financial swap is anticipated to produce operating income in the summer months of May through October and operating losses in the winter months of November through April. Since the swap was entered into in May 2006, results for the three months ended June 30, 2006 contain only the positive contribution associated with May and June 2006. For the three months ended June 30, 2007, earnings from this derivative instrument included a loss in April 2007.

Net revenues for the second quarter of 2007 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $0.4 million compared to the same quarter of 2006, reflecting an increase in variable revenues which are a function of electric generation associated with KeySpan's Long Island based generating facilities. (For a description of the LIPA Agreements and power purchase agreements, see KeySpan's 2006 Annual Report on Form 10-K for the year ended December 31, 2006 Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "Electric Services – Revenue Mechanisms.")

Revenues associated with KeySpan's electric marketing activities increased $1.5 million during the second quarter of 2007 compared to second quarter of 2006 mainly attributable to favorable pricing.

Total electric net revenues realized during the six months ended June 30, 2007 were $47.6 million, or 8%, lower than such revenues realized during the same period of 2006.

Net revenues from the Ravenswood Generating Station decreased $61.0 million for the six months ended June 30, 2007 compared to the same period last year mainly due to lower energy margins of $46.8 million. Further, capacity margins decreased $14.2 million as a result of additional capacity installed in New York City last year.

The decrease in energy margins associated with the Ravenswood Generating Station was due to the comparative impact of KeySpan's hedging activities. As noted previously, we employ derivative financial instruments to economically hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil consumed at the Ravenswood Generating Station, as well as for a portion of forecasted electric energy sales. For the first six months of 2007, KeySpan's hedging strategies resulted in a gain of $9.0 million compared to hedging gains of $62.8 million realized during the same period last year, resulting in a net comparative reduction in operating income of $53.8 million. Due to the dual-fuel capability of the Ravenswood Generating Station and the impact that the two hurricanes in the summer of 2005 in the Gulf Coast of the United States had on oil and gas prices, KeySpan was able to "lock-in" very favorable fuel pricing and resultant electric energy margins during the later part of 2005 for the early part of 2006.

Offsetting, to some extent, the adverse impact of the comparative hedging results, was an increase in physical "spark-spreads" (the selling price of electricity less the cost of fuel, exclusive of hedging gains or losses), which resulted in a benefit of $7.0 million to energy margins for the first six months of 2007 compared to the same period of 2006.

Net revenues for the first six months of 2007 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, increased $24.5 million compared to the same period of 2006. The increase is due, in part, to recovery of operations and maintenance charges billed to LIPA of approximately $14.0 million. These recoveries had no impact on operating income since actual expenses increased by a like amount. Therefore, only approximately $10.5 million of the increase in net revenues resulted in a benefit to operating income. This increase in net revenues from the LIPA service agreements was driven by higher capacity revenues, which are predominately timing in nature, as well as from higher off-system electric energy sales, emission credit sales and variable revenues, which are a function of electric generation.

As noted, KeySpan has a Swap Agreement for a fixed for floating unforced capacity financial swap with Morgan Stanley Capital Group Inc. This agreement has a three year term that began on May 1, 2006. For the first six months of 2007, KeySpan realized a gain of $4.6 million from this derivative financial instrument compared to a gain of $17.7 million realized last year. As mentioned previously, this financial swap is anticipated to produce operating income in the summer months of May through October and operating losses in the winter months of November through April. Since the swap was entered into in May 2006, results for the first six months of 2006 contain only the positive contribution associated with May and June 2006. For the first six months of 2007, earnings from this derivative instrument included losses for the period January through April.

Revenues associated with KeySpan's electric marketing activities increased $2.0 million in the first six months of 2007 compared to same period of 2006 mainly attributable to favorable pricing.

*Operating Expenses*

For the three months ended June 30, 2007, operating expenses increased $9.2 million, or 3%, compared to the same quarter of 2006. Operations and maintenance expenses increased $4.6 million mainly due to an increase in overhaul costs and outage work performed on our Long Island based electric generating units.

Operating taxes, principally property taxes, increased $4.3 million in the second quarter of 2007 compared to the same quarter of 2006. These taxes are primarily associated with KeySpan's Long Island based electric generating units and are fully recoverable from LIPA.

For the six months ended June 30, 2007, operating expenses increased $36.9 million compared to the same period of 2006. Operations and maintenance expenses increased $34.7 million reflecting, in part, a $14.0 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 actually impacted operating income increased approximately $20.7 million. These expenses reflect, in part, an increase in overhaul costs and non-outage maintenance work performed on the Ravenswood Generating Station and our Long Island based electric generating units amounting to $12.8 million. The remaining increase was mainly due to higher general and administrative costs and the timing of maintenance work on LIPA's transmission and distribution system.

Operating taxes, principally property taxes, increased $3.9 million in the first six months of 2007 compared to the same period of 2006. Comparative depreciation charges decreased $1.7 million year-over-year. These costs are primarily associated with KeySpan's Long Island based electric generating units and are fully recoverable from LIPA.

*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 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 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 New York Independent System Operator ("NYISO") included the Melville project in its Reliability Report as one of the market solutions to help address the long-term reliability of New York State's electric grid. At June 30, 2007, total capitalized costs associated with the siting, permitting and procurement of equipment for the Melville facility were $64.8 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) | Three Months Ended June 30, 2007 | 2006 | Six Months Ended June 30, 2007 | 2006 |
|---|---|---|---|---|
| Revenues | $ 54.9 | $ 52.6 | $ 109.6 | $ 103.4 |
| Operating expenses | 52.9 | 50.6 | 106.2 | 101.8 |
| Operating Income | $ 2.0 | $ 2.0 | $ 3.4 | $ 1.6 |

The Energy Services segment posted an operating profit of $2.0 million for the quarter ended June 30, 2007, even with last year. KeySpan's fiber optic operations realized a benefit to operating income from an increase in bandwidth sales and the successful completion of certain projects. In addition, general and administrative expenses were lower in 2007 compared to 2006 as a result of the implementation of cost containment measures. These benefits to comparative operating income were completely offset by a reduction in earnings under long-term energy service and energy supply contracts.

For the six months ended June 30, 2007 operating income in the Energy Services segment increased $1.8 million. KeySpan's fiber optic operations realized higher operating income of $0.9 million year-over-year from an increase in bandwidth sales and the successful completion of certain projects. In addition, general and administrative expenses were $1.6 million lower in 2007 compared to 2006. However, earnings under long-term energy service and energy supply contracts decreased $0.7 million year-over-year.

**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.

This segment is also engaged in pipeline development activities. KeySpan and Spectra 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 for these energy-related investments is set forth in the following table for the periods indicated.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 | 2007 | 2006 |
| Revenues | $ 10.5 | $ 11.2 | $ 21.8 | $ 20.4 |
| Less: Operation and maintenance expense | 6.4 | 7.4 | 12.8 | 14.0 |
| Other operating expenses | 3.5 | 3.0 | 7.0 | 6.2 |
| Add: Equity earnings | 4.9 | 2.9 | 8.5 | 6.3 |
| Sale of assets | - | - | - | 0.2 |
| Operating Income | $ 5.5 | $ 3.7 | $ 10.5 | $ 6.7 |

As indicated in the above table, operating income for the Energy Investments segment increased $1.8 million in the second quarter of 2007 compared to the corresponding quarter of 2006 due to generally higher earnings on equity investments.

For the six months ended June 30, 2007, operating income increased $3.8 million compared to the same period in 2006 reflecting an increase in operating income from a KeySpan subsidiary engaged in the transportation of liquefied natural gas, lower general and administrative expenses and generally higher earnings on equity investments.

*Other Matters*

In order to serve the anticipated market requirements in our New York service territories, KeySpan and Spectra Energy Corporation each have a 50% ownership 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. 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. Oral argument was conducted on April 10, 2007. Subject to obtaining final permits and financing, Islander East anticipates that this pipeline will be in service in late 2008. As of June 30, 2007, KeySpan's total capitalized costs associated with the siting and permitting of the Islander East pipeline were approximately $32.2 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, New York 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 has commenced construction of the project and is in the process of finalizing agreements with lenders to provide financing for the construction of the balance of the project, as well as finalizing certain agreements pertaining to the completion of construction of the project. Subject to the final negotiation and execution of these agreements, Millennium expects that the first phase of the project will be in service by November 2008. As of June 30, 2007, KeySpan's investment in the Millennium Pipeline project was $28.7 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 third or fourth 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. An unfavorable outcome to the FERC litigation would mean that KeySpan would be unable to construct the proposed upgrade. Similarly, if the FERC litigation is resolved favorably but the Rhode Island litigation is not, KeySpan could be required to obtain a permit under Rhode Island State law. If the Rhode Island State law permit were denied, an appeal would lie only with the Rhode Island State court. Accordingly, an unfavorable outcome to the Rhode Island litigation could similarly have a material impact on KeySpan's ability to proceed with the proposed upgrade.

Pursuant to a letter agreement with BG LNG Services extending the term of the current precedent agreement referenced above, BG LNG Services reimbursed KeySpan LNG $7.6 million for a portion of its development costs. If the project is placed into service, BG LNG Services may elect to have this contribution count as a contribution reducing BG LNG Services cost of service for the Project or return to BG LNG Services in full on the service commencement date, in which case such costs will be included in the cost of service under the service agreement. As of June 30, 2007, our investment in this project was $11.5 million.

**Allocated Costs**

We are subject to the jurisdiction of the FERC under the Public Utility Holding Company Act of 2005 ("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" of $20.3 million for the three months ended June 30, 2007 compared to the same quarter last year, reflects, in part, lower legal and consulting costs incurred this year associated with KeySpan's pending Merger with National Grid plc of approximately $8.0 million. Additionally, employee benefit costs and the timing of service company allocations resulted in a favorable variation year-over-year of $17.8 million. These costs, other than service company allocations, reside at KeySpan's holding company level and are not allocated to KeySpan's operating segments. During the second quarter of 2006, 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 three months ended June 30, 2006 associated with these settlement agreements.

The operating income variation as reflected in "elimination and other" of $27.2 million for the first six months of 2007 compared to the same period last year, reflects, in part, lower legal and consulting costs incurred this year associated with KeySpan's pending Merger with National Grid plc of approximately $8.0 million, as previously noted. Additionally, employee benefit costs, corporate advertising and sponsorship fees, as well as the timing of service company allocations resulted in a favorable variation year-over-year of $24.7 million. As noted above, in 2006 KeySpan recorded a $5.5 million benefit in its Consolidated Statement of Income associated with settlement agreements with its insurance carriers for recovery of certain environmental costs.

**Liquidity**

Cash flow from operations decreased $183.6 million during the first six months of 2007 compared to the same period of 2006 primarily reflecting changes in working capital requirements. The variation in working capital requirements was primarily driven by the favorable impact of receipt of customer payments during the early part of 2006 associated with the 2005 fourth quarter winter heating season, partially offset by the adverse impact of cash payments for natural gas purchases. Outstanding accounts receivable balances associated with KeySpan's gas distribution activities at December 31, 2005 were high due to strong gas sales in 2005 and unusually high natural gas prices. The collection of these accounts receivables generated significant cash flow in 2006. Also as a result of the unusually high natural gas prices in 2005, comparative accounts payable balances associated with natural gas purchases were also high at December 2005. Payment of these outstanding payable balances during the early part of 2006 offset some of the cash benefits from the collection of outstanding accounts receivables previously noted.

At June 30, 2007, we had cash and temporary cash investments of $496.5 million. During the first six months of 2007, we borrowed $46.5 million of commercial paper and at June 30, 2007, Keyspan had $131.5 million commercial paper outstanding at which time the average interest rate was 5.49%. We had the ability to borrow up to an additional $1.4 billion at June 30, 2007, under the terms of our credit facility. The majority of KeySpan's cash and temporary cash investments balance at June 30, 2007, resides with its New York based gas distribution utilities. As dictated by New York State Public Service Commission ("NYPSC") policy, KeySpan is prohibited from using excess utility funds for general corporate purposes, i.e. this cash can only be used for KeySpan's New York based gas distribution operations. As a result, during the six months ended June 30, 2007, KeySpan needed to borrow commercial paper for working capital requirements not associated with its New York based gas distribution utilities.

KeySpan has two credit facilities which total $1.5 billion - $920 million for five years through 2010, and $580 million 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 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 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 June 30, 2007, KeySpan's consolidated indebtedness was 49.4% 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. 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 Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement" 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:

| | Six Months Ended June 30, | |
|---|---|---|
| *(In Millions of Dollars)* | 2007 | 2006 |
| Gas Distribution | $ 192.2 | $ 184.9 |
| Electric Services | 38.8 | 42.9 |
| Energy Investments | 12.8 | 12.8 |
| Energy Services and other | 2.3 | 6.4 |
| | $ 246.1 | $ 247.0 |

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. KeySpan anticipates incurring approximately the same amount of construction expenditures in 2007 as it incurred in 2006.

*Financing*

KeySpan did not engage in any financing activities during the first six months of 2007, other than commercial paper borrowings as noted earlier. At this point in time, KeySpan does not anticipate engaging in any financing activities in the next twelve months, except for the potential refinancing of maturing long-term debt.

The following table represents the ratings of KeySpan's long-term debt at June 30, 2007. In 2004 Standard & Poor's reaffirmed its ratings on KeySpan's and its subsidiaries' long-term debt. Further in 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 June 30, 2007. 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 $66.2 million of surety bonds associated with certain construction projects currently being performed by former subsidiaries; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of $95.9 million; and (iii) $76.6 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.

As noted previously, KeySpan owns a 26.25% ownership interest in the Millennium Pipeline Company LLC ("Millennium"), the developer of the Millennium Pipeline project. The other partners in the Millennium Pipeline project are Columbia Transmission 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, New York to Ramapo, New York, interconnecting with the pipeline systems of various other utilities in New York. Subject to the receipt of certain remaining permits and financing, Millennium expects that the first phase of the project will be in service by November 2008.

Consolidated Edison, KEDLI and Columbia Transmission have each entered into precedent agreements to purchase capacity on the pipeline. Upon and subject to the terms and conditions set forth in Precedent Agreements, KeySpan has agreed to guarantee the full and prompt payment of $15.8 million (the "Guaranteed Amount") of the contingent $60 million financial obligation that Millennium may incur for liquidated damages under the Precedent Agreements to Consolidated Edison and KEDLI. The liquidated damages are intended to reimburse Consolidated Edison and KEDLI for costs incurred to secure additional capacity if Millennium is unable to provide the contracted capacity. The guaranteed amount reflects KeySpan's proportionate share of the $60 million of financial security that is required to be provided to Consolidated Edison and KEDLI pursuant to the Precedent Agreements based on KeySpan's proportionate ownership interest in the Millennium Pipeline project. At June 30, 2007, the fair value of these guarantees was $0.7 million and has been recorded as a deferred liability and as an increase to the Millennium investment on KeySpan's Consolidated Balance Sheet. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees.)

**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. These obligations, which were disclosed in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, have remained substantially unchanged since December 31, 2006. (For additional details regarding these obligations see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, as well as Note 6 "Long-Term Debt" and Note 7 "Contractual Obligations, Financial Guarantees and Contingencies" to those Consolidated Financial Statements.)

In addition to the above obligations, in January 2007, KeySpan adopted the provisions of FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes – An Interpretation of FASB Statement no. 109" ("FIN 48"). At June 30, 2007, KeySpan had a liability for unrecognized tax benefits of $84.3 million, which includes accrued interest payable of $29 million. At this point in time we are unable to determine the timing of future tax payments. For additional details on the implementation of FIN 48 see, Note 11 to the Consolidated Financial Statements "Adoption of FASB Interpretation 48."

**Discussions 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.

Below is a discussion of KeySpan's critical accounting policies and assumptions at June 30, 2007. For a more detailed discussion of these policies and assumptions see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations "Discussion of Critical Accounting Policies and Assumptions."

*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 annual operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set annual budgetary guidelines. At June 30, 2007, 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.

*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 orders issued by the MADTE relating to the Eastern Enterprise acquisition in 2000, 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.

As is further discussed under the caption "Regulation and Rate Matters," in October 2003 the MADTE rendered its decision on the Boston Gas Company 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. 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*

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.

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At June 30, 2007, we had a funding credit balance in excess of the ERISA minimum funding requirements. Although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Therefore, for 2007 KeySpan expects to contribute a total of $131 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. (In addition to Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations in KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, see also Note 4 of those Consolidated Financial Statements, "Postretirement Benefits.")

*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.

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. 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 declared a quarterly common stock dividend of $0.475 per share, payable August 1, 2007, to shareholders of record as of July 11, 2007. This dividend payment reflects an annual increase of $0.04 per share over last year's dividend.

In anticipation of the close of the pending Merger with National Grid plc, KeySpan's Board of Directors approved the payment of a pro-rata dividend to shareholders of record one business day prior to the transaction close date with National Grid plc. The amount of such dividend will be based on the number of days elapsed between July 9, 2007 (ex-dividend date), up to but not including the closing date.

**Regulation and Rate Matters**

*Gas Matters*

The rate agreements for KEDNY and KEDLI have expired. Under the terms of the KEDNY and

KEDLI rate agreements, gas distribution rates and all other provisions will remain in effect until changed by the NYPSC. As discussed in the "Introduction to the Notes to the Consolidated Financial Statements," in late June 2007, KeySpan and National Grid plc reached an agreement in principle with the Staff of the NYPSC, the New York State Consumer Protection Board and certain other parties that would, upon NYPSC approval, resolve all issues in the pending Merger application before the NYPSC. On July 6, 2007, the Merger and Gas Revenue Requirement Joint Proposal (the "Merger JP") was filed with the NYPSC and the Administrative Law Judges presiding over the Merger proceeding.

The Merger JP supersedes the proposed ten-year rate plan included with the merger application filed with the NYPSC on July 20, 2006. If adopted by the NYPSC, the Merger JP would provide for five-year rate plans for KEDNY and KEDLI that would go into effect on January 1, 2008. The Merger JP provides for no increase in gas delivery rates in each of the five years of KEDNY's merger rate plan and an increase of $60 million in gas delivery rates in the first year of the KEDLI merger rate plan and no further increase in years two through five. The individual KEDNY and KEDLI rate plan applications filed with the NYPSC on October 3, 2006 will supplement the Merger JP. If the Merger JP is approved by the NYPSC, the merger rate plans, as they may be supplemented by KEDNY's and KEDLI's individual rate cases, will go into effect on January 1, 2008.

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 $8.7 million under the Plan. In addition, an increase of $3.7 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 Boston Gas's 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'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 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 base rates continue as set by the NHPUC in 1993.

For an additional discussion of our current gas distribution rate agreements, see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Regulation and Rate Matters."

*Electric 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. The settlement agreement reflects a cost of equity of 9.5%, as well as 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. (For a further discussion on the LIPA agreements see Note 10 to the Consolidated Financial Statements "2006 LIPA Settlement," as well as KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Electric Services – LIPA Agreements.")

*The Public Utility Holding Company Act of 2005*

Pursuant to PUHCA 2005, FERC 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. The SEC's jurisdiction over KeySpan's activities is limited to the registration and issuance of our securities under the federal securities laws. Moreover, our affiliate transactions also remain subject to certain regulations of the NYPSC, MADTE and NHPUC, in addition to FERC.

**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.

We estimate that the remaining cost of our MGP related environmental cleanup activities, including costs associated with the Ravenswood Generating Station, will be approximately $340.4 million and we have recorded a related liability for such amount. We have also recorded an additional $8.7 million liability, representing the estimated environmental cleanup costs related to a former coal tar processing facility. As of June 30, 2007, we have expended a total of $248.7 million on environmental investigation and remediation activities. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies.")

**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, 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. The most significant contingency involves the evolution of the gas distribution and electric industries towards more competitive and deregulated environments. The risks associated with KeySpan's gas distribution operations have not changed substantially since December 31, 2006. For additional information regarding these risks see KeySpan's Annual Report on Form 10-K for the year ended December 31, 2006, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Market and Credit Risk Management Activities." The following is an update to certain matters related to KeySpan's electric operations.

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 require 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, were rejected.

The NYISO, Consolidated 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, which appeal is pending.

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 Consolidated Edison developed additional mitigation measures that would apply to certain In-City generation owned by KeySpan. These mitigation measures essentially proposed to 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, from the current offer cap of $105/kW-year to $82/kW-year plus 3%.

FERC rejected the $82 In-City Capacity Mitigation Proposal filed by the NYISO. FERC found that the NYISO filing failed to meet the burden of proof required to support revisions to market rules. Nevertheless, on its own motion, FERC initiated a proceeding to investigate and consider the justness and reasonableness of the NYISO's In-City capacity market, including whether and how market rules should be revised to provide a fair level of compensation that will attract and retain needed infrastructure.
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, if the FERC rules that a refund is required, the effective date will be on or about May 15, 2007 regardless of when this proceeding is completed. However, the FERC is under no obligation to order refunds and has not indicated whether it intends to do so in this proceeding. In connection with this proceeding, in July 2007, KeySpan received notice that the FERC Office of Enforcement is conducting a formal investigation into matters regarding the offering practices of generating units serving New York City's In-city capacity market.

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 the Astoria discrepancy.

On March 15, 2007, FERC issued an order denying the NYISO's complaint against Astoria regarding Astoria's capacity certification prior to the May 2006 installed capacity auctions. Even though FERC denied the complaint, it found that Astoria did not supply its certified capacity in May 2006, and must therefore pay a deficiency charge for its capacity shortfall. The NYISO was directed to pay the affected suppliers for the capacity it supplied in May. On April 16, 2007, the Ravenswood Generating Station sought clarification and rehearing of the order. The NYISO also sought clarification and Astoria requested a rehearing. A decision by the FERC related to the rehearing and clarification requests 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. The case is still pending at FERC and 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.

**Item 3. 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. The Ravenswood Generating Station uses derivative physical and financial instruments to economically 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 economically hedges the cash flow variability associated with a portion of electric energy sales using OTC electricity swaps.

*Commodity Derivative Instruments that are not Accounted for as Hedges:* As noted above, the Ravenswood Generating Station uses derivative physical and financial instruments to economically 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 as well as portion of electric energy sales. A portion of the derivative financial instruments associated with the Ravenswood Generating Station do not qualify for hedge accounting treatment under SFAS 133.

KeySpan also employees a limited number of OTC natural gas swaps to hedge a small portion of its risk associated with changing prices for fleet fuel. Additionally, KeySpan has an International SWAP Dealers Association Master Agreement ("Swap Agreement") for a fixed for floating unforced capacity financial swap with Morgan Stanley Capital Group Inc.

The following tables set forth selected financial data associated with these derivative financial instruments noted above that were outstanding at June 30, 2007.

| Type of Contract | Year of Maturity | Volumes mmcf | Fixed Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Gas** | | | | | |
| Swaps/Futures - Long Natural Gas | 2007 | 11,881 | 7.68 - 9.82 | 6.77 - 8.57 | (11.3) |
| | 2008 | 687 | 9.08 - 9.82 | 7.85 - 8.93 | (0.3) |
| OTC Swaps - Short Natural Gas | 2007 | 1,371 | 5.86 - 9.98 | 6.77 - 8.57 | (2.0) |
| | 2008 | 1,944 | 6.77 - 8.90 | 7.85 - 9.24 | (3.2) |
| | 2009 | 1,341 | 7.60 - 10.90 | 7.88 - 9.51 | (0.1) |
| Optimization Contract | | | | | 0.7 |
| | | 17,224 | | | (16.2) |

| Type of Contract | Year of Maturity | Volumes Barrels | Fixed Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| **Oil** | | | | | |
| Swaps - Long Fuel Oil | 2007 | 172,408 | 48.30 - 67.60 | 58.39 - 59.64 | 1.1 |
| | 2008 | 60,607 | 60.00 - 67.60 | 59.14 - 61.74 | (0.3) |
| | | 233,015 | | | 0.8 |

| Type of Contract | Year of Maturity | MWh | Fixed Margin/ Price $ | Current Price $ | Fair Value (In $ Millions) |
|---|---|---|---|---|---|
| Electricity | | | | | |
| Swaps - Energy | 2007 | 1,137,804 | 65.05 - 135.50 | 59.50 - 135.50 | 12.9 |
| | 2008 | 35,920 | 67.95 - 70.10 | 60.00 - 84.50 | - |
| UCAP Swap | 2009 | | | | (1.0) |
| | | 1,173,724 | | | 11.9 |

| *Change in Fair Value of Derivative Instruments* | 2007 (In $ Millions) |
|---|---|
| Fair value of contracts at January 1, | (5.6) |
| Net (gains) on contracts realized | (5.3) |
| Increase in fair value of all open contracts | 7.4 |
| Fair value of contracts outstanding at June 30, | (3.5) |

| *(In Millions of Dollars)* | | | |
|---|---|---|---|
| | Fair Value of Contracts | | |
| Sources of Fair Value | Mature Within 12 Months | Thereafter | Total Fair Value |
| Prices actively quoted | $ (14.5) | $ (1.7) | $ (16.2) |
| Local published indicies | 12.7 | - | 12.7 |
| | $ (1.8) | $ (1.7) | $ (3.5) |

We measure the commodity risk of our derivative hedging instruments using a sensitivity analysis. Based on a sensitivity analysis as of June 30, 2007 a 10% increase/decrease in natural gas prices would decrease/increase the value of derivative instruments maturing in one year by $4.2 million.

The main driver of the Swap Agreement is the clearing price of capacity in the NYISO administered Spot auction. If the Spot auction clearing prices were to clear at $7.32, which is $0.25 per kW-Month below the fixed price of $7.57 per kW-Month in the Swap Agreement, assuming no other capacity market changes, KeySpan would incur a loss of $0.5 million per month. If the Spot auction clearing prices were to clear at $7.82, which is 0.25 per kW-Month above the fixed price of $7.57 per kW-Month in the Swap Agreement, assuming no other capacity market changes, KeySpan would incur a gain of $0.5 million per month.
*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. Further, KeySpan has a gas distribution asset optimization contract that employs derivative financial instruments. 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 June 30, 2007.

| Type of Contract | Year of Maturity | Volumes mmcf | Floor ($) | Ceiling ($) | Fixed Price ($) | Current Price ($) | Fair Value (In $ Millions) |
|---|---|---|---|---|---|---|---|
| Options | 2007 | 450 | 5.50 - 7.00 | 8.00 - 9.50 | - | 6.77 - 8.57 | (1.5) |
| | 2008 | 830 | 7.00 | 9.50 | - | 7.85 - 8.93 | (0.8) |
| Swaps | 2007 | 30,919 | | | 6.79 - 11.18 | 6.77 - 8.57 | (29.0) |
| | 2008 | 57,624 | | | 7.16 - 11.64 | 7.85 - 9.24 | (34.8) |
| | 2009 | 6,831 | | | 7.92 - 9.96 | 7.89 - 9.51 | (2.1) |
| Optimization Contract | | | | | | | 14.3 |
| | | 96,654 | | | | | (53.9) |

See Note 4 to the Consolidated Financial Statements "Hedging and Derivative Financial Instruments" for a further description of all our derivative instruments.

## Item 4. Controls and Procedures

We maintain disclosure controls and procedures (as defined under Exchange Act Rule 13a-15(e) and 15d-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 June 30, 2007. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that the design and operation of our disclosure controls and procedures were effective at the reasonable assurance level in alerting them timely to material information required to be included in KeySpan's periodic SEC reports.

Furthermore, there has been no change in KeySpan's internal control over financial reporting 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.

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

See Note 6 to the Consolidated Financial Statements "Financial Guarantees and Contingencies."

## Item 1A. Risk Factors

Certain statements contained in this Quarterly Report on Form 10-Q concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are other than statements of historical facts, are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Without limiting the foregoing, all statements under the captions "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk" relating to our future outlook, anticipated capital expenditures, future cash flows and borrowings, pursuit of potential future acquisition opportunities and sources of funding, are forward-looking statements. Such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties and actual results may differ materially from those discussed in such statements.

Among the factors that could cause actual results to differ materially are:

- the occurrence of any event, change or other circumstances that could give rise to the termination of the Merger Agreement with National Grid plc or the failure of the Merger to close for any reason;
- volatility of fuel prices 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 manage our cost structure and operate efficiently;
- our ability to successfully contract for natural gas supplies required to meet the needs of our customers;
- implementation of new accounting standards or changes in accounting standards or Generally Accepted Accounting Principles which may require adjustments to financial statements;
- inflationary trends and interest rates;
- the ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of such acquisitions;

- available sources and cost of fuel;
- creditworthiness of counterparties to derivative instruments and commodity contracts;
- the resolution of certain disputes with LIPA concerning each party's rights and obligations under various agreements;
- retention of key personnel;
- federal and state regulatory initiatives that threaten cost and investment recovery, and place limits on the type and manner in which we invest in new businesses and conduct operations;
- the impact of federal, state and local utility regulatory policies, legislation 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 facing our unregulated Energy Services businesses;
- 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;
- a change in the fair market value of our investments that could cause a significant change in the carrying value of such investments or the carrying value of related goodwill;
- timely receipts of payments from LIPA and the NYISO, our two largest customers;
- changes in the unforced capacity financial swap pricing structure;
- receipt of approval for, and the timing thereof, the 2006 LIPA Agreements; and
- other risks detailed from time to time in other reports and other documents filed by KeySpan with the SEC

For any of these statements, KeySpan claims the protection of the safe harbor for forward-looking information contained in the Private Securities Litigation Reform Act of 1995, as amended. For additional discussion on these risks, uncertainties and assumptions, see "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk."

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Submission of Matters to a Vote of Security Holders**

None

**Item 5. Other Information**

None

**Item 6. Exhibits**

31.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1* Certification of the Chairman and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

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*Filed Herewith

## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on behalf of the undersigned there unto duly authorized.

**KEYSPAN CORPORATION**

(Registrant)

By: /s/Gerald Luterman
Name: Gerald Luterman
Title: Executive Vice President and
Chief Financial Officer

Date: August 3, 2007

/s/ Gerald Luterman
Gerald Luterman
Executive Vice President and Chief
Financial Officer

Date: August 3, 2007

/s/ Theresa A. Balog
Theresa A. Balog
Vice President and
Chief Accounting Officer

**ENERGYNORTH NATURAL GAS, INC d/b/a NATIONAL GRID NH**
**Dues & Memberships**
**Test Year Expenditures in Excess of $5,000**
**PUC 1604.01(a)(11)**

| Project | Proj Description | Activity | Activity Description | Account | Account Description | Cost Type | CT Description | Provider Cost Center | Provider Company | PER Net |
|---|---|---|---|---|---|---|---|---|---|---|
| K02158 | Community Affairs NE | 002420 | CORPORATE SPONSORED MEMBERSHIPS | 9210K | Office Supplies and Expenses | 450 | DUES AND MEMBERSHIPS | 345 CORPORATE AFFAIRS | KEYSPAN CORPORATE SERVICES (31) * | 11,209.26 |
| K02102 | VP Field Operations NE | 002004 | GENERAL & ADMINISTRATIVE EXPENSE | 88700 | T&D-MAINTENANCE OF MAINS | 450 | DUES AND MEMBERSHIPS | 114 VP DELIVER GAS NE | EnergyNorth Company (06) | 18,163.54 |

* Note: These charges all represent Service Company allocations of EnergyNorth's share of Dues & Memberships. Specific details are maintained in the Service Company and will be furnished upon request.

**Management Audits and Depreciation Studies**
**Performed Within the Last Five Years**
**(1604.01(a)(12))**

No management or depreciation studies have been undertaken by the company in the past five years. The depreciation study that is being filed with this case can be found at Attachment PMN-2 to the Testimony of Paul Normand.

## Audits or Studies Referred to in 1604.01(a)(12) (1604.01(a)(13))

There are none

**EnergyNorth Natural Gas, Inc.**
**Principal Officers as of January 31, 2008**
**Compensation for 2006 and 2007**
**1604.01(a)(14)**

| | | 2006 | | | 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| **Name** | **Title** | **Base Salary at 12/31/06** | **Bonus Paid 3/15/06** | **Total** | **Base Salary at 12/31/07** | **Bonus Paid 3/15/07** | **Bonus Paid 9/07/07** | **Total** |
| Akley, William J. | Senior Vice President, Gas Operations | | | | | | | |
| Bailey, Paul J. | Vice President & Controller | | (a) | | | (b) | | |
| Bishar, John J., Jr. | Executive Vice President & Secretary | | **REDACTED** | | | **REDACTED** | | |
| Daly, Kenneth D. | Senior Vice President & Chief Financial Officer | | | | | | | |
| Doxsee, David B. | Vice President & Treasurer | | | | | | | |
| Murphy, Richard D. | Senior Vice President, Sales & Account Management | | | | | | | |
| Saad, Daniel G. | Vice President, Gas Operations | | | | | | | |
| Stavropoulos, Nickolas | President & Chief Operating Officer | | | | | | | |

**(a)** Annual bonus paid in June 2006
**(b)** Annual bonus paid in June 2007

Note: Each individual is employed by one of National Grid's service companies. Only a portion of the salaries listed above are allocated to EnergyNorth Natural Gas, Inc.

Note: Mr. Stavropoulous is the sole director of EnergyNorth Natural Gas, Inc.

# Voting Stock
# (1604.01(a)(15))

EnergyNorth Natural Gas, Inc. is 100% owned by KeySpan New England, LLC. As such, all its voting stock is owned by KeySpan New England, LLC. There are no voting shares owned by an officer or director individually, by the spouse or minor child of an officer or director, or controlled by the officer or director directly or indirectly.

EnergyNorth (06)
Payments to Individuals or Corporations for Contractual Services*

Test year : July 01st, 2006 - June 30th, 2007

| Vendor Long | TYPE | PAYMENT $ | |
|---|---|---|---|
| ACTION, INC. | PRODUCT SUPPLIERS | $479,487.20 | |
| R H WHITE CONSTRUCTION CO INC | PIPELINE CONTRACTORS | $7,420,067.13 | |
| MCLANE, GRAF, RAULERSON | LEGAL | $1,911,133.98 | |
| PHH VEHICLE MANAGEMENT SERVICES | LEASING COMPANIES | $554,509.74 | |
| CORAL ENERGY RESOURCES LP | GAS SUPPLIERS | $28,672,165.57 | |
| TENNESSEE GAS PIPELINE CO | GAS SUPPLIERS | $7,960,486.27 | |
| CHEVRONTEXACO | GAS SUPPLIERS | $4,143,360.78 | |
| ALBERTA NORTHEAST GAS | GAS SUPPLIERS | $4,049,231.76 | |
| DEUTSCHE BANK SECURITIES INC CUSTOMER SEGREGATED ACCOUNT | GAS SUPPLIERS | $3,940,183.55 | |
| DTE ENERGY TRADING | GAS SUPPLIERS | $3,363,828.20 | |
| DISTRIGAS OF MASSACHUSSETS | GAS SUPPLIERS | $3,306,507.43 | |
| LOUIS DREYFUS ENERGY | GAS SUPPLIERS | $2,433,816.80 | |
| TOTAL GAS & POWER NORTH AMERICA, INC | GAS SUPPLIERS | $863,646.45 | |
| BARCLAYS CAPITAL | GAS SUPPLIERS | $634,370.40 | |
| IROQUOIS GAS TRANSMISSION SYSTEM | GAS SUPPLIERS | $314,872.92 | |
| PORTLAND NATURAL GAS | GAS SUPPLIERS | $299,781.35 | |
| NATIONAL FUEL GAS SUPPLY CORP | GAS SUPPLIERS | $273,293.86 | |
| AES LONDONDERRY CONST. | GAS SUPPLIERS | $244,304.32 | |
| MERRILL LYNCH COMMODITIES INC | GAS SUPPLIERS | $159,312.74 | |
| CONSTELLATION POWER SOURCE INC | GAS SUPPLIERS | $149,334.24 | |
| HESS ENERGY SERVICES CO LLC | GAS SUPPLIERS | $140,106.95 | |
| UBS WARBURG ENERGY | GAS SUPPLIERS | $116,155.50 | |
| HONEOYE STORAGE CORPORATION | GAS SUPPLIERS | $104,932.68 | |
| SPRAGUE ENERGY CORP. | FLEET FUEL | $205,184.04 | |
| SEMPRA ENERGY TRADING CORP | ENERGY PURCHASES | $11,627,219.58 | |
| EMERA ENERGY SERVICES, INC | ENERGY PURCHASES | $10,498,001.61 | |
| TENASKA MARKETING VENTURES | ENERGY PURCHASES | $10,042,135.25 | |
| J. ARON & COMPANY | ENERGY PURCHASES | $2,282,394.80 | |
| ETC MARKETING LTD | ENERGY PURCHASES | $1,409,368.12 | |
| COUNTRY GAS DISTRIBUTORS | ENERGY PURCHASES | $1,149,449.92 | |
| SOUTHWEST ENERGY LP | ENERGY PURCHASES | $1,114,500.00 | |
| VIRGINIA POWER ENERGY MARKETING, INC | ENERGY PURCHASES | $517,473.65 | |
| HONEYWELL INTERNATIONAL | CONTRACTORS | $380,745.20 | |
| MSR UTILITY MAINTENANCE | CONTRACTORS | $106,953.50 | |
| ANCHOR ENVIRONMENTAL LLC | CONSULTANTS | $113,759.29 | |
| NORTHEAST GAS MARKET | ASSOCIATIONS | $8,107,063.18 | ** |
| TRANSGAS INC | LNG TRUCKING | $248,347.54 | |
| | | $119,337,485.50 | |

* Service company allocations not included
** Note - Payments to NORTHEAST Gas Marketers are comprised of $13,384.65 for Service Fees and $8,093,678.53 for pass through payments to third party gas suppliers.

# Asset and Cost Allocations for Non-Utility Operations (1604.01(a)(17))

There are none

TABLE 10 — BALANCE SHEET ACCOUNTS — 100

Sheet 1 of 3 — Assets and Other Debits

| | Balance at Beginning of period 1/1/2004 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2004 | Increase or Decrease |
|---|---|---|---|---|---|---|
| | | | Fixed Assets: | | | |
| 1. | 231 505,942 | 100 | Fixed Capital--Gas | 102 | 243,752,458 | 12,246,516 |
| 2. | | 108 | Fixed Capital--Other | | | |
| 3. | 146,949 | 110 | Non-Operating Property | 104 | 146,949 | 0 |
| 4. | **231,652,891** | | **Total Fixed Assets** | | **243,899,407** | **12,246,516** |
| | | | Investments: | | | |
| 5. | | 111 | Investments in Affiliated Companies | 105 | | |
| 6. | 183 | 112 | Miscellaneous Investments | 105 | 183 | 0 |
| 7. | | 113 | Sinking Funds | 106 | | |
| 8. | | 114 | Miscellaneous Special Funds | 106 | | |
| 9. | | 115 | Depreciation Funds | 106 | | |
| 10. | **183** | | **Total Investments** | | **183** | **0** |
| | | | Current Assets: | | | |
| 11. | 605,876 | 120 | Cash | | 0 | (605,876) |
| 12. | 0 | 121 | Special Deposits | | 0 | 0 |
| 13. | 0 | 122 | Working Funds | | 0 | 0 |
| 14. | 0 | 124 | Notes Receivable | | 0 | 0 |
| 15. | 18,394,701 | 125 | Accounts Receivable | 107 | 19,719,227 | 1,324,526 |
| 16. | 3,887,023 | 126 | Receivables from Affiliated Companies | 107 | 1,520,043 | (2,366,980) |
| 17. | | 127 | Subscriptions to Capital Stock | | | |
| 18. | 0 | 128 | Interest and Dividends Receivable | | 0 | 0 |
| 19. | 12,264,678 | 131 | Materials and Supplies | 107 | 14,721,037 | 2,456,359 |
| 20. | 800 | 132 | Prepayments | 106 | 83,806 | 83,006 |
| 21. | 0 | 133 | Miscellaneous Current Assets | | 0 | 0 |
| 22. | **35,153,078** | | **Total Current Assets** | | **36,044,113** | **891,035** |
| | | | Deferred Debits: | | | |
| 23. | 1,600,122 | 140 | Unamortized Debt Discount and Expense | 108 | 0 | (1,600,122) |
| 24. | 0 | 146.1 | Base Gas Costs | 113 | 0 | 0 |
| 25. | 0 | 143 | Clearing Accounts | | 0 | 0 |
| 26. | | 145.1 | Maintenance Work in Progress | | | |
| 27. | | 145.2 | Jobbing Accounts | | | |
| 28. | 116,159,224 | 146.2 | Miscellaneous Suspense | 113 | 120,133,524 | 3,974,300 |
| 29. | **117,759,346** | | **Total Deferred Debits** | | **120,133,524** | **2,374,178** |
| | | | Company Securities Owned: | | | |
| 30. | | 152 | Reacquired Securities | 106 | | |
| 31. | | 154 | Unissued Securities | | | |
| 32. | | | **Total Company Securities Owned** | | | |
| 33. | **384,565,499** | | **Total Assets and Other Debits** | | **400,077,226** | **15,511,727** |

BALANCE SHEET ACCOUNTS 101
Liabilities and Other Credits

| | Balance at Beginning of period 1/1/2004 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2004 | Increase or Decrease |
|---|---|---|---|---|---|---|
| | | | Capital Stocks: | | | |
| 1. | 3,000,000 | 200 | Common Stock | 109 | 3,000,000 | 0 |
| 2. | 0 | 201 | Preferred Stock | 109 | 0 | 0 |
| 3. | | 202 | Stock Liability for Conversion | | | |
| 4. | | 203 | Premium on Capital Stock | | | |
| 5. | | 204 | Capital Stock Subscribed | | | |
| 6. | | 205 | Installments Paid on Capital Stock | | | |
| 7. | **3,000,000** | | **Total Capital Stocks** | | **3,000,000** | **0** |
| | | | Non-Corporate Proprietorship: | | | |
| 8. | 0 | 209 | Non-Corporate Proprietorship | | | |
| | | | Long Term Debt: | | | |
| 9. | 40,285,000 | 210 | Bonds and Notes | 109 | 0 | (40,285,000) |
| 10. | | 211 | Receivers' Certificates | 109 | | |
| 11. | | 212 | Advances from Affiliated Companies | 109 | | |
| 12. | | 213 | Miscellaneous Long Term Debt | 109 | | |
| 13. | **40,285,000** | | **Total Long Term Debt** | | **0** | **(40,285,000)** |
| | | | Current and Accrued Liabilities: | | | |
| 14. | 0 | 220 | Notes Payable | 110 | 0 | 0 |
| 15. | 14,537,692 | 222 | Accounts Payable | | 19,094,214 | 4,556,523 |
| 16. | 63,720,971 | 223 | Payables to Affiliated Companies | 110 | 108,532,683 | 44,811,712 |
| 17. | 0 | 224 | Dividends Declared | 108 | 0 | 0 |
| 18. | | 225 | Matured Bonds | | | |
| 19. | | 226 | Matured Interest | | | |
| 20. | 228,369 | 227 | Customers' Deposits | | 236,594 | 8,225 |
| 21. | 447,534 | 228 | Taxes Accrued | | (1,486,126) | (1,933,661) |
| 22. | 1,020,968 | 229 | Interest Accrued | | 74,890 | (946,078) |
| 23. | 448,276 | 230.1 | Miscellaneous Current Liabilities | | 449,876 | 1,600 |
| 24. | 543,108 | 230.2 | Miscellaneous Accruals | | 518,294 | (24,814) |
| 25. | **80,946,918** | | **Total Current and Accrued Liabilities** | | **127,420,424** | **46,473,506** |
| | | | Deferred Credits: | | | |
| 26. | | 240 | Unamortized Premiums on Bonds | | | |
| 27. | 34,056,845 | 242 | Miscellaneous Unadjusted Credits | 112 | 35,802,402 | 1,745,557 |
| 28. | **34,056,845** | | **Total Deferred Credits** | | **35,802,402** | **1,745,557** |
| | | | Reserves: | | | |
| 29. | 72,359,366 | 250 | Depreciation Reserve | 111 | 75,651,673 | 3,292,307 |
| 30. | 711,075 | 251 | Amortization Reserve | 112 | 1,242,570 | 531,495 |
| 31. | 1,173,826 | 254 | Uncollectible Accounts Reserve | 112 | 1,349,757 | 175,931 |
| 32. | 0 | 255 | Casualty and Insurance Reserve | 112 | 0 | 0 |
| 33. | | 258.1 | Sinking Funds Reserve | 112 | | |
| 34. | | 258.2 | Reserve for Dividends | 112 | | |
| 35. | (907,455) | 258.3 | Miscellaneous Reserves | 112 | (2,889,859) | (1,982,404) |
| 36. | **73,336,811** | | **Total Reserves** | | **75,354,141** | **2,017,330** |

| BALANCE SHEET ACCOUNTS Liabilities and Other Credits | | | | | | 101 cont. |
|---|---|---|---|---|---|---|
| | Balance at Beginning of period 1/1/2004 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2004 | Increase or Decrease |
| | | | Contribution in Aid of Construction: | | | |
| 1. | 0 | 265 | **Contribution in Aid of Construction** | | 0 | 0 |
| | | | Surplus: | | | |
| 2. | 220,653,012 | 270 | Capital Surplus | 113 | 220,653,012 | 0 |
| 3. | (65,459,800) | 271 | Earned Surplus | | (59,949,512) | 5,510,288 |
| 4. | (2,253,289) | | Other Comprehensive Income | | (2,203,245) | 50,044 |
| 5. | **152,939,923** | | **Total Surplus** | | **158,500,255** | **5,560,332** |
| 6. | **384,565,498** | | **Total Liabilities and Other Credits** | | **400,077,222** | **15,511,724** |

# Income Statement

Table 40 200

2004 PUC Pages 200-206.xls

| | Account Number | Items | 12/31/2004 Amount | Totals | Increase or Decrease | |
|---|---|---|---|---|---|---|
| 1 | 1501 | Operating Revenues - Gas | 146,051,219 | 146,051,219 | 13,159,701 | |
| 2 | 1701-1812 | Operations and Maintenance - Gas | 119,935,615 | | 15,531,394 | |
| 3 | 1503 | Depreciation - Gas | 7,210,408 | | 900,720 | |
| 4 | 1504 | Amortization - Gas | 560,183 | | 108,084 | |
| 5 | 1507 | Taxes - Gas | 7,297,090 | | (2,852,210) | |
| 6 | | Total Revenue Deductions | | 135,003,296 | | 13,687,988 |
| 7 | | Gas Operating Income | | 11,047,923 | | (527,991) |
| 8 | 1508.1 | Rent for Lease of Gas Plant | | | | |
| 9 | 1508.2 | Rent from Lease of Gas Plant | | | | |
| 10 | 1508.3 | Joint Facility Rents | | | | |
| 11 | 1508.4 | Rent from Gas Appliances | | | | |
| 12 | 1508.5 | Miscellaneous Rents | | | | |
| 13 | 1508 | Operating Rents - Net | | | | |
| 14 | | Net Gas Operating Income | | 11,047,923 | - | (527,991) |
| 15 | 1509 | Operating Income - Other Utilities Operations | | - | | |
| 16 | | Net Utility Operating Income | | 11,047,923 | - | (527,991) |
| 17 | 1522 | Revenues from Non-Operating Property | 25,000 | | 29,763 | |
| 18 | 1523 | Dividend Income | | | | |
| 19 | 1524 | Interest Income | 69,835 | | (44,416) | |
| 20 | 1525 | Income From Special Funds | | | | |
| 21 | 1526 | Miscellaneous Non-Operating Revenues | 54,123 | | 45,731 | |
| 22 | | Non-Operating Property Revenues | | 148,958 | - | 31,078 |
| 23 | 1527 | Non-Operating Property Deductions | 120,048 | | 386,896 | |
| 24 | | Reorganization Costs ( + KeySpan Merger Costs) | | | | - |
| 25 | | Non_operating Property Income | | 120,048 | - | 386,896 |
| 26 | | Gross Income | - | 11,316,930 | - | (110,016) |
| 27 | 1530 | Interest on Long-Term Debt | 2,058,751 | | (1,367,790) | |
| 28 | 1531 | Amortization of Debt Discount and Expenses | 39,083 | | (27,917) | |
| 29 | 1533 | Taxes Assumed on Interest | | | | |
| 30 | 1535 | Miscellaneous Interest Deductions | 3,813,710 | | 1,788,036 | |
| 31 | 1536 | Interest Charges to Property-Credit | (104,877) | | 206,543 | |
| 32 | 1537 | Miscellaneous Amortization | | | | - |
| 33 | 1538 | Miscellaneous Deductions from Income | | | | - |
| 34 | 1540 | Contractual Appropriations of Income | | | | - |
| 35 | | Deductions from Income | | 5,806,667 | | 598,872 |
| | | | | | | - |
| 36 | | Income Balance Transferred to Earned Surplus | | 5,510,263 | | (708,888) |

| 12/31/2003 Amount | Totals |
|---|---|
| 132,891,518 | |
| | |
| 104,404,221 | |
| 6,309,688 | |
| 452,099 | |
| 10,149,300 | |
| | 121,315,308 |
| | 11,575,914 |
| - | 11,575,914 |
| - | |
| - | 11,575,914 |
| (4,763) | |
| 114,251 | |
| 8,392 | |
| | 117,880 |
| (266,848) | |
| | (266,848) |
| | 11,426,946 |
| 3,426,541 | |
| 67,000 | |
| 2,025,674 | |
| (311,420) | |
| | 5,207,795 |
| - | 6,219,151 |

| TABLE 10<br>Sheet 1 of 3 | | | BALANCE SHEET ACCOUNTS<br>Assets and Other Debits | | | 100 |
|---|---|---|---|---|---|---|
| | Balance at Beginning of period 1/1/2005 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2005 | Increase or Decrease |
| | | | Fixed Assets: | | | |
| 1. | 243,752,458 | 100 | Fixed Capital–Gas | 102 | 258,341,099 | 14,588,641 |
| 2. | | 108 | Fixed Capital–Other | | | |
| 3. | 146,949 | 110 | Non-Operating Property | 104 | 146,949 | 0 |
| 4. | **243,899,407** | | **Total Fixed Assets** | | **258,488,048** | **14,588,641** |
| | | | Investments: | | | |
| 5. | | 111 | Investments in Affiliated Companies | 105 | | |
| 6. | 183 | 112 | Miscellaneous Investments | 105 | 183 | 0 |
| 7. | | 113 | Sinking Funds | 106 | | |
| 8. | | 114 | Miscellaneous Special Funds | 106 | | |
| 9. | | 115 | Depreciation Funds | 106 | | |
| 10. | **183** | | **Total Investments** | | **183** | **0** |
| | | | Current Assets: | | | |
| 11. | 0 | 120 | Cash | | 0 | 0 |
| 12. | 0 | 121 | Special Deposits | | 0 | 0 |
| 13. | 0 | 122 | Working Funds | | 0 | 0 |
| 14. | 0 | 124 | Notes Receivable | | 0 | 0 |
| 15. | 19,719,227 | 125 | Accounts Receivable | 107 | 24,414,457 | 4,695,230 |
| 16. | 1,520,043 | 126 | Receivables from Affiliated Companies | 107 | 1,637,176 | 117,133 |
| 17. | | 127 | Subscriptions to Capital Stock | | | |
| 18. | 0 | 128 | Interest and Dividends Receivable | | 0 | 0 |
| 19. | 14,721,037 | 131 | Materials and Supplies | 107 | 18,472,896 | 3,751,859 |
| 20. | 83,806 | 132 | Prepayments | 106 | 464,721 | 380,915 |
| 21. | 0 | 133 | Miscellaneous Current Assets | | 0 | 0 |
| 22. | **36,044,113** | | **Total Current Assets** | | **44,989,250** | **8,945,137** |
| | | | Deferred Debits: | | | |
| 23. | 0 | 140 | Unamortized Debt Discount and Expense | 108 | 0 | 0 |
| 24. | 0 | 146.1 | Base Gas Costs | 113 | 0 | 0 |
| 25. | 0 | 143 | Clearing Accounts | | 0 | 0 |
| 26. | | 145.1 | Maintenance Work in Progress | | | |
| 27. | | 145.2 | Jobbing Accounts | | | |
| 28. | 120,133,524 | 146.2 | Miscellaneous Suspense | 113 | 158,574,324 | 38,440,800 |
| 29. | **120,133,524** | | **Total Deferred Debits** | | **158,574,324** | **38,440,800** |
| | | | Company Securities Owned: | | | |
| 30. | | 152 | Reacquired Securities | 106 | | |
| 31. | | 154 | Unissued Securities | | | |
| 32. | | | **Total Company Securities Owned** | | | |
| 33. | **400,077,227** | | **Total Assets and Other Debits** | | **462,051,804** | **61,974,577** |

**BALANCE SHEET ACCOUNTS** **101**

**Liabilities and Other Credits**

| | Balance at Beginning of period 1/1/2005 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2005 | Increase or Decrease |
|---|---|---|---|---|---|---|
| | | | Capital Stocks: | | | |
| 1. | 3,000,000 | 200 | Common Stock | 109 | 3,000,000 | 0 |
| 2. | 0 | 201 | Preferred Stock | 109 | 0 | 0 |
| 3. | | 202 | Stock Liability for Conversion | | | |
| 4. | | 203 | Premium on Capital Stock | | | |
| 5. | | 204 | Capital Stock Subscribed | | | |
| 6. | | 205 | Installments Paid on Capital Stock | | | |
| 7. | **3,000,000** | | **Total Capital Stocks** | | **3,000,000** | **0** |
| | | | Non-Corporate Proprietorship: | | | |
| 8. | 0 | 209 | Non-Corporate Proprietorship | | | |
| | | | Long Term Debt: | | | |
| 9. | 0 | 210 | Bonds and Notes | 109 | 0 | 0 |
| 10. | | 211 | Receivers' Certificates | 109 | | |
| 11. | | 212 | Advances from Affiliated Companies | 109 | | |
| 12. | | 213 | Miscellaneous Long Term Debt | 109 | | |
| 13. | **0** | | **Total Long Term Debt** | | **0** | **0** |
| | | | Current and Accrued Liabilities: | | | |
| 14. | 0 | 220 | Notes Payable | 110 | 0 | 0 |
| 15. | 19,094,214 | 222 | Accounts Payable | | 23,701,407 | 4,607,193 |
| 16. | 108,532,683 | 223 | Payables to Affiliated Companies | 110 | 115,323,325 | 6,790,642 |
| 17. | 0 | 224 | Dividends Declared | 108 | 0 | 0 |
| 18. | | 225 | Matured Bonds | | | |
| 19. | | 226 | Matured Interest | | | |
| 20. | 236,594 | 227 | Customers' Deposits | | 226,069 | (10,525) |
| 21. | (1,486,126) | 228 | Taxes Accrued | | (111,159) | 1,374,967 |
| 22. | 74,890 | 229 | Interest Accrued | | 76,814 | 1,924 |
| 23. | 449,876 | 230.1 | Miscellaneous Current Liabilities | | 495,318 | 45,442 |
| 24. | 518,294 | 230.2 | Miscellaneous Accruals | | 509,985 | (8,309) |
| 25. | **127,420,425** | | **Total Current and Accrued Liabilities** | | **140,221,758** | **12,801,333** |
| | | | Deferred Credits: | | | |
| 26. | | 240 | Unamortized Premiums on Bonds | | | |
| 27. | 35,802,402 | 242 | Miscellaneous Unadjusted Credits | 112 | 70,451,540 | 34,649,138 |
| 28. | **35,802,402** | | **Total Deferred Credits** | | **70,451,540** | **34,649,138** |
| | | | Reserves: | | | |
| 29. | 75,651,673 | 250 | Depreciation Reserve | 111 | 80,173,064 | 4,521,391 |
| 30. | 1,242,570 | 251 | Amortization Reserve | 112 | 1,880,021 | 637,451 |
| 31. | 1,349,757 | 254 | Uncollectible Accounts Reserve | 112 | 2,395,604 | 1,045,847 |
| 32. | 0 | 255 | Casualty and Insurance Reserve | 112 | 0 | 0 |
| 33. | | 258.1 | Sinking Funds Reserve | 112 | | |
| 34. | | 258.2 | Reserve for Dividends | 112 | | |
| 35. | (2,889,859) | 258.3 | Miscellaneous Reserves | 112 | (350,511) | 2,539,348 |
| 36. | **75,354,141** | | **Total Reserves** | | **84,098,178** | **8,744,037** |

**BALANCE SHEET ACCOUNTS** **101 cont.**
**Liabilities and Other Credits**

| | Balance at Beginning of period 1/1/2005 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2005 | Increase or Decrease |
|---|---|---|---|---|---|---|
| | | | Contribution in Aid of Construction: | | | |
| 1. | 0 | 265 | **Contribution in Aid of Construction** | | 0 | **0** |
| | | | Surplus: | | | |
| 2. | 220,653,012 | 270 | Capital Surplus | 113 | 220,653,012 | **0** |
| 3. | (59,949,512) | 271 | Earned Surplus | | **(54,169,141)** | 5,780,371 |
| 4. | (2,203,245) | | Other Comprehensive Income | | (2,203,543) | (298) |
| 5. | **158,500,255** | | **Total Surplus** | | **164,280,328** | **5,780,073** |
| 6. | **400,077,223** | | **Total Liabilities and Other Credits** | | **462,051,804** | **61,974,581** |

# Income Statement

Table 40 200

2005 PUC Pages 200-206.xls

| | Account Number | Items | 12/31/2005 Amount | Totals | Increase or Decrease | |
|---|---|---|---|---|---|---|
| 1 | 1501 | Operating Revenues - Gas | 166,215,324 | 166,215,324 | 20,164,105 | |
| 2 | 1701-1812 | Operations and Maintenance - Gas | 142,644,371 | | 22,708,756 | |
| 3 | 1503 | Depreciation - Gas | 7,320,902 | | 110,494 | |
| 4 | 1504 | Amortization - Gas | 608,764 | | 48,581 | |
| 5 | 1507 | Taxes - Gas | 6,847,511 | | (449,579) | |
| 6 | | Total Revenue Deductions | | 157,421,547 | | 22,418,251 |
| 7 | | Gas Operating Income | | 8,793,777 | | (2,254,146) |
| 8 | 1508.1 | Rent for Lease of Gas Plant | | | | |
| 9 | 1508.2 | Rent from Lease of Gas Plant | | | | |
| 10 | 1508.3 | Joint Facility Rents | | | | |
| 11 | 1508.4 | Rent from Gas Appliances | | | | |
| 12 | 1508.5 | Miscellaneous Rents | | | | |
| 13 | 1508 | Operating Rents - Net | | | | |
| 14 | | Net Gas Operating Income | | 8,793,777 | - | (2,254,146) |
| 15 | 1509 | Operating Income - Other Utilities Operations | | - | | |
| 16 | | Net Utility Operating Income | | 8,793,777 | - | (2,254,146) |
| 17 | 1522 | Revenues from Non-Operating Property | 12,500 | | (12,500) | |
| 18 | 1523 | Dividend Income | | | | |
| 19 | 1524 | Interest Income | 64,909 | | (4,926) | |
| 20 | 1525 | Income From Special Funds | | | | |
| 21 | 1526 | Miscellaneous Non-Operating Revenues | 3,400 | | (50,723) | |
| 22 | | Non-Operating Property Revenues | | 80,809 | - | (68,149) |
| 23 | 1527 | Non-Operating Property Deductions | (176,321) | | (296,369) | |
| 24 | | Reorganization Costs ( + KeySpan Merger Costs) | | | | - |
| 25 | | Non_operating Property Income | | (176,321) | - | (296,369) |
| 26 | | Gross Income | - | 8,698,266 | - | (2,618,663) |
| 27 | 1530 | Interest on Long-Term Debt | - | | (2,058,751) | |
| 28 | 1531 | Amortization of Debt Discount and Expenses | - | | (39,083) | |
| 29 | 1533 | Taxes Assumed on Interest | | | | |
| 30 | 1535 | Miscellaneous Interest Deductions | 3,115,586 | | (698,124) | |
| 31 | 1536 | Interest Charges to Property-Credit | (197,690) | | (92,813) | |
| 32 | 1537 | Miscellaneous Amortization | | | | - |
| 33 | 1538 | Miscellaneous Deductions from Income | | | | - |
| 34 | 1540 | Contractual Appropriations of Income | | | | - |
| 35 | | Deductions from Income | | 2,917,896 | | (2,888,771) |
| | | | | | | - |
| 36 | | Income Balance Transferred to Earned Surplus | | 5,780,371 | | 270,109 |

| TABLE 10 | | | BALANCE SHEET ACCOUNTS | | | 100 |
|---|---|---|---|---|---|---|
| Sheet 1 of 3 | | | Assets and Other Debits | | | |
| | Balance at Beginning of period 1/1/2006 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2006 | Increase or Decrease |
| | | | Fixed Assets: | | | |
| 1. | 258,341,099 | 100 | Fixed Capital--Gas | 102 | 272,877,604 | 14,536,505 |
| 2. | | 108 | Fixed Capital--Other | | | |
| 3. | 146,949 | 110 | Non-Operating Property | 104 | 146,949 | 0 |
| 4. | **258,488,048** | | **Total Fixed Assets** | | **273,024,553** | **14,536,505** |
| | | | Investments: | | | |
| 5. | | 111 | Investments in Affiliated Companies | 105 | | |
| 6. | 183 | 112 | Miscellaneous Investments | 105 | 1 | (182) |
| 7. | | 113 | Sinking Funds | 106 | | |
| 8. | | 114 | Miscellaneous Special Funds | 106 | | |
| 9. | | 115 | Depreciation Funds | 106 | | |
| 10. | **183** | | **Total Investments** | | **1** | **(182)** |
| | | | Current Assets: | | | |
| 11. | 0 | 120 | Cash | | 0 | 0 |
| 12. | 0 | 121 | Special Deposits | | 0 | 0 |
| 13. | 0 | 122 | Working Funds | | 0 | 0 |
| 14. | 0 | 124 | Notes Receivable | | 0 | 0 |
| 15. | 24,414,457 | 125 | Accounts Receivable | 107 | 20,551,009 | (3,863,448) |
| 16. | 1,637,176 | 126 | Receivables from Affiliated Companies | 107 | 147,188 | (1,489,988) |
| 17. | | 127 | Subscriptions to Capital Stock | | | |
| 18. | 0 | 128 | Interest and Dividends Receivable | | 0 | 0 |
| 19. | 18,472,896 | 131 | Materials and Supplies | 107 | 20,753,378 | 2,280,482 |
| 20. | 464,721 | 132 | Prepayments | 106 | 570,708 | 105,987 |
| 21. | 0 | 133 | Miscellaneous Current Assets | | 0 | 0 |
| 22. | **44,989,250** | | **Total Current Assets** | | **42,022,283** | **(2,966,967)** |
| | | | Deferred Debits: | | | |
| 23. | 0 | 140 | Unamortized Debt Discount and Expense | 108 | 0 | 0 |
| 24. | 0 | 146.1 | Base Gas Costs | 113 | 0 | 0 |
| 25. | 0 | 143 | Clearing Accounts | | 0 | 0 |
| 26. | | 145.1 | Maintenance Work in Progress | | | |
| 27. | | 145.2 | Jobbing Accounts | | | |
| 28. | 158,574,324 | 146.2 | Miscellaneous Suspense | 113 | 182,746,353 | 24,172,029 |
| 29. | **158,574,324** | | **Total Deferred Debits** | | **182,746,353** | **24,172,029** |
| | | | Company Securities Owned: | | | |
| 30. | | 152 | Reacquired Securities | 106 | | |
| 31. | | 154 | Unissued Securities | | | |
| 32. | | | **Total Company Securities Owned** | | | |
| 33. | **462,051,805** | | **Total Assets and Other Debits** | | **497,793,189** | **35,741,384** |

## BALANCE SHEET ACCOUNTS 101
### Liabilities and Other Credits

| | Balance at Beginning of period 1/1/2006 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2006 | Increase or Decrease |
|---|---|---|---|---|---|---|
| | | | Capital Stocks: | | | |
| 1. | 3,000,000 | 200 | Common Stock | 109 | 3,000,000 | 0 |
| 2. | 0 | 201 | Preferred Stock | 109 | 0 | 0 |
| 3. | | 202 | Stock Liability for Conversion | | | |
| 4. | | 203 | Premium on Capital Stock | | | |
| 5. | | 204 | Capital Stock Subscribed | | | |
| 6. | | 205 | Installments Paid on Capital Stock | | | |
| 7. | **3,000,000** | | **Total Capital Stocks** | | **3,000,000** | **0** |
| | | | Non-Corporate Proprietorship: | | | |
| 8. | 0 | 209 | Non-Corporate Proprietorship | | | |
| | | | Long Term Debt: | | | |
| 9. | 0 | 210 | Bonds and Notes | 109 | 0 | 0 |
| 10. | | 211 | Receivers' Certificates | 109 | | |
| 11. | | 212 | Advances from Affiliated Companies | 109 | | |
| 12. | | 213 | Miscellaneous Long Term Debt | 109 | | |
| 13. | **0** | | **Total Long Term Debt** | | **0** | **0** |
| | | | Current and Accrued Liabilities: | | | |
| 14. | 0 | 220 | Notes Payable | 110 | 0 | 0 |
| 15. | 23,701,407 | 222 | Accounts Payable | | 34,591,973 | 10,890,566 |
| 16. | 115,323,325 | 223 | Payables to Affiliated Companies | 110 | 105,928,277 | (9,395,048) |
| 17. | 0 | 224 | Dividends Declared | 108 | 0 | 0 |
| 18. | | 225 | Matured Bonds | | | |
| 19. | | 226 | Matured Interest | | | |
| 20. | 226,069 | 227 | Customers' Deposits | | 166,240 | (59,829) |
| 21. | (111,159) | 228 | Taxes Accrued | | 2,452 | 113,611 |
| 22. | 76,814 | 229 | Interest Accrued | | 27,125 | (49,689) |
| 23. | 495,318 | 230.1 | Miscellaneous Current Liabilities | | (484,682) | (980,000) |
| 24. | 509,985 | 230.2 | Miscellaneous Accruals | | 569,551 | 59,566 |
| 25. | **140,221,759** | | **Total Current and Accrued Liabilities** | | **140,800,937** | **579,178** |
| | | | Deferred Credits: | | | |
| 26. | | 240 | Unamortized Premiums on Bonds | | | |
| 27. | 70,451,540 | 242 | Miscellaneous Unadjusted Credits | 112 | 98,586,060 | 28,134,520 |
| 28. | **70,451,540** | | **Total Deferred Credits** | | **98,586,060** | **28,134,520** |
| | | | Reserves: | | | |
| 29. | 80,173,064 | 250 | Depreciation Reserve | 111 | 86,042,351 | 5,869,287 |
| 30. | 1,880,021 | 251 | Amortization Reserve | 112 | 2,511,368 | 631,347 |
| 31. | 2,395,604 | 254 | Uncollectible Accounts Reserve | 112 | 2,041,104 | (354,500) |
| 32. | 0 | 255 | Casualty and Insurance Reserve | 112 | 0 | 0 |
| 33. | | 258.1 | Sinking Funds Reserve | 112 | | |
| 34. | | 258.2 | Reserve for Dividends | 112 | | |
| 35. | (350,511) | 258.3 | Miscellaneous Reserves | 112 | 1,726,636 | 2,077,147 |
| 36. | **84,098,178** | | **Total Reserves** | | **92,321,460** | **8,223,282** |

| | BALANCE SHEET ACCOUNTS<br>Liabilities and Other Credits | | | | | 101 cont. |
|---|---|---|---|---|---|---|
| | Balance at Beginning of period 1/1/2006 | Acct. No. | Title of Account | Detail on page | Balance at end of year 12/31/2006 | Increase or Decrease |
| | | | Contribution in Aid of Construction: | | | |
| 1. | 0 | 265 | **Contribution in Aid of Construction** | | 0 | **0** |
| | | | Surplus: | | | |
| 2. | 220,653,012 | 270 | Capital Surplus | 113 | 220,653,012 | **0** |
| 3. | (54,169,141) | 271 | Earned Surplus | | **(51,448,608)** | **2,720,533** |
| 4. | (2,203,543) | | Other Comprehensive Income | | (6,119,673) | **(3,916,130)** |
| 5. | **164,280,328** | | **Total Surplus** | | **163,084,731** | **(1,195,597)** |
| 6. | **462,051,805** | | **Total Liabilities and Other Credits** | | **497,793,188** | **35,741,383** |

# Income Statement

Table 40 200

PUC Pages 200-206.xls

| | Account Number | Items | 12/31/2006 Amount | Totals | Increase or Decrease | |
|---|---|---|---|---|---|---|
| 1 | 1501 | Operating Revenues - Gas | 160,839,242 | 160,839,242 | (5,376,082) | |
| 2 | 1701-1812 | Operations and Maintenance - Gas | 141,409,077 | | (1,235,294) | |
| 3 | 1503 | Depreciation - Gas | 8,052,859 | | 731,957 | |
| 4 | 1504 | Amortization - Gas | 631,346 | | 22,582 | |
| 5 | 1507 | Taxes - Gas | 5,217,724 | | (1,629,787) | |
| 6 | | Total Revenue Deductions | | 155,311,005 | | (2,110,542) |
| 7 | | Gas Operating Income | | 5,528,237 | | (3,265,540) |
| 8 | 1508.1 | Rent for Lease of Gas Plant | | | | |
| 9 | 1508.2 | Rent from Lease of Gas Plant | | | | |
| 10 | 1508.3 | Joint Facility Rents | | | | |
| 11 | 1508.4 | Rent from Gas Appliances | | | | |
| 12 | 1508.5 | Miscellaneous Rents | | | | |
| 13 | 1508 | Operating Rents - Net | | | | |
| 14 | | Net Gas Operating Income | | 5,528,237 | - | (3,265,540) |
| 15 | 1509 | Operating Income - Other Utilities Operations | | - | | |
| 16 | | Net Utility Operating Income | | 5,528,237 | - | (3,265,540) |
| 17 | 1522 | Revenues from Non-Operating Property | 59,500 | | 47,000 | |
| 18 | 1523 | Dividend Income | - | | | |
| 19 | 1524 | Interest Income | 47,418 | | (17,491) | |
| 20 | 1525 | Income From Special Funds | - | | | |
| 21 | 1526 | Miscellaneous Non-Operating Revenues | - | | (3,400) | |
| 22 | | Non-Operating Property Revenues | | 106,918 | - | 26,109 |
| 23 | 1527 | Non-Operating Property Deductions | 261,434 | | 437,755 | |
| 24 | | | | | | - |
| 25 | | Non_operating Property Income | | 261,434 | - | 437,755 |
| 26 | | Gross Income | - | 5,896,589 | - | (2,801,677) |
| 27 | 1530 | Interest on Long-Term Debt | | | | |
| 28 | 1531 | Amortization of Debt Discount and Expenses | | | | |
| 29 | 1533 | Taxes Assumed on Interest | | | | |
| 30 | 1535 | Miscellaneous Interest Deductions | 3,355,990 | | 240,404 | |
| 31 | 1536 | Interest Charges to Property-Credit | (179,934) | | 17,756 | |
| 32 | 1537 | Miscellaneous Amortization | | | | - |
| 33 | 1538 | Miscellaneous Deductions from Income | | | | - |
| 34 | 1540 | Contractual Appropriations of Income | | | | - |
| 35 | | Deductions from Income | | 3,176,056 | | 258,160 |
| | | | | | | - |
| 36 | | Income Balance Transferred to Earned Surplus | | 2,720,533 | | (3,059,837) |

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: MARCH-05

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 1,580,901 | (2.26) | 71,428,468 | 69,847,567 |
| Other revenues | 2,208,297 | 77.45 | (642,961) | (2,851,258) |
| Revenues from transp. of gas of others | 5,974 | (0.37) | 1,627,829 | 1,621,854 |
| TOTAL OPERATING REVENUES | 3,795,172 | (5.53) | 72,413,336 | 68,618,163 |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 3,336,685 | 6.54 | 54,388,684 | 51,052,000 |
| Operations-other | 190,019 | 6.28 | 3,213,871 | 3,023,852 |
| Maintenance | 169,009 | 20.71 | 985,247 | 816,238 |
| Depreciation, depletion & amortization | 113,225 | 5.95 | 2,017,488 | 1,904,263 |
| Operating taxes | (665,307) | (37.43) | 1,112,187 | 1,777,494 |
| Income taxes-current | 32,587 | 1.26 | 2,611,606 | 2,579,019 |
| Income taxes-deferred & other | 984,714 | 363.09 | 1,255,919 | 271,205 |
| Intercompany expenses | (689) | (24.87) | 2,082 | 2,772 |
| TOTAL OPERATING EXPENSES | 4,160,242 | 6.77 | 65,587,085 | 61,426,844 |
| TOTAL OPERATING INCOME(LOSS) | (365,069) | 5.08 | 6,826,250 | 7,191,320 |

| | | | | |
|---|---|---|---|---|
| OTHER INCOME (DEDUCTIONS) | | | | |
| Allow. for other funds used during constr. | 0 | (443) | 443 | 100.00 |
| Other income(deductions) net | (58,190) | 18,023 | (76,213) | 422.86 |
| Income taxes-deferred & other | 30,609 | 0 | 30,609 | n/m |
| TOTAL OTHER INCOME (DEDUCTIONS) | (27,581) | 17,580 | (45,161) | 256.88 |
| INCOME BEFORE INTEREST CHARGES | 6,798,670 | 7,208,900 | (410,230) | 5.69 |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | 856,635 | (856,635) | (100.00) |
| Other interest expense (income) | 637,883 | 1,005,124 | (367,241) | (36.54) |
| Allow. for borrowed funds used during constr. | (21,262) | (26,581) | 5,318 | (20.01) |
| Intercompany Interest Expense | 0 | 0 | 0 | n/m |
| TOTAL INTEREST CHARGES (CREDITS) | 616,620 | 1,835,178 | (1,218,558) | (66.40) |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | 6,182,049 | 5,373,722 | 808,327 | (15.04) |
| NET INCOME (LOSS) | 6,182,049 | 5,373,722 | 808,327 | (15.04) |

KEYSPAN CORPORATION

Date: 13-FEB-08 13:06:38

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: MARCH-05

currency USD

COMPANY=06 (EnergyNorth Company)

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| Expected Net Income | 6,182,049 | 5,373,722 | 808,327 | (15.04) |

| | | | | |
|---|---|---|---|---|
| Difference | 0 | 106.25 | 0 | 0 |

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: JUNE-05

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 6,190,486 | (23.23) | 32,833,513 | 26,643,027 |
| Other revenues | (4,166,261) | (65.12) | (10,564,112) | (6,397,850) |
| Revenues from transp. of gas of others | 80,806 | (7.89) | 1,104,536 | 1,023,730 |
| TOTAL OPERATING REVENUES | 2,105,031 | (9.90) | 23,373,938 | 21,268,906 |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 1,917,725 | 13.95 | 15,669,057 | 13,751,332 |
| Operations-other | (271,641) | (6.66) | 3,809,860 | 4,081,501 |
| Maintenance | 209,922 | 24.33 | 1,072,729 | 862,807 |
| Depreciation, depletion & amortization | 25,141 | 1.33 | 1,911,344 | 1,886,203 |
| Operating taxes | 897,227 | 450.28 | 1,096,488 | 199,260 |
| Income taxes-current | 1,060,055 | 313.66 | 1,398,021 | 337,966 |
| Income taxes-deferred & other | (1,397,333) | 542.65 | (1,654,836) | (257,503) |
| Intercompany expenses | (733) | (19.60) | 3,004 | 3,737 |
| TOTAL OPERATING EXPENSES | 2,440,363 | 11.70 | 23,305,666 | 20,865,303 |
| TOTAL OPERATING INCOME(LOSS) | (335,332) | 83.08 | 68,271 | 403,603 |

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| OTHER INCOME (DEDUCTIONS) | | | | |
| Allow. for other funds used during constr. | (1,941) | (36) | (1,905) | (5,333.90) |
| Other income(deductions) net | (14,323) | 70,445 | (84,769) | 120.33 |
| Income taxes-deferred & other | 30,609 | 61,218 | (30,609) | 50.00 |
| TOTAL OTHER INCOME (DEDUCTIONS) | 14,345 | 131,628 | (117,283) | 89.10 |
| INCOME BEFORE INTEREST CHARGES | 82,616 | 535,231 | (452,615) | 84.56 |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | 856,635 | (856,635) | (100.00) |
| Other interest expense (income) | 912,206 | 741,649 | 170,557 | 23.00 |
| Allow. for borrowed funds used during constr. | (24,044) | (42,622) | 18,578 | (43.59) |
| Intercompany Interest Expense | 0 | 0 | 0 | n/m |
| TOTAL INTEREST CHARGES (CREDITS) | 888,161 | 1,555,662 | (667,501) | (42.91) |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | (805,546) | (1,020,431) | 214,886 | 21.06 |
| NET INCOME (LOSS) | (805,546) | (1,020,431) | 214,886 | 21.06 |

KEYSPAN CORPORATION

Date: 13-FEB-08 13:06:38

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: JUNE-05

currency USD

COMPANY=06 (EnergyNorth Company)

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| Expected Net Income | (805,546) | (1,020,431) | 214,886 | 21.06 |

| | | | | |
|---|---|---|---|---|
| | -------------- | -------------- | -------------- | ------------ |
| Difference | 0 | 0 | 0 | (46.77) |
| | ============== | ============== | ============== | ============ |

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: SEPTEMBER-05

currency USD

COMPANY=06 (EnergyNorth Company)

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 12,750,062 | 11,901,986 | 848,076 | (7.13) |
| Other revenues | (432,491) | (184,402) | (248,089) | (134.54) |
| Revenues from transp. of gas of others | 595,388 | 547,950 | 47,438 | (8.66) |
| TOTAL OPERATING REVENUES | 12,912,959 | 12,265,534 | 647,425 | (5.28) |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 7,490,576 | 6,666,867 | 823,710 | 12.36 |
| Operations-other | 3,800,503 | 3,532,095 | 268,408 | 7.60 |
| Maintenance | 1,034,106 | 884,913 | 149,193 | 16.86 |
| Depreciation, depletion & amortization | 1,979,021 | 1,949,569 | 29,452 | 1.51 |
| Operating taxes | 1,095,849 | 965,259 | 130,589 | 13.53 |
| Income taxes-current | (2,067,298) | (2,338,536) | 271,238 | (11.60) |
| Income taxes-deferred & other | 729,449 | 997,154 | (267,705) | (26.85) |
| Intercompany expenses | 1,015 | 2,594 | (1,579) | (60.88) |
| TOTAL OPERATING EXPENSES | 14,063,221 | 12,659,916 | 1,403,306 | 11.08 |
| TOTAL OPERATING INCOME(LOSS) | (1,150,262) | (394,382) | (755,880) | (191.66) |

| | | | | |
|---|---|---|---|---|
| **OTHER INCOME (DEDUCTIONS)** | | | | |
| Allow. for other funds used during constr. | 1,941 | 0 | 1,941 | n/m |
| Other income(deductions) net | (2,075) | 16,533 | (18,608) | 112.55 |
| Income taxes-deferred & other | 30,609 | 30,609 | 0 | 0.00 |
| TOTAL OTHER INCOME (DEDUCTIONS) | 30,475 | 47,142 | (16,667) | 35.35 |
| INCOME BEFORE INTEREST CHARGES | (1,119,787) | (347,240) | (772,547) | (222.48) |
| **INTEREST CHARGES (CREDITS)** | | | | |
| Interest on long term debt | 0 | 345,480 | (345,480) | (100.00) |
| Other interest expense (income) | 875,615 | 1,273,007 | (397,392) | (31.22) |
| Allow. for borrowed funds used during constr. | (62,674) | (66,293) | 3,619 | (5.46) |
| Intercompany Interest Expense | 0 | 0 | 0 | n/m |
| TOTAL INTEREST CHARGES (CREDITS) | 812,941 | 1,552,195 | (739,254) | (47.63) |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | (1,932,727) | (1,899,434) | (33,293) | (1.75) |
| NET INCOME (LOSS) | (1,932,727) | (1,899,434) | (33,293) | (1.75) |

KEYSPAN CORPORATION

Date: 13-FEB-08 13:06:38

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: SEPTEMBER-05

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| Expected Net Income | (33,293) | (1.75) | (1,932,727) | (1,899,434) |

| | | | | |
|---|---|---|---|---|
| | -------------- | ------------ | -------------- | -------------- |
| Difference | 0 | (90.91) | 0 | 0 |
| | ============== | ============ | ============== | ============== |

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: DECEMBER-05

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 10,461,842 | (34.08) | 41,162,548 | 30,700,706 |
| Other revenues | 3,207,864 | (26.46) | 15,329,539 | 12,121,675 |
| Revenues from transp. of gas of others | (53,230) | 4.95 | 1,023,005 | 1,076,235 |
| TOTAL OPERATING REVENUES | 13,616,476 | (31.02) | 57,515,092 | 43,898,616 |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 13,508,487 | 43.17 | 44,802,180 | 31,293,693 |
| Operations-other | 2,095,146 | 67.90 | 5,180,949 | 3,085,803 |
| Maintenance | 316,384 | 36.21 | 1,190,050 | 873,667 |
| Depreciation, depletion & amortization | (8,743) | (0.43) | 2,021,812 | 2,030,555 |
| Operating taxes | (1,018,170) | (103.48) | (34,262) | 983,909 |
| Income taxes-current | 8,768,885 | (283.50) | 5,675,773 | (3,093,112) |
| Income taxes-deferred & other | (9,123,924) | (187.16) | (4,248,949) | 4,874,975 |
| Intercompany expenses | (1,288) | (73.84) | 456 | 1,744 |
| TOTAL OPERATING EXPENSES | 14,536,777 | 36.30 | 54,588,010 | 40,051,234 |
| TOTAL OPERATING INCOME(LOSS) | (920,301) | 23.92 | 2,927,082 | 3,847,382 |

| | | | | |
|---|---|---|---|---|
| OTHER INCOME (DEDUCTIONS) | | | | |
| Allow. for other funds used during constr. | 0 | (1,909) | 1,909 | 100.00 |
| Other income(deductions) net | (20,924) | (61,954) | 41,030 | 66.23 |
| Income taxes-deferred & other | 30,609 | 30,609 | 0 | 0.00 |
| TOTAL OTHER INCOME (DEDUCTIONS) | 9,685 | (33,254) | 42,939 | 129.12 |
| INCOME BEFORE INTEREST CHARGES | 2,936,767 | 3,814,128 | (877,362) | 23.00 |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | 0 | 0 | n/m |
| Other interest expense (income) | 689,882 | 833,014 | (143,132) | (17.18) |
| Allow. for borrowed funds used during constr. | (89,709) | (75,292) | (14,417) | 19.15 |
| Intercompany Interest Expense | 0 | 0 | 0 | n/m |
| TOTAL INTEREST CHARGES (CREDITS) | 600,172 | 757,722 | (157,549) | (20.79) |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | 2,336,594 | 3,056,407 | (719,812) | 23.55 |
| NET INCOME (LOSS) | 2,336,594 | 3,056,407 | (719,812) | 23.55 |

KEYSPAN CORPORATION

Date: 13-FEB-08 13:06:38

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: DECEMBER-05

currency USD

COMPANY=06 (EnergyNorth Company)

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| Expected Net Income | 2,336,594 | 3,056,407 | (719,812) | 23.55 |

| | | | | |
|---|---|---|---|---|
| Difference | 0 | 0 | 0 | (39.01) |

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KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: MARCH-06

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 9,213,161 | (12.90) | 80,641,629 | 71,428,468 |
| Other revenues | (6,376,035) | (991.67) | (7,018,996) | (642,961) |
| Revenues from transp. of gas of others | 45,040 | (2.77) | 1,672,868 | 1,627,829 |
| TOTAL OPERATING REVENUES | 2,882,166 | (3.98) | 75,295,502 | 72,413,336 |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 4,732,243 | 8.70 | 59,120,928 | 54,388,684 |
| Operations-other | 642,282 | 19.98 | 3,856,153 | 3,213,871 |
| Maintenance | (20,223) | (2.05) | 965,023 | 985,247 |
| Depreciation, depletion & amortization | 94,081 | 4.66 | 2,111,569 | 2,017,488 |
| Other regulatory amortization | 769 | n/m | 769 | 0 |
| Operating taxes | 2,952 | 0.27 | 1,115,139 | 1,112,187 |
| Income taxes-current | 1,071,465 | 41.03 | 3,683,071 | 2,611,606 |
| Income taxes-deferred & other | (1,616,323) | (128.70) | (360,404) | 1,255,919 |
| Intercompany expenses | 325 | 15.60 | 2,407 | 2,082 |
| TOTAL OPERATING EXPENSES | 4,907,570 | 7.48 | 70,494,655 | 65,587,085 |
| TOTAL OPERATING INCOME(LOSS) | (2,025,403) | 29.67 | 4,800,847 | 6,826,250 |

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| OTHER INCOME (DEDUCTIONS) | | | | |
| Other income(deductions) net | 13,076 | (58,190) | 71,266 | 122.47 |
| Income taxes-deferred & other | 30,609 | 30,609 | 0 | 0.00 |
| TOTAL OTHER INCOME (DEDUCTIONS) | 43,685 | (27,581) | 71,266 | 258.39 |
| INCOME BEFORE INTEREST CHARGES | 4,844,532 | 6,798,670 | (1,954,138) | 28.74 |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | 0 | 0 | n/m |
| Other interest expense (income) | 467,089 | 637,883 | (170,794) | (26.78) |
| Allow. for borrowed funds used during constr. | (98,977) | (21,262) | (77,715) | 365.50 |
| Intercompany Interest Expense | 0 | 0 | 0 | n/m |
| TOTAL INTEREST CHARGES (CREDITS) | 368,112 | 616,620 | (248,509) | (40.30) |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | 4,476,420 | 6,182,049 | (1,705,629) | 27.59 |
| NET INCOME (LOSS) | 4,476,420 | 6,182,049 | (1,705,629) | 27.59 |

KEYSPAN CORPORATION

Date: 13-FEB-08 13:06:38

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: MARCH-06

currency USD

COMPANY=06 (EnergyNorth Company)

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| Expected Net Income | 4,476,420 | 6,182,049 | (1,705,629) | 27.59 |

| | | | | |
|---|---|---|---|---|
| | -------------- | ------------ | -------------- | -------------- |
| Difference | 0 | 348.48 | 0 | 0 |
| | ============== | ============ | ============== | ============== |

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 862,497 | (2.63) | 33,696,010 | 32,833,513 |
| Other revenues | 3,069,814 | 29.06 | (7,494,298) | (10,564,112) |
| Revenues from transp. of gas of others | (89,868) | 8.14 | 1,014,668 | 1,104,536 |
| TOTAL OPERATING REVENUES | 3,842,443 | (16.44) | 27,216,380 | 23,373,938 |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 3,447,566 | 22.00 | 19,116,623 | 15,669,057 |
| Operations-other | 460,878 | 12.10 | 4,270,738 | 3,809,860 |
| Maintenance | 169,135 | 15.77 | 1,241,863 | 1,072,729 |
| Depreciation, depletion & amortization | 301,173 | 15.76 | 2,212,517 | 1,911,344 |
| Other regulatory amortization | (769) | n/m | (769) | 0 |
| Operating taxes | (3,056) | (0.28) | 1,093,431 | 1,096,488 |
| Income taxes-current | (2,259,297) | (161.61) | (861,276) | 1,398,021 |
| Income taxes-deferred & other | 1,713,757 | (103.56) | 58,921 | (1,654,836) |
| Intercompany expenses | (3,514) | (116.96) | (510) | 3,004 |
| TOTAL OPERATING EXPENSES | 3,825,872 | 16.42 | 27,131,539 | 23,305,666 |
| TOTAL OPERATING INCOME(LOSS) | 16,571 | (24.27) | 84,842 | 68,271 |

| | This Year | Last Year | Increase (Decrease) | Percent Incr/(Decr) |
|---|---|---|---|---|
| OTHER INCOME (DEDUCTIONS) | | | | |
| Allow. for other funds used during constr. | 45,035 | (1,941) | 46,976 | 2,420.22 |
| Other income(deductions) net | 31,616 | (14,323) | 45,939 | 320.73 |
| Income taxes-deferred & other | 30,609 | 30,609 | 0 | 0.00 |
| TOTAL OTHER INCOME (DEDUCTIONS) | 107,260 | 14,345 | 92,916 | (647.74) |
| INCOME BEFORE INTEREST CHARGES | 192,102 | 82,616 | 109,486 | (132.52) |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | 0 | 0 | n/m |
| Other interest expense (income) | 934,021 | 912,206 | 21,815 | 2.39 |
| Allow. for borrowed funds used during constr. | (41,301) | (24,044) | (17,256) | 71.77 |
| Intercompany Interest Expense | 0 | 0 | 0 | n/m |
| TOTAL INTEREST CHARGES (CREDITS) | 892,720 | 888,161 | 4,559 | 0.51 |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | (700,618) | (805,546) | 104,927 | 13.03 |
| NET INCOME (LOSS) | (700,618) | (805,546) | 104,927 | 13.03 |

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Date: 13-FEB-08 12:59:52

Page: 2

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: JUNE-06

currency USD

COMPANY=06 (EnergyNorth Company)

| INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Expected Net Income | (700,618) | (805,546) | 104,927 | 13.03 |
| | -------------- | -------------- | -------------- | ------------ |
| Difference | 0 | 0 | 0 | (72.83) |
| | ============= | ============= | ============= | =========== |

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: SEPTEMBER-06

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 822,488 | (6.45) | 13,572,551 | 12,750,062 |
| Other revenues | 925,053 | 213.89 | 492,563 | (432,491) |
| Revenues from transp. of gas of others | 141,244 | (23.72) | 736,631 | 595,388 |
| TOTAL OPERATING REVENUES | 1,888,785 | (14.63) | 14,801,745 | 12,912,959 |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 1,419,590 | 18.95 | 8,910,167 | 7,490,576 |
| Operations-other | (69,499) | (1.83) | 3,731,004 | 3,800,503 |
| Maintenance | 80,491 | 7.78 | 1,114,598 | 1,034,106 |
| Depreciation, depletion & amortization | 187,115 | 9.45 | 2,166,136 | 1,979,021 |
| Operating taxes | 7,323 | 0.67 | 1,103,172 | 1,095,849 |
| Income taxes-current | 1,758,754 | (85.08) | (308,544) | (2,067,298) |
| Income taxes-deferred & other | (1,675,858) | (229.74) | (946,409) | 729,449 |
| Intercompany expenses | 1,429 | 140.78 | 2,443 | 1,015 |
| TOTAL OPERATING EXPENSES | 1,709,345 | 12.15 | 15,772,567 | 14,063,221 |
| TOTAL OPERATING INCOME(LOSS) | 179,440 | 15.60 | (970,822) | (1,150,262) |

| | | | | |
|---|---|---|---|---|
| OTHER INCOME (DEDUCTIONS) | | | | |
| Allow. for other funds used during constr. | 76,705 | (3,951.82) | 78,645 | 1,941 |
| Other income(deductions) net | (5,004) | (241.22) | (7,079) | (2,075) |
| Income taxes-deferred & other | 0 | 0.00 | 30,609 | 30,609 |
| | -------------- | ------------ | -------------- | -------------- |
| TOTAL OTHER INCOME (DEDUCTIONS) | 71,700 | (235.27) | 102,175 | 30,475 |
| | -------------- | ------------ | -------------- | -------------- |
| INCOME BEFORE INTEREST CHARGES | 251,140 | 22.43 | (868,647) | (1,119,787) |
| | -------------- | ------------ | -------------- | -------------- |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | n/m | 0 | 0 |
| Other interest expense (income) | 121,463 | 13.87 | 997,078 | 875,615 |
| Allow. for borrowed funds used during constr. | 40,776 | (65.06) | (21,898) | (62,674) |
| Intercompany Interest Expense | 0 | n/m | 0 | 0 |
| | -------------- | ------------ | -------------- | -------------- |
| TOTAL INTEREST CHARGES (CREDITS) | 162,240 | 19.96 | 975,180 | 812,941 |
| | -------------- | ------------ | -------------- | -------------- |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | 88,900 | 4.60 | (1,843,827) | (1,932,727) |
| | -------------- | ------------ | -------------- | -------------- |
| NET INCOME (LOSS) | 88,900 | 4.60 | (1,843,827) | (1,932,727) |
| | -------------- | ------------ | -------------- | -------------- |

KEYSPAN CORPORATION

Date: 13-FEB-08 12:59:52

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: SEPTEMBER-06

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| | -------------- | ------------ | -------------- | -------------- |
| Expected Net Income | 88,900 | 4.60 | (1,843,827) | (1,932,727) |

| | | | | |
|---|---|---|---|---|
| Difference | 0 | 741.67 | 0 | 0 |

3 Summary ENH IS QTR DEC-06 DEC-05.txt

Date: 13-FEB-08 12:59:52

Page: 1

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: DECEMBER-06

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | (6,821,507) | 16.57 | 34,341,042 | 41,162,548 |
| Other revenues | (6,104,173) | 39.82 | 9,225,365 | 15,329,539 |
| Revenues from transp. of gas of others | (1,063,796) | 103.99 | (40,791) | 1,023,005 |
| TOTAL OPERATING REVENUES | (13,989,476) | 24.32 | 43,525,616 | 57,515,092 |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | (10,833,066) | (24.18) | 33,969,114 | 44,802,180 |
| Operations-other | (1,472,630) | (28.42) | 3,708,319 | 5,180,949 |
| Maintenance | 207,567 | 17.44 | 1,397,617 | 1,190,050 |
| Depreciation, depletion & amortization | 172,171 | 8.52 | 2,193,983 | 2,021,812 |
| Operating taxes | 466,872 | (1,362.66) | 432,610 | (34,262) |
| Income taxes-current | (9,965,755) | (175.58) | (4,289,982) | 5,675,773 |
| Income taxes-deferred & other | 8,746,944 | (205.86) | 4,497,995 | (4,248,949) |
| Intercompany expenses | 2,133 | 467.61 | 2,589 | 456 |
| TOTAL OPERATING EXPENSES | (12,675,765) | (23.22) | 41,912,245 | 54,588,010 |
| TOTAL OPERATING INCOME(LOSS) | (1,313,711) | 44.88 | 1,613,370 | 2,927,082 |

| | | | | |
|---|---|---|---|---|
| OTHER INCOME (DEDUCTIONS) | | | | |
| Allow. for other funds used during constr. | 63,310 | n/m | 63,310 | 0 |
| Other income(deductions) net | 42,237 | 201.86 | 21,312 | (20,924) |
| Income taxes-deferred & other | 0 | 0.00 | 30,609 | 30,609 |
| TOTAL OTHER INCOME (DEDUCTIONS) | 105,546 | (1,089.80) | 115,231 | 9,685 |
| INCOME BEFORE INTEREST CHARGES | (1,208,165) | 41.14 | 1,728,602 | 2,936,767 |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | n/m | 0 | 0 |
| Other interest expense (income) | 267,920 | 38.84 | 957,802 | 689,882 |
| Allow. for borrowed funds used during constr. | 71,951 | (80.20) | (17,759) | (89,709) |
| Intercompany Interest Expense | 0 | n/m | 0 | 0 |
| TOTAL INTEREST CHARGES (CREDITS) | 339,871 | 56.63 | 940,043 | 600,172 |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | (1,548,036) | 66.25 | 788,559 | 2,336,594 |
| NET INCOME (LOSS) | (1,548,036) | 66.25 | 788,559 | 2,336,594 |

KEYSPAN CORPORATION

Date: 13-FEB-08 12:59:52

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: DECEMBER-06

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| Expected Net Income | (1,548,036) | 66.25 | 788,559 | 2,336,594 |

| | | | | |
|---|---|---|---|---|
| Difference | 0 | 199.13 | 0 | 0 |

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: MARCH-07

currency USD

COMPANY=06 (EnergyNorth Company)

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 85,881,225 | 80,641,629 | 5,239,595 | (6.50) |
| Other revenues | (1,089,514) | (7,018,996) | 5,929,482 | 84.48 |
| Revenues from transp. of gas of others | 1,900,085 | 1,672,868 | 227,217 | (13.58) |
| TOTAL OPERATING REVENUES | 86,691,796 | 75,295,502 | 11,396,294 | (15.14) |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 69,425,386 | 59,120,928 | 10,304,459 | 17.43 |
| Operations-other | 4,287,862 | 3,856,153 | 431,709 | 11.20 |
| Maintenance | 1,140,564 | 965,023 | 175,541 | 18.19 |
| Depreciation, depletion & amortization | 2,234,506 | 2,111,569 | 122,937 | 5.82 |
| Other regulatory amortization | 0 | 769 | (769) | (100.00) |
| Operating taxes | 1,122,584 | 1,115,139 | 7,445 | 0.67 |
| Income taxes-current | 5,907,735 | 3,683,071 | 2,224,664 | 60.40 |
| Income taxes-deferred & other | (2,537,915) | (360,404) | (2,177,511) | 604.19 |
| Intercompany expenses | (177) | 2,407 | (2,585) | (107.36) |
| TOTAL OPERATING EXPENSES | 81,580,546 | 70,494,655 | 11,085,891 | 15.73 |
| TOTAL OPERATING INCOME(LOSS) | 5,111,250 | 4,800,847 | 310,403 | (6.47) |

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| OTHER INCOME (DEDUCTIONS) | | | | |
| Allow. for other funds used during constr. | 88,227 | 0 | 88,227 | n/m |
| Other income(deductions) net | (1,134) | 13,076 | (14,210) | 108.67 |
| Income taxes-deferred & other | 30,609 | 30,609 | 0 | 0.00 |
| TOTAL OTHER INCOME (DEDUCTIONS) | 117,702 | 43,685 | 74,017 | (169.43) |
| INCOME BEFORE INTEREST CHARGES | 5,228,951 | 4,844,532 | 384,419 | (7.94) |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | 0 | 0 | n/m |
| Other interest expense (income) | 310,126 | 467,089 | (156,963) | (33.60) |
| Allow. for borrowed funds used during constr. | (24,810) | (98,977) | 74,167 | (74.93) |
| Intercompany Interest Expense | 0 | 0 | 0 | n/m |
| TOTAL INTEREST CHARGES (CREDITS) | 285,315 | 368,112 | (82,797) | (22.49) |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | 4,943,636 | 4,476,420 | 467,216 | (10.44) |
| NET INCOME (LOSS) | 4,943,636 | 4,476,420 | 467,216 | (10.44) |

KEYSPAN CORPORATION

Date: 13-FEB-08 12:59:52

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: MARCH-07

currency USD

COMPANY=06 (EnergyNorth Company)

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Expected Net Income | 4,943,636 | 4,476,420 | 467,216 | (10.44) |
| Difference | 0 | 0 | 0 | (139.19) |

KEYSPAN CORPORATION

INTERNAL I/S SUMMARY - QUARTER

Current Period: JUNE-07

currency USD

COMPANY=06 (EnergyNorth Company)

| | INCREASE (DECREASE) | PERCENT INCR/(DECR) | THIS YEAR | LAST YEAR |
|---|---|---|---|---|
| OPERATING REVENUES | | | | |
| Gas revenues | 3,173,603 | (9.42) | 36,869,613 | 33,696,010 |
| Other revenues | (620,889) | (8.28) | (8,115,187) | (7,494,298) |
| Revenues from transp. of gas of others | 1,731,938 | (170.69) | 2,746,606 | 1,014,668 |
| TOTAL OPERATING REVENUES | 4,284,651 | (15.74) | 31,501,032 | 27,216,380 |
| OPERATING EXPENSES | | | | |
| Operations-fuel and purchased power | 3,917,934 | 20.49 | 23,034,557 | 19,116,623 |
| Operations-other | 203,600 | 4.77 | 4,474,338 | 4,270,738 |
| Maintenance | (97,445) | (7.85) | 1,144,418 | 1,241,863 |
| Depreciation, depletion & amortization | 16,967 | 0.77 | 2,229,483 | 2,212,517 |
| Other regulatory amortization | 769 | (100.00) | 0 | (769) |
| Gain from disposition of property | 113,812 | n/m | 113,812 | 0 |
| Operating taxes | 10,751 | 0.98 | 1,104,182 | 1,093,431 |
| Income taxes-current | 2,508,267 | (291.23) | 1,646,991 | (861,276) |
| Income taxes-deferred & other | (2,385,124) | (4,048.00) | (2,326,203) | 58,921 |
| Intercompany expenses | 510 | (100.00) | 0 | (510) |
| TOTAL OPERATING EXPENSES | 4,290,041 | 15.81 | 31,421,579 | 27,131,539 |
| TOTAL OPERATING INCOME(LOSS) | | | 79,453 | 84,842 |

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| | | | (5,389) | 6.35 |
| OTHER INCOME (DEDUCTIONS) | | | | |
| Allow. for other funds used during constr. | 96,104 | 45,035 | 51,069 | (113.40) |
| Other income(deductions) net | (22,341) | 31,616 | (53,956) | 170.66 |
| Income taxes-deferred & other | (30,609) | 30,609 | (61,218) | 200.00 |
| TOTAL OTHER INCOME (DEDUCTIONS) | 43,155 | 107,260 | (64,105) | 59.77 |
| INCOME BEFORE INTEREST CHARGES | 122,607 | 192,102 | (69,494) | 36.18 |
| INTEREST CHARGES (CREDITS) | | | | |
| Interest on long term debt | 0 | 0 | 0 | n/m |
| Other interest expense (income) | 1,143,853 | 934,021 | 209,833 | 22.47 |
| Allow. for borrowed funds used during constr. | (26,965) | (41,301) | 14,335 | (34.71) |
| Intercompany Interest Expense | 0 | 0 | 0 | n/m |
| TOTAL INTEREST CHARGES (CREDITS) | 1,116,888 | 892,720 | 224,168 | 25.11 |
| NET INCOME (LOSS) before EXTRAORDINARY ITEMS | (994,281) | (700,618) | (293,662) | (41.91) |

KEYSPAN CORPORATION

Date: 13-FEB-08 12:59:52

INTERNAL I/S SUMMARY - QUARTER

Page: 2

Current Period: JUNE-07

currency USD

COMPANY=06 (EnergyNorth Company)

| | THIS YEAR | LAST YEAR | INCREASE (DECREASE) | PERCENT INCR/(DECR) |
|---|---|---|---|---|
| NET INCOME (LOSS) | (994,281) | (700,618) | (293,662) | (41.91) |

```
    --------------    ------------

Expected Net Income                          (994,281)          (700,618)
          (293,662)         (41.91)
                                          --------------     --------------
    --------------    ------------
Difference                                         0                  0
                  0        (377.66)
                                          ==============     ==============
    ==============    ============
```

**KEDNE - EnergyNorth**
**Volumes**
**2003 - 2007 QTRS**

| Energy North | 2003 QTR 1 | 2003 QTR 2 | 2003 QTR 3 | 2003 QTR 4 | 2003 Calendar Year |
|---|---|---|---|---|---|
| Residential | 32,791,518 | 13,503,552 | 4,027,583 | 14,623,599 | 64,946,252 |
| C&I | 29,483,159 | 12,148,454 | 4,034,806 | 12,156,165 | 57,822,584 |
| Miscellaneous | | | | | - |
| Standby | | | | | - |
| Non-Core Sales | | | | | - |
| Broker Sales | | | | | - |
| Unbilled Sales | | | | | - |
| Subtotal - Firm Sales | 62,274,677 | 25,652,006 | 8,062,389 | 26,779,764 | 122,768,836 |
| C&I | 8,398,082 | 6,047,370 | 4,790,755 | 6,539,474 | 25,775,681 |
| Non-Core Firm | | | | | - |
| Core Firm | | | | | - |
| Subtotal - Firm Transportation | 8,398,082 | 6,047,370 | 4,790,755 | 6,539,474 | 25,775,681 |
| Non-Firm Sales, CNG Fuel & Swap | 951,266 | 57,136 | 853,353 | 180,097 | 2,041,852 |
| Resale Non-Firm Sales | 396 | 396 | 396 | 396 | 1,584 |
| **Off-System Sales** | | | | | |
| Interruptible Transportation | | | | | |
| Subtotal - Non-Firm Sales & Transp | 951,662 | 57,532 | 853,749 | 180,493 | 2,043,436 |
| Less: Unbundled | | | | | |
| Add: Other Operating Revenue | | | | | |
| Total | 71,624,421 | 31,756,908 | 13,706,893 | 33,499,731 | 150,587,953 |

**KEDNE - EnergyNorth**
**Volumes**
**2003 - 2007 QTRS**

| **Energy North** | **2004 QTR 1** | **2004 QTR 2** | **2004 QTR 3** | **2004 QTR 4** | **2004 Calendar Year** |
|---|---|---|---|---|---|
| Residential | 32,567,277 | 11,717,352 | 4,135,130 | 13,436,048 | 61,855,807 |
| C&I | 28,776,911 | 9,833,749 | 3,771,305 | 11,247,389 | 53,629,354 |
| Miscellaneous | | | | | - |
| Standby | | | | | - |
| Non-Core Sales | | | | | - |
| Broker Sales | | | | | - |
| Unbilled Sales | | | | | - |
| Subtotal - Firm Sales | 61,344,188 | 21,551,101 | 7,906,435 | 24,683,437 | 115,485,161 |
| C&I | 9,447,462 | 6,444,351 | 5,398,553 | 6,765,605 | 28,055,971 |
| Non-Core Firm | | | | | - |
| Core Firm | | | | | - |
| Subtotal - Firm Transportation | 9,447,462 | 6,444,351 | 5,398,553 | 6,765,605 | 28,055,971 |
| Non-Firm Sales, CNG Fuel & Swap | 432,300 | 230,942 | 214,738 | 291,160 | 1,169,140 |
| Resale Non-Firm Sales | - | - | - | - | - |
| **Off-System Sales** | | | | | |
| Interruptible Transportation | | | | | |
| Subtotal - Non-Firm Sales & Transp | 432,300 | 230,942 | 214,738 | 291,160 | 1,169,140 |
| Less: Unbundled | | | | | |
| Add: Other Operating Revenue | | | | | |
| Total | 71,223,950 | 28,226,394 | 13,519,726 | 31,740,202 | 144,710,272 |

**KEDNE - EnergyNorth**
**Volumes**
**2003 - 2007 QTRS**

| Energy North | 2005 QTR1 | 2005 QTR2 | 2005 QTR3 | 2005 QTR4 | 2005 Calendar Year |
|---|---|---|---|---|---|
| Residential | 31,381,374 | 12,810,331 | 4,076,004 | 13,718,912 | 61,986,621 |
| C&I | 27,599,456 | 11,018,740 | 3,551,464 | 12,103,354 | 54,273,014 |
| Miscellaneous | | | | | - |
| Standby | | | | | - |
| Non-Core Sales | | | | | - |
| Broker Sales | | | | | - |
| Unbilled Sales | | | | | - |
| Subtotal - Firm Sales | 58,980,830 | 23,829,071 | 7,627,468 | 25,822,266 | 116,259,635 |
| C&I | 8,965,237 | 5,210,036 | 5,449,646 | 7,001,076 | 26,625,995 |
| Non-Core Firm | | | | | - |
| Core Firm | | | | | - |
| Subtotal - Firm Transportation | 8,965,237 | 5,210,036 | 5,449,646 | 7,001,076 | 26,625,995 |
| Non-Firm Sales, CNG Fuel & Swap | 277,418 | 224,587 | 457,842 | 373,301 | 1,333,148 |
| Resale Non-Firm Sales | 415 | 396 | 320 | 206 | 1,337 |
| **Off-System Sales** | | | | | |
| Interruptible Transportation | | | | | |
| Subtotal - Non-Firm Sales & Transp | 277,833 | 224,983 | 458,162 | 373,507 | 1,334,485 |
| Less: Unbundled | | | | | |
| Add: Other Operating Revenue | | | | | |
| Total | 68,223,900 | 29,264,090 | 13,535,276 | 33,196,849 | 144,220,115 |

**KEDNE - EnergyNorth**
**Volumes**
**2003 - 2007 QTRS**

| **Energy North** | **2006 QTR 1** | **2006 QTR 2** | **2006 QTR 3** | **2006 QTR 4** | **2006 Calendar Year** |
|---|---|---|---|---|---|
| Residential | 27,645,898 | 11,460,107 | 4,012,284 | 12,074,247 | 55,192,536 |
| C&I | 25,282,742 | 10,527,281 | 3,961,383 | 10,986,766 | 50,758,172 |
| Miscellaneous | | | | | - |
| Standby | | | | | - |
| Non-Core Sales | | | | | - |
| Broker Sales | | | | | - |
| Unbilled Sales | | | | | - |
| Subtotal - Firm Sales | 52,928,640 | 21,987,388 | 7,973,667 | 23,061,013 | 105,950,708 |
| C&I | 8,804,498 | 6,768,825 | 6,705,425 | 8,032,688 | 30,311,436 |
| Non-Core Firm | | | | | - |
| Core Firm | | | | | - |
| Subtotal - Firm Transportation | 8,804,498 | 6,768,825 | 6,705,425 | 8,032,688 | 30,311,436 |
| Non-Firm Sales, CNG Fuel & Swap | 239,609 | 251,325 | 255,174 | 541,259 | 1,287,367 |
| Resale Non-Firm Sales | 225 | 225 | 225 | 225 | 900 |
| **Off-System Sales** | | | | | - |
| Interruptible Transportation | | | | | |
| Subtotal - Non-Firm Sales & Transp | 239,834 | 251,550 | 255,399 | 541,484 | 1,288,267 |
| Less: Unbundled | | | | | |
| Add: Other Operating Revenue | | | | | |
| Total | 61,972,972 | 29,007,763 | 14,934,491 | 31,635,185 | 137,550,411 |

**KEDNE - EnergyNorth**
**Volumes**
**2003 - 2007 QTRS**

| **Energy North** | **2007 QTR 1** | **2007 QTR 2** | **2007 QTR 3** | **2007 QTR 4** | **2007 Calendar Year** |
|---|---|---|---|---|---|
| Residential | 29,647,291 | 12,164,149 | 3,857,705 | 14,152,228 | 59,821,373 |
| C&I | 26,860,628 | 10,858,975 | 3,654,980 | 12,938,231 | 54,312,814 |
| Miscellaneous | | | | | - |
| Standby | | | | | - |
| Non-Core Sales | | | | | - |
| Broker Sales | | | | | - |
| Unbilled Sales | | | | | - |
| Subtotal - Firm Sales | 56,507,919 | 23,023,124 | 7,512,685 | 27,090,459 | 114,134,187 |
| C&I | 10,196,360 | 7,838,244 | 6,582,357 | 9,809,796 | 34,426,757 |
| Non-Core Firm | | | | | - |
| Core Firm | | | | | - |
| Subtotal - Firm Transportation | 10,196,360 | 7,838,244 | 6,582,357 | 9,809,796 | 34,426,757 |
| Non-Firm Sales, CNG Fuel & Swap | 326,356 | 211,841 | 142,817 | (273,630) | 407,384 |
| Resale Non-Firm Sales | 225 | 225 | 114 | (114) | 450 |
| **Off-System Sales** | | | | | |
| Interruptible Transportation | | | | | |
| Subtotal - Non-Firm Sales & Transp | 326,581 | 212,066 | 142,931 | (273,744) | 407,834 |
| Less: Unbundled | | | | | |
| Add: Other Operating Revenue | | | | | |
| Total | 67,030,860 | 31,073,434 | 14,237,973 | 36,626,511 | 148,968,778 |

**ENERGYNORTH NATURAL GAS, INC d/b/a NATIONAL GRID NH**
**Puc 1604.01(a)(21)**

**Sources and Use of Funds Statement**
**And External Financing Requirements**
($000)

| **Sources of Funds** | **Calendar Yr 2007 Actuals** | **Calendar Yr 2008 Forecast** | **Calendar Yr 2009 Forecast** |
|---|---|---|---|
| **Internal** [1] | | | |
| Net Income | 4,168 | 4,055 | 4,787 |
| Depreciation & Amortization | 9,062 | 9,075 | 9,651 |
| Deferred Taxes | (6,016) | 3,679 | (1,174) |
| Changes in Working Capital/Other | (9,245) | (13,344) | 5,111 |
| Total Internal Sources | (2,031) | 3,465 | 18,375 |
| **External** | | | |
| Long-Term Debt | 0 | 80,000 | 0 |
| Money Pool Borrowings | 21,101 | 0 | 11,104 |
| Total External Sources | 21,101 | 80,000 | 11,104 |
| **Total Sources of Funds** | 19,070 | 83,465 | 29,479 |
| **Uses of Funds** | | | |
| Capital Expenditures | 19,070 | 22,081 | 29,479 |
| Redemptions | | | |
| Long-Term Debt | 0 | 40,000 | 0 |
| Money Pool Debt | 0 | 21,384 | 0 |
| **Total Uses of Funds** | 19,070 | 83,465 | 29,479 |

[1] Assumes no change in current base rates.

EnergyNorth Natural Gas, Inc. d/b/a National Grid NH

Capital Expenditures
Puc 1604.01(a)(22)

| | Calendar Year 2007 Actuals | Calendar Year 2008 Budget | Calendar Year 2009 Budget |
|---|---|---|---|
| **Growth** | | | |
| Main & Service Costs | $ 5,128,860 | $ 4,862,825 | $ 4,774,147 |
| Meter Purchases & Installations | $ 397,236 | $ 542,065 | $ 590,342 |
| Fitters | $ 274,018 | $ 601,992 | $ 711,317 |
| Customer Contributions | $ (164,760) | $ (228,971) | $ (250,375) |
| Subtotal | $ 5,635,354 | $ 5,777,911 | $ 5,825,430 |
| **Mandated** | | | |
| Corrosion | $ 544,076 | $ 544,076 | $ 544,076 |
| City State Construction (CSC) | $ 3,563,630 | $ 3,884,295 | $ 3,991,183 |
| Main Repl - Construct (Prog work) | $ 77,102 | $ 1,988,561 | $ 3,656,429 |
| Main Repl - Maintain (Rush New Mains) | $ 667,694 | $ 541,924 | $ 500,000 |
| Operational Capital | $ - | $ 375,000 | $ 500,000 |
| Meter Changes | $ 173,017 | $ 173,017 | $ 173,017 |
| Purchase Meters (Replacements) | $ 408,143 | $ 408,143 | $ 408,143 |
| Service Replacements - Leaks | $ 221,006 | $ 221,006 | $ 221,006 |
| Service Replacements - Non-Leaks/Other | $ 529,803 | $ 529,803 | $ 529,803 |
| Mandated Programs - Maintain | $ 233,052 | $ 471,626 | $ 551,151 |
| Leak Repairs - Service (inside fitting work) | $ 297,974 | $ 297,974 | $ 297,974 |
| Scada - Security (NY allocation) | $ 12,995 | $ 12,995 | $ 12,995 |
| Subtotal | $ 6,728,491 | $ 9,448,418 | $ 11,385,775 |
| **Reliability & Integrity** | | | |
| Reliability | | | |
| Main Installation - Reinforcements | $ 4,144,097 | $ 3,600,465 | $ 2,585,843 |
| Tilton Highline | $ - | $ - | $ 6,198,750 |
| SCADA Moderization | $ 2,534 | $ 19,384 | $ 25,000 |
| Special Projects & Other Reliability | $ 2,132,248 | $ 2,116,467 | $ 2,109,092 |
| Regulator Stations | $ (3,134) | $ 204,717 | $ 274,000 |
| Subtotal Reliability | $ 6,275,745 | $ 5,941,032 | $ 11,192,685 |
| Integrity | | | |
| Production Plant | $ 218,474 | $ 368,969 | $ 419,134 |
| Subtotal Integrity | $ 218,474 | $ 368,969 | $ 419,134 |
| Subtotal Reliability & Integrity | $ 6,494,219 | $ 6,310,001 | $ 11,611,820 |
| **Other** | | | |
| Purchase Capital Equip - Administration | $ 110,357 | $ 68,115 | $ 54,034 |
| AMR ERTs | $ 101,363 | $ 116,984 | $ 122,191 |
| Expanded Coring Operation & misc | $ - | $ 360,000 | $ 480,000 |
| Subtotal | $ 211,720 | $ 545,099 | $ 656,225 |
| **Total Capital** | **$ 19,069,784** | **$ 22,081,430** | **$ 29,479,250** |

## Sinking Fund Provisions
## (1604.01(a)(23))

There are none

**ENERGYNORTH SHORT TERM INDEBTEDNESS**

| Money Pool Borrowings ($)<br>Monthly Balances July 2006 - June 2007 | Jul-06 | Aug-06 | Sep-06 | Oct-06 | Nov-06 | Dec-06 | Jan-07 | Feb-07 | Mar-07 | Apr-07 | May-07 | Jun-07 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Fuel Financing | 15,817,917 | 16,759,147 | 17,661,579 | 18,610,395 | 19,788,394 | 20,588,477 | 20,757,961 | 19,345,846 | 15,671,582 | 11,832,948 | 9,076,084 | 6,166,896 |
| Other Than Fuel Financing | 19,816,865 | 18,049,725 | 8,499,934 | 9,517,725 | 11,300,980 | 13,439,019 | 17,641,541 | 19,306,796 | 18,511,658 | 14,211,033 | 10,750,076 | 25,903,802 |
| Combined (Fuel & Other) | 35,634,782 | 34,808,871 | 26,161,513 | 28,128,120 | 31,089,374 | 34,027,497 | 38,399,502 | 38,652,641 | 34,183,240 | 26,043,980 | 19,826,160 | 32,070,697 |

## Parent Company Information
## (1604.01(a)(25))

Information relating to the parent company is included in other locations within this filing

**DG 08-009**
**Attestation**

I affirm, based on my personal knowledge, information and belief that: (1) the cost and revenue statements and the supporting data submitted, which purport to reflect the books and records of EnergyNorth Natural Gas, Inc. d/b/a National Grid NH (the "Company"), do in fact set forth the results shown by such books and records and that all differences between the books and the test year data and any changes in the manner of recording an item on the utility's books during the test year have been expressly noted, and; (2) the proper amounts have been allocated to the Company from affiliates and that those amounts have been included in the Company's cost of service.

February 21, 2008

Kenneth Daly, Senior Vice President and Chief Financial Officer EnergyNorth Natural Gas, Inc. d/b/a National Grid NH

I, Kenneth Daly, Senior Vice President and Chief Financial Officer EnergyNorth Natural Gas, Inc. d/b/a National Grid NH being first duly sworn, hereby depose and say that I have read the foregoing Attestation and the facts alleged therein are true to the best of my knowledge and belief.

Dated: February 21, 2008

STATE OF NEW YORK
COUNTY OF KINGS

Sworn to and subscribed before me this 21st day of February, 2008.

Justice of the Peace/Notary Public
My Commission Expires: 3/13/2011

JOHN ALLOCCA
NOTARY PUBLIC, State of New York
No. 02AL4948263
Qualified in Kings County
Commission Expires March 13, 2011

UNIFORM STATISTICAL REPORT - YEAR ENDED DECEMBER 31, 2005
Company: Keyspan Energy Delivery New England

Please submit the required pages to the American Gas Association for use in compiling statistics published in A.G.A.'s Gas Facts.

BECAUSE THIS REPORT IS FREQUENTLY USED IN CONJUNCTION WITH THE COMPANY'S ANNUAL REPORT TO STOCKHOLDERS, THE DATA INCLUDED HEREIN SHOULD AGREE WITH THE COMPARABLE INFORMATION IN SUCH ANNUAL REPORT. To assure accuracy and consistency, numerous crossties and footnotes have been appended to the schedules so that statistics for the same item shown on more than one schedule will be identical.

All energy and dollar amount should be reported in thousands.

**Name and Address of Company:**

Boston Gas Company
Essex Gas Company
Colonial Gas Company
Energy North Natural Gas, Inc. D/B/A KeySpan Energy Delivery, New England 52 Second Avenue Waltham, MA 02453

List Affiliated Companies:
Indicate Relationship (Parent, Subsidiary, Associates, etc.)

KeySpan Corporation-Parent

Individual Furnishing Information

| | | | |
|---|---|---|---|
| Name | Joseph F. Bodanza | Authorizer | Joseph H. Hajjar |
| Title | Senior Vice President & CFO | Title | Vice President & Controller |
| Telephone | 718-403-2000 | | |
| Recipient E-mail: | | | |

☐ Check This Box if Individual Company Data may be Released

**THIS REPORT HAS BEEN PREPARED FOR THE PURPOSE OF PROVIDING GENERAL AND STATISTICAL INFORMATION CONCERNING THE COMPANY AND NOT IN CONNECTION WITH ANY SALE, OFFER FOR SALE OR SOLICITATION OF AN OFFER TO BUY ANY SECURITIES.**

**I - General Statistics**

Company: **Keyspan Energy Delivery New England**

**Page 1 - Schedule I - General Statistics**

1. Utility systems acquired, sold or otherwise disposed of: (Indicate the period for which these acquisitions or sales are reflected in this report.)

| ACQUIRED DURING | | | SOLD OR OTHERWISE DISPOSED OF DURING YEAR | | |
|---|---|---|---|---|---|
| Name of System | Date | # of Customers | Name of System | Date | # of Customers |

of Income and Retained Earnings
Company: Keyspan Energy Delivery New England

| INCOME | | Total | Electric | Gas | Other |
|---|---|---|---|---|---|
| 1. Operating Revenues | 2,1, | 1714505 | 0 | 1714505 | 0 |
| Operating Expenses: | | | | | |
| 2. Operation | 2,2, | 1380659 | 0 | 1380659 | 0 |
| 3. Maintenance | 2,3, | 54944 | 0 | 54944 | 0 |
| 4. Depreciation | 2,4, | 97061 | 0 | 97061 | 0 |
| 5. Depletion | 2,5, | 0 | 0 | 0 | 0 |
| 6. Amort. Charged to Operation | 2,6, | 10081 | 0 | 10081 | 0 |
| 7. Property Losses Charged to Operation | 2,7, | 0 | 0 | 0 | 0 |
| 8. Taxes | 2,8, | 62423 | 0 | 62423 | 0 |
| 9. | 2,9, | 62423 | 0 | 0 | 0 |
| 10. Total Operating Expenses | 2,10, | 1605168 | 0 | 1605168 | 0 |
| 11. Operating Income | 2,11, | 109337 | 0 | 109337 | 0 |
| 12. Other Operating Income | 2,12, | 2 | 0 | 2 | 0 |
| 13. Total Operating Income | 2,13, | 109339 | 0 | 109339 | 0 |
| 14. A.F.U.D.C | 2,14, | 0 | | | |
| 15.Other Income Less Deductions Net | 2,15, | 5444 | | | |
| 16. | 2,16, | 0 | | | |
| 17. Minority Interest | 2,17, | 0 | | | |
| 18. Income Before Interest Charges | 2,18, | 114783 | | | |
| Interest Charges : | | | | | |
| 19. Interest on Long -Term Debt | 2,19, | 22577 | | | |
| 20. Interest on Short -Term Debt | 2,20, | 0 | | | |
| 21. Amort. Of Debt Disc. Exp. And Prem. (Net) | 2,21, | 446 | | | |
| 22.Other Interest Expense | 2,22, | 37954 | | | |
| 23. Allow for Borrowed funds Used During Constr. Credit | 2,23, | -82 | | | |
| 24. Net Interest Charges | 2,24, | 60895 | | | |
| 25. Income Before Ext. Items and Cumulative Effects | 2,25, | 53888 | | | |
| 26. Ext. Items and Cumulative Effects (Net) | 2,26, | 0 | | | |
| 27.Net Income Before Pfd Dividends | 2,27, | 53888 | | | |
| 28.Pfd and Pfc Dividend Requirements | 2,28, | 0 | | | |
| 29. Net Income Available for Common Stock | 2,29, | 53888 | | | |
| 30. Common Dividends | 2,30, | 0 | | | |
| 31. Net Income After Dividends | 2,31, | 53888 | | | |
| RETAINED EARNINGS | | | | | |
| 32. Balance, January 1 | 2,32, | -296 | | | |
| 33. Net Income (Line 27) | 2,33, | 53888 | | | |
| 34.Pfd and Pfc Dividends Declared | 2,34, | 0 | | | |
| 35. Common Dividends Declared Cash | 2,35, | 0 | | | |
| 36. Common Dividends Declared Other | 2,36, | 0 | | | |
| 37. Adjustments | 2,37, | -4 | | | |
| 38. Balance, YEAR END | 2,38, | 53588 | | | |

Schedule IV
Keyspan Energy Delivery New England

Page 3 - Schedule IV -Functional Details of Operation and Maintenance Expenses

| | PRODUCTION: | ELECTRIC | | | GAS | | |
|---|---|---|---|---|---|---|---|
| | | Total | Operation | Maintenance | Total | Operation | Maintenance |
| 1. | Fuel (a).. | 0 | | | 0 | 0 | |
| 2. | Purchased Power (Net) | 0 | | | | | |
| 3. | Purchased Gas (Net) (b) | | | | 1184286 | 1184286 | |
| 4. | Other Prod. Expenses ( c) | 0 | 0 | 0 | 7197 | 6066 | 1131 |
| 5. | Total Production | 0 | 0 | 0 | 1191483 | 1190352 | 1131 |
| 6. | Storage & Liquefied Natural Gas (d) | | | | -13176 | 884 | -14060 |
| 7. | Transmission (e) | 0 | 0 | 0 | 0 | 0 | 0 |
| 8. | Distribution (f) | 0 | 0 | 0 | 103059 | 35189 | 67870 |
| 9. | Customer Accounts (g) | 0 | 0 | 0 | 67772 | 67772 | 0 |
| 10. | Customer Service & Info. (h) | 0 | 0 | 0 | 0 | 0 | 0 |
| 11. | Sales (i) | 0 | 0 | 0 | 14348 | 14348 | 0 |
| 12. | Administrative & General | 0 | 0 | 0 | 72117 | 72114 | 3 |
| 13. | Total | 0 | 0 | 0 | 1435603 | 1380659 | 54944 |
| 14. | Credit Residual included in Line | | | 4,14, | | | |

(a) Includes FERC System of Accounts 501,518 and 547.

(b) Includes FERC System of Accounts 800 (wellhead purchases), 801 (field line purchases), 802 (plant outlet purchases), 803 (transmission line purchases), 804 (city gate purchases) LESS 804.1 (LNG), and 807 (Purchased gas expense)

(c ) Includes FERC System of Accounts 805 (Other gas purchases and purchase gas adjustments), 806 (Exchange gas), 812 (Gas used for other utility operations), and 813 (other gas supply expense)

(d) Includes FERC System of Accounts 814 (Operation supervision and engineering), 815 (Maps and records), 816 (Wells expenses), 817 (Lines Expenses) and 818 (Compressor station expenses)

(e) Includes FERC System of Accounts 850 (Operations, supervision and engineering), 851 (System control and load dispatching), 852 (Communication system expenses), 853 (Compressor station labor and expenses), 854 (Gas for compressor station fuel), 855 (Other fuel and power for compressor stations), 856 (Main expenses), 857 (Measuring and regulating station expenses), 858 (Transmission and compression of gas by others), 859 (Other expenses), 860 (Rents), 861 (Maintenance supervision and engineering), 862 (Maintenance of structures and improvements), 863 (Maintenance of mains), 864 (Maintenance of compressor station equipment), 865 (Maintenance of measuring and regulating station equipment), 866 (Maintenance of communication equipment), 867 (Maintenance of other equipment), and 870 (Operation supervision and engineering)

(f) Includes FERC System of Accounts 871 (Distribution load dispatching), 872 (Compressor station labor and expenses), 873 (Compressor station fuel and power (Major only)), 874 (Mains and sevice expenses), 875 (Measuring and regulating station expenses - General), 876 (Measuring and regulating station expenses - Industrial), 877 (Measuring and regulating station expenses - City Gate Check Stations), 878 (Meter and house regulator expenses), 879 (Customer installation expenses), 880 (Other expenses), 881 (Rents), 885 (Maintenance supervision and engineering), 886 (Maintenance of structure and improvements), 887 (Maintenance of mains), 888 (Maintenance of compressor station equipment), 889 (Maintenance of measuring and regulating station equipment - General), 890 Maintenance of measuring and regulating station equipment - Industrial), 891 (Maintenance of measuring and regulating station equipment - City Gate Check Stations), 892 (Maintenance of services), 893 (Maintenance of meters and house regulators), and 894 (Maintenance of other equipment)

(g) Includes FERC System of Accounts 901 (Supervision), 902 (Meter reading expense), 903 (Customer records and collection expenses), 904(Uncollectable accounts), and 905 (Misc. customer accounts expenses)

(h) Includes FERC System of Accounts 907 (Supervision), 908 (Customer assistance expenses), 909 (Informational and instructional advertising expense),and 910 (Misc customer and informational expense)

(i) (i) Includes FERC System of Accounts 911 (Supervision), 912 Demonstrating and selling expenses), 913 (Advertising expense), and 916 (Misc sales expenses)

SCHEDULE V
Company: Keyspan Energy Delivery New England

ACCRUALS CHARGED TO :

OPERATING EXPENSES TAXES (THOUSANDS OF $)

| | | TOTAL | Electric | Gas | Other Depts. | All Other Accounts (a) |
|---|---|---|---|---|---|---|
| 1.Property, Ad valorem, etc | 5.1 | 23053 | | 23053 | | |
| 2. Franchise | 5.2 | 8041 | | 8041 | | |
| 3. Gross Receipts | 5.3 | | | | | |
| 4. | 5.4 | | | | | |
| 5. Miscellaneous | 5.5 | 27 | 27 | 27 | | |
| 6. Total State & Local Taxes | 5.6 | 31121 | | 31121 | | |
| Misc. Federal Taxes | | | | | | |
| 7. Payroll | 5.7 | 2641 | | 2641 | | |
| 8. | 5.8 | | | | | |
| 9.Total Misc. Federal Taxes | 5.9 | 2641 | | 2641 | | |
| 10.Total Taxes Income | 5.10 | 33762 | | 33762 | | |
| Income Taxes Current | | | | | | |
| 11.Federal Income Taxes | 5.11 | 30461 | | 30461 | | |
| 12.State Income Taxes | 5.12 | 2241 | | 2241 | | |
| 13.Total Income Taxes | 5.13 | 32702 | | 32702 | | |
| Deferred Income Tax Charges | | | | | | |
| 14.Federal | 5.14 | -2468 | | -2468 | | |
| 15. State | 5.15 | -1573 | | -1573 | | |
| Deferred Income Tax Credits | | | | | | |
| 16.Federal | 5.16 | | | | | |
| 17.State | 5.17 | | | | | |
| 18.Investment Tax Credit | 5.18 | | | | | |
| 19.Total Taxes (b) | 5.19 | 62423 | | 62423 | | |

(a) Such as Utility Plant, Other Income Deductions, Extraordinary items, Clearing Accounts, Retained Earnings, etc.
(b) Should equal Total of Lines 10, 13, 14, 15, 16, 17 and 18 and agree with line 8, Schedule II.

Balance Sheet
Company : Keyspan Energy Delivery New England
Page 5 - Schedule VI - Balance Sheet

## ASSETS

| | | |
|---|---|---|
| UTILITY PLANT: | | |
| Plant in Service: | | |
| 1. Electric | 6,1 | 0 |
| 2. Gas | 6,2 | 3654661 |
| 3. Common | 6,3 | 0 |
| 4. Land | 6,4 | 608 |
| 5. Total Plant in Service | 6,5 | 3655269 |
| 6.Accum. Prov. for Depr. & Amort. | 6,6 | 980898 |
| 7. Construction Work in Progress | 6,7 | 84251 |
| 8. Nuclear Fuel | 6,8 | 0 |
| 9. Accum. Prov. for Amort. Of Nuclear Fuel | 6,9 | 0 |
| 10. Held for Future Use | 6,10 | 516 |
| 11. | 6,11 | 0 |
| 12. Net Utility Plant | 6,12 | 2759138 |
| 13. Gas Stored Underground | 6,13 | 0 |
| 14. | 6,14 | 0 |
| 15.Other Property and Investments (Net) | 6,15 | 14524 |
| 16. Decommissioning Funds | 6,16 | 0 |
| Current and Accrued Assets: | | |
| 17. Cash, Spec. Dep., Wkg. Funds & Temp.Cash Investments | 6,17 | 11928 |
| 18.Gas Stored Underground (Current) | 6,18 | 0 |
| 19. LNG Held and Stored for Processing | 6,19 | 0 |
| 20. Notes Receivable | 6,20 | 0 |
| 21. Customer Accounts Receivable (Net) | 6,21 | 224188 |
| 22. Receivables from Investor Owned Elec. Cos. | 6,22 | 0 |
| 23. Other Receivables | 6,23 | 259241 |
| 24. Accrued Unbilled Revenues | 6,24 | 139025 |
| 25. Materials and Supplies | 6,25 | 201851 |
| 26. Prepayments | 6,26 | 2682 |
| 27. Other Current and Accrued Assets | 6,27 | 44596 |
| 28. Recoverable Fuel | 6,28 | 87420 |
| 29. Total Current & Accrued Assets | 6,29 | 970931 |
| Deferred Debits: | | |
| 30. Regulatory Assets | 6,30 | 2746 |
| 31. Unamortized Debt Expense | 6,31 | 6295 |
| 32. Extraordinary Property losses | 6,32 | 0 |
| 33. Other Deferred Debits | 6,33 | 347617 |
| 34. | 6,34 | 0 |
| 35. Total Deferred Debits | 6,35 | 356658 |
| 36. Total Assets | 6,36 | 4101251 |

## CAPITALIZATION AND LIABILITIES

| | | |
|---|---|---|
| Capitalization: | | |
| 37. Common Stock | 6,37 | 76389 |
| 38. Other Comprehensive Income | 6,38 | -2098 |
| 39. Premium on Common Stock (if not in Line 40) | 6,39 | 420069 |
| 40. Other Paid-In Capital | 6,40 | 1068456 |
| 41. Retained Earnings | 6,41 | 53588 |
| 42. Total Common Stock Equity | 6,42 | 1616404 |
| 43. | 6,43 | 0 |
| 44. Preferred and Preference Stock not subject to mandatory Redemption | 6,44 | 0 |
| 45. Preferred and Preference Stock subject to Mandatory Redemption | 6,45 | 0 |
| Long Term Debt: (Ex.amt.due within 1 yr) | | |
| 46. Mortgage Bonds | 6,46 | 0 |
| 47. Debentures | 6,47 | 290000 |
| 48. Other | 6,48 | 10727 |
| 49. | 6,49 | 0 |
| 50. Total Long-Term Debt | 6,50 | 300727 |
| 51. Total capitalization(Excl.amt. due with in one year) | 6,51 | 1917131 |
| Other Non-Current Liabilities: | | |
| 52. Accum. Prov. for Rate Refunds | 6,52 | 0 |
| 53. | 6,53 | 0 |
| 54. Total Other Non Current Liabilities | 6,54 | 0 |
| Current and Accrued Liabilities: | | |
| 55. Amounts Due within one year | 6,55 | 0 |
| 56. Short Term Debt | 6,56 | 0 |
| 57. Accts. Payable (Excl.amt. in Line 58) | 6,57 | 50723 |
| 58. Payables to Investor Owned Elec. Cos. | 6,58 | 0 |
| 59. Taxes Accrued | 6,59 | 586 |
| 60.Other Current and Accrued Liabilities | 6,60 | 1614657 |
| 61. Total Other Non-Current Liabilities | 6,61 | 1665966 |
| Deferred Credits: | | |
| 62. Accumulated Deferred Income Taxes | 6,62 | 0 |
| 63. Accum. Deferred Investment Tax Credits | 6,63 | 0 |
| 64. Regulatory Liabilities | 6,64 | 0 |
| 65. Customer Advances for Construction | 6,65 | 225 |
| 66. Other Deferred Costs | 6,66 | 193115 |
| 67. Total Deferred Credits | 6,67 | 193340 |
| 69. Total Capitalization and Liabilities | 6,69 | 4101251 |

SCHEDULE VIII
Company: Keyspan Energy Delivery New England

UTILITY PLANT BY FUNCTIONAL ACCOUNTS (THOUSANDS Of $) CONSTRUCTION EXPENDITURES

| | | Utility Plant | Accum. Prov. for Amort and Depl. | For Reported Year |
|---|---|---|---|---|
| ELECTRIC | | | | |
| 1. Intangible Production Plant | 8.1 | 0 | 0 | 0 |
| 2. Steam | 8.2 | 0 | 0 | 0 |
| 3. Nuclear | 8.3 | 0 | 0 | 0 |
| 4. Hydro | 8.4 | 0 | 0 | 0 |
| 5. Pumped Storage | 8.5 | 0 | 0 | 0 |
| 6. Gas Turbine | 8.6 | 0 | 0 | 0 |
| 7. Other | 8.7 | 0 | 0 | 0 |
| 8. Total Prod. Plant | 8.8 | 0 | 0 | 0 |
| 9. Transmission Plant | 8.9 | 0 | 0 | 0 |
| 10. Distribution Plant | 8.10 | 0 | 0 | 0 |
| 11. General Plant | 8.11 | 0 | 0 | 0 |
| 12.Subtotal | 8.12 | 0 | 0 | 0 |
| 13. Miscell. Plant | 8.13 | 0 | 0 | 0 |
| 14. Construction Work in Progress | 8.14 | 0 | XXXXXXXXXX | XXXXXXXXXX |
| 15. Plant Held for Future Use | 8.15 | 0 | 0 | 0 |
| 16. Plant Acq Adj & Other Adj | 8.16 | 0 | 0 | XXXXXXXXXX |
| 17. Ele Plant Excl Nucl | 8.17 | 0 | 0 | 0 |
| 18. Nuclear Fuel | 8.18 | 0 | 0 | 0 |
| 19. Total Electric Plant | 8.19 | 0 | 0 | 0 |
| GAS | | | | |
| 20. Intangible Plant | 8.20 | 1387473 | 0 | 0 |
| 21. Production | 8.21 | 57380 | 0 | 0 |
| 22. Underground Storage | 8.22 | 0 | 0 | 0 |
| 23. Other Storage | 8.23 | 32377 | 0 | 0 |
| 24. LNG.Stor., Term. & Proc | 8.24 | 0 | 0 | 0 |
| 25.Transmission | 8.25 | 0 | 0 | 0 |
| 26. Distribution | 8.26 | 2119515 | 0 | 0 |
| 27.General | 8.27 | 57861 | 0 | 0 |
| 28.Subtotal | 8.28 | 3654606 | 0 | 0 |
| 29. Misc. Plant | 8.29 | 0 | 980898 | 0 |
| 30. Const. Work in Progress | 8.30 | 84251 | XXXXXXXXXX | XXXXXXXXXX |
| 31. Plant Held for Future Use | 8.31 | 516 | 0 | 0 |
| 32. Plant Acq Adj & Other Adj | 8.32 | 55 | 0 | XXXXXXXXXX |
| 33. Total Gas Plant | 8.33 | 3739428 | 980898 | 0 |
| OTHER UTILITY PLANT | | | | |
| 34. Land | 8.34 | 608 | 0 | 0 |
| 35. | 8.35 | 0 | 0 | 0 |
| 36. Total Other Utility Plant | 8.36 | 608 | 0 | 0 |
| 37. Common Plant | 8.37 | 0 | 0 | 0 |
| 38. Total Utility Plant | 8.38 | 3740036 | 980898 | 0 |

Schedule 12 - Statement of Cash Flows
Company: Keyspan Energy Delivery New England

Page 7 - Schedule XII - Statement of Cash Flows

| | | |
|---|---|---|
| | OPERATING ACTIVITIES | |
| 1. | Net Income | 53888 |
| 2. | Depreciation, Depletion and Amortization | 107142 |
| 3 | Deferred Income taxes (Net) | -35962 |
| 4 | Deferred Investment Tax Credits | |
| 5 | Allowance for Funds Used During Construction (Equity) | |
| 6 | | |
| 7 | | |
| 8 | Materials and Supplies, Fuel Inventories, Gas in Storage | -35832 |
| 9 | Accounts Receivable (Net) | -98396 |
| 10 | | |
| 11 | Other Current Assets | |
| 12 | Accounts Payable | -113273 |
| 13 | Accrued Taxes | 5778 |
| 14 | | |
| 15 | | |
| 16 | Other Current Liabilities | 340569 |
| 17 | # BLANK6# | |
| 18 | Net Cash Provided by (Used For) Operational Activities | 223914 |
| | INVESTING ACTIVITIES | |
| 19 | Construction Expenditures (excl. AFDC-Equity) | -156160 |
| 20 | Purchase of other Investments | |
| 21 | Sale of other Investments | |
| 22 | Cost of Removal | -15239 |
| 23 | | |
| 24 | | |
| 25 | Net Cash Provided by (Used For) Investing Activities | -171399 |
| | FINANCING ACTIVITIES | |
| 26 | Common Stock Dividends | |
| 27 | Preferred/Preference Stock Dividends | |
| 28 | Issuance of Long-Term Debt (Net Proceeds) | -15000 |
| 29 | Issuance of Preferred/Preference Stock (Net Proceeds) | |
| 30 | Issuance of Common Stock (Net Proceeds) | |
| 31 | Increase (Decrease) in Short-Term Debt (Net) | |
| 32 | Redemption of Long-Term Debt (Net Payments) | |
| 33 | Redemption of Preferred/Preference Stock (Net Payments) | |
| 34 | Intercompany (Net) | -27135 |
| 35 | | |
| 36 | Net Cash Provided By (Used For) Financial Activities | -42135 |
| 37 | Increase (Decrease) in Cash and Cash Equivalents | 10380 |
| 38 | Cash and Cash Equivalents at Beginning of Year | -5720 |
| 39 | Cash and Cash Equivalents at End of Year | 4660 |

Page 8- Schedule XIII- Employee Data
Company: Keyspan Energy Delivery New England

#Survey Name1#

Allocate to Electric, Gas and Other common employees who devote part of their time to Electric and part to Gas, and/or Other Departments.

Estimate Splits on basis of payroll dollars or any other reasonable basis.

When submitting gas utility data and your utility is a subsidiary/affiliate with shared employees, financial statements, etc., please utilize the employee allocation methodology you would employ when providing data in a gas utility rate case filing.

| NUMBER OF EMPLOYEES | ELECTRIC | GAS | OTHER | TOTAL |
|---|---|---|---|---|
| 1. Average for the Year * (IMPORTANT NOTE) | 0 | 1105 | 0 | 1105 |
| 2. At Year End * (IMPORTANT NOTE) | 0 | 1112 | 0 | 1112 |
| SALARIES AND WAGES (THOUSANDS of $) (a) | | | | |
| 3. Operation and Maintenance | 0 | 86724 | 0 | 86724 |
| 4. Construction | 0 | 37542 | 0 | 37542 |
| 5. Other (describe) Plant Removal & Misc | 0 | 15345 | 0 | 15345 |
| 6. Total | 0 | 139611 | 0 | 139611 |
| PENSIONS AND BENEFITS (THOUSANDS of $) | | | | |
| 7. Operation and Maintenance | 0 | 0 | 0 | 0 |
| 8. Construction | 0 | 0 | 0 | 0 |
| 9. Other (describe) | 0 | 0 | 0 | 0 |
| 10. Total | 0 | 0 | 0 | 0 |

(a) Do not include pensions and benefits

* FOR ANY COMPANIES WISHING TO RECEIVE THE AGA FINANCIAL BENCHMARKING RESULTS BOTH YEAR END AND AVERAGE EMPLOYEE DATA MUST BE COMPLETED

CLASSIFICATIONS OF GAS VOLUMES, REVENUES AND CUSTOMERS
Company: Keyspan Energy Delivery New England

Page 9 - Schedule XX - Classifications of Gas Volumes, Revenues and Customers

Companies operating in more than one state should complete this schedule for each state in which they operate.
Note: Report Data for All Types of Gases EXCEPT BOTTLED GAS.
Customers: Average number of bills rendered should be based on twelve monthly figures. Utilities not reading all meters each month should make allowance for unread meters of active customers. Enter count of customers who fall into more than one category only in category of greater usage.
Residential Heating Data: Furnish estimates, if figures are not available directly from company records, of all residential heating customers should include amounts associated with other appliance usage of these customers.
Other Sales (Columns 1 and 2, Lines 11, 12, 13, and 14): Include Data Pertaining to sales and revenues in FERC Accounts 482 and 484.Other Operating Revenues (Line 19): Include total FERC Accounts 485 through 496.

| | Volume units(a) | Volumes Dekatherms<br>Column 1 | Revenues ($000s)(b)<br>Column 2 | Customers Average<br>Column 3 |
|---|---|---|---|---|
| Residential Sales | | | | |
| 1. With Heating | 20,1, | 675810 | 1019662 | 755174 |
| 2. Without Heating | 20,2, | 31650 | 66699 | 50365 |
| Commercial Sales | | | | |
| 3. Firm | 20,3, | 210700 | 308262 | 68378 |
| 4. Interruptible | 20,4, | 0 | 0 | 0 |
| Industrial Sales | | | | |
| 5. Firm-Excluding Electric Generation | 20,5, | 344590 | 180026 | 8152 |
| 6. Interruptible-Excluding Electric Generation | 20,6, | 12510 | 15984 | 3 |
| Electric Generation | | | | |
| 7. Electric Utilities-Firm | 20,7, | 0 | 0 | 0 |
| 8. Electric Utilities-Interruptible | 20,8, | 0 | 0 | 0 |
| 9. Nonutility Generation-Firm | 20,9, | 0 | 0 | 0 |
| 10.Nonutility Generation-Interruptible | 20,10, | 0 | 0 | 0 |
| Other Sales | | | | |
| 11. Refueling Stations for Vehicular Fuel | 20,11, | 0 | 0 | 0 |
| 12. Municipal and Other Public Authorities | 20,12, | 0 | 0 | 0 |
| 13. Interdepartmental | 20,13, | 0 | 0 | 0 |
| 14. Other | 20,14, | 1690 | 1980 | 3 |
| 15. TOTAL SALES LINES 1 THRU 14 | 20,15, | 1276950 | 1592613 | 882075 |
| 16.Gas Utilities(for Resale) | 20,16, | 34210 | 2967 | 0 |
| 17. TOTAL GAS SALES,REVENUES,CUSTOMERS | 20,17, | 1311160 | 1595580 | 882075 |
| 18. Transportation Volumes to End Users | 20,18, | 26620 | 69429 | 470 |
| 19. Other Operating Revenues | 20,19, | | 49496 | |
| 20. Less Provision for Rate Refund | 20,20, | | 0 | |
| 21.TOTAL GAS OPERATING REVENUES ( c) | 20,21, | | 1714505 | |
| 22. Average BTU as Distributed | 20,22, | 1 | | |

(a) If billed at different Btu value from that shown on Line 22, indicate Btu value for billing: 0 per cubic foot.
(b) Includes unbilled revenues of m$ 0 for 0 on line(s)
(c) Should agree with Schedule II, Gas Column, Line 1.

CLASSIFICATIONS OF GAS VOLUMES, REVENUES AND CUSTOMERS
Company: Keyspan Energy Delivery New England

Page 9 - Schedule XX - Classifications of Gas Volumes, Revenues and Customers

Companies operating in more than one state should complete this schedule for each state in which they operate.
Note: Report Data for All Types of Gases EXCEPT BOTTLED GAS.
Customers: Average number of bills rendered should be based on twelve monthly figures. Utilities not reading all meters each month should make allowance for unread meters of active customers. Enter count of customers who fall into more than one category only in category of greater usage.
Residential Heating Data: Furnish estimates, if figures are not available directly from company records, of all residential heating customers should include amounts associated with other appliance usage of these customers.
Other Sales (Columns 1 and 2, Lines 11, 12, 13, and 14): Include Data Pertaining to sales and revenues in FERC Accounts 482 and 484.Other Operating Revenues (Line 19): Include total FERC Accounts 485 through 496.

| | Volume units(a) | Volumes Mcf<br>Column 1 | Revenues ($000s)(b)<br>Column 2 | Customers Average<br>Column 3 |
|---|---|---|---|---|
| Residential Sales | | | | |
| 1. With Heating | 20,1, | 675810 | 1019662 | 755174 |
| 2. Without Heating | 20,2, | 31650 | 66699 | 50365 |
| Commercial Sales | | | | |
| 3. Firm | 20,3, | 210700 | 308262 | 68378 |
| 4. Interruptible | 20,4, | 0 | 0 | 0 |
| Industrial Sales | | | | |
| 5. Firm-Excluding Electric Generation | 20,5, | 344590 | 180026 | 8152 |
| 6. Interruptible-Excluding Electric Generation | 20,6, | 12510 | 15984 | 3 |
| Electric Generation | | | | |
| 7. Electric Utilities-Firm | 20,7, | 0 | 0 | 0 |
| 8. Electric Utilities-Interruptible | 20,8, | 0 | 0 | 0 |
| 9. Nonutility Generation-Firm | 20,9, | 0 | 0 | 0 |
| 10.Nonutility Generation-Interruptible | 20,10, | 0 | 0 | 0 |
| Other Sales | | | | |
| 11. Refueling Stations for Vehicular Fuel | 20,11, | 0 | 0 | 0 |
| 12. Municipal and Other Public Authorities | 20,12, | 0 | 0 | 0 |
| 13. Interdepartmental | 20,13, | 0 | 0 | 0 |
| 14. Other | 20,14, | 1690 | 1980 | 3 |
| 15. TOTAL SALES LINES 1 THRU 14 | 20,15, | 1276950 | 1592613 | 882075 |
| 16.Gas Utilities(for Resale) | 20,16, | 34210 | 2967 | 0 |
| 17. TOTAL GAS SALES,REVENUES,CUSTOMERS | 20,17, | 1311160 | 1595580 | 882075 |
| 18. Transportation Volumes to End Users | 20,18, | 26620 | 69429 | 470 |
| 19. Other Operating Revenues | 20,19, | | 49496 | |
| 20. Less Provision for Rate Refund | 20,20, | | 0 | |
| 21.TOTAL GAS OPERATING REVENUES ( c) | 20,21, | | 1714505 | |
| 22. Average BTU as Distributed | 20,22, | 1 | | |

(a) If billed at different Btu value from that shown on Line 22, indicate Btu value for billing: 0 per cubic foot.
(b) Includes unbilled revenues of m$ 0 for 0 on line(s)
(c) Should agree with Schedule II, Gas Column, Line 1.

SCHEDULE XXVII
Company: Keyspan Energy Delivery New England

CONFIDENTIAL INFORMATION

Construction Expenditures (THOUSANDS OF $)

| All TYPES OF GAS | | Actual | Estimated | | | |
|---|---|---|---|---|---|---|
| | | | 2007 | 2008 | 2009 | 2010 |
| 1.Intangible Plant | 27.1 | | 2582 | 2582 | 2582 | 2582 |
| 2. General and Miscellaneous Plant | 27.2 | | 22219 | 22219 | 21785 | 21785 |
| Production | | | | | | |
| 3. SNG Plant | 27.3 | | | | | |
| 4. LNG Plant | 27.4 | | | | | |
| 5. LNG Ships | 27.5 | | | | | |
| 6. Propane Plant | 27.6 | | | | | |
| 7. Exploration & Drilling | 27.7 | | | | | |
| 8. Other (Specify) | 27.8 | | | | | |
| 9. TOTAL PRODUCTION | 27.9 | | | | | |
| Transmission | | | | | | |
| 10. New & Replacement Pipelines | 27.10 | | | | | |
| 11. Compressor Stations | 27.11 | | | | | |
| 12. Other (Specify) | 27.12 | | | | | |
| 13. TOTAL PRODUCTION | 27.13 | | | | | |
| Storage | | | | | | |
| 14. Underground Storage | 27.14 | | | | | |
| 15. LNG Storage, Terminaling, & Processing | 27.15 | | 2008 | 2008 | 2008 | 2008 |
| 16. Other (Specify) | 27.16 | | | | | |
| 17. TOTAL STORAGE | 27.17 | | | | | |
| Distribution | | | | | | |
| 18. New & Replacement Main and Service Lines | 27.18 | | 134140 | 134140 | 134140 | 134140 |
| 19. Compressor Stations | 27.19 | | | | | |
| 20. Other (Specify) | 27.20 | | 7110 | 7110 | 7110 | 7110 |
| 21. TOTAL DISTRIBUTION | 27.21 | | 141250 | 141250 | 141250 | 141250 |
| 22. TOTAL CONSTRUCTION EXPENDITURES | 27.22 | | 168059 | 168059 | 167625 | 167625 |
| 23. Additional Funds Necessary in excess of Construction Expenditure | 27.23 | | | | | |
| 24. Total Funds Required (Line 22 + 23) | 27.24 | | 168059 | 168059 | 167625 | 167625 |
| Method of Financing Funds (Percent) | | | | | | |
| 25. Internal Sources (a) | 27.25 | | | | | |
| 26. Equity Issues (a) | 27.26 | | | | | |
| 27. Debt Issues (a) | 27.27 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| 28. Bonds (if available) (b) | 27.28 | | | | | |
| 29. Debentures (if available) (b) | 27.29 | | | | | |
| 30. Long Term Notes (if available) (b) | 27.30 | | | | | |
| 31. Short Term Notes (Net, if available) (b) | 27.31 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

* If Figures are in Constant Dollars, Please give adjustment factor used 27.32

(a) Sum of Lines 25,26 and 27 should equal 100%

(b) Sum of Lines 28,29,30 and 31 should equal 100% and represent percentage breakdown of Debt Issues Total on Line 27

Schedule XXI Residential Gas Househeating Survey
Company: Keyspan Energy Delivery New England

| Schedule XXI Residential Gas Househeating Survey | OPERATING STATE | MA |
|---|---|---|
| A. RESIDENTIAL CUSTOMER DATA | | |
| Percentage of all homes in service area with gas service | 63.4 | % |
| Percentage of your gas customers that use gas for space heat | 83.2 | % |
| B. 2005 RESIDENTIAL GAS APPLIANCE INFORMATION | | |
| Annual consumption per unit furnace/boiler (Mcf) | 98 | mcf/yr |
| Annual consumption per unit Water Heater (Mcf) | 25 | mcf/yr |
| Annual consumption per unit Gas Range (Mcf) | 6 | mcf/yr |
| Annual consumption per unit Gas Clothes Dryer (Mcf) | 6 | mcf/yr |
| Annual consumption per unit Gas Fireplace/Hearth products (Mcf) | 11 | mcf/yr |
| GAS SPACE HEATING UNIT INVENTORY | | |
| ADDITIONS from New Construction | 6846 | |
| Total Conversions TO Natural Gas | 10648 | |
| Conversions to Natural Gas from Existing electric heated units | 495 | |
| Conversions to Natural Gas from Existing oil heated units | 6766 | |
| Conversions to Natural Gas from other/unknown | 3387 | |
| Total Losses from Demolition and Conversions | 0 | |
| Estimated 1% of new residential customers from conversions | 61 | % |
| COMPETITIVE FUEL PRICES | | |
| Propane residential price (cents/gallon) | 2.1800 | |
| Distillate oil (#2) residential price (cents/gallon) | 2.2000 | |

GLOSSARY

CONVERSIONS- Existing housing units, which formerly consumed an energy other than natural gas (oil, propane, electricity, coal, wood or renewables)to meet space heating requirements, that converted to operate on natural gas. Do not include conversion from one type of natural gas equipment to another.
NEW CONSTRUCTION- new single-family residential gas homes that were COMPLETED.
SERVICE AREA Defined as the territory in which a utility system is required or has the right to supply gas service to all potential customers
GAS HEARTH/FIREPLACE PRODUCTS Refers to products that burn natural gas and include stoves, ventless, and gas logs. Not wood burning products.

Uniform Statistical Report Year Ended December 31, 2006
Company: Keyspan Energy Delivery New England

Please submit the required pages to the American Gas Association for use in compiling statistics published in A.G.A.'s Gas Facts.

BECAUSE THIS REPORT IS FREQUENTLY USED IN CONJUNCTION WITH THE COMPANY'S ANNUAL REPORT TO STOCKHOLDERS, THE DATA INCLUDED HEREIN SHOULD AGREE WITH THE COMPARABLE INFORMATION IN SUCH ANNUAL REPORT. To assure accuracy and consistency, numerous crossties and footnotes have been appended to the schedules so that statistics for the same item shown on more than one schedule will be identical.

All energy and dollar amount should be reported in thousands.

**Name and Address of Company:**

Boston Gas Company
Essex Gas Company
Colonial Gas Company
Energy North Natural Gas,
Inc. D/B/A KeySpan
Energy Delivery, New
England 52 Second
Avenue Waltham, MA
02453

List Affiliated Companies:
Indicate Relationship (Parent, Subsidiary, Associates, etc.)

KeySpan Corporation - Parent

Individual Furnishing Information

| | | | |
|---|---|---|---|
| Name | Kenneth D. Daly | Authorizer | Paul J. Bailey |
| Title | Senior Vice President & CFO | Title | Vice President & Controller |
| Telephone | 718-403-2000 | | |
| Recipient E-mail: | | | |

Check This Box if Individual Company Data may be Released

**THIS REPORT HAS BEEN PREPARED FOR THE PURPOSE OF PROVIDING GENERAL AND STATISTICAL INFORMATION CONCERNING THE COMPANY AND NOT IN CONNECTION WITH ANY SALE, OFFER FOR SALE OR SOLICITATION OF AN OFFER TO BUY ANY SECURITIES.**

Company: **Keyspan Energy Delivery New England**

**Page 1 - Schedule I - General Statistics**

1. Utility systems acquired, sold or otherwise disposed of: (Indicate the period for which these acquisitions or sales are reflected in this report.)

| ACQUIRED DURING | SOLD OR OTHERWISE DISPOSED OF DURING YEAR |
|---|---|

| Name of System | - | Date | - | # of Customers | - | Name of System | - | Date | - | # of Customers |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | |
| | | | | | | | | | | |
| | | | | | | | | | | |
| | | | | | | | | | | |

Keyspan Energy Delivery New England

Page 2 - Schedule II - Statements of Income and Retained Earnings

| INCOME | | Total | Electric | Gas | Other |
|---|---|---|---|---|---|
| 1. Operating Revenues | 2,1, | 1623833 | | 1623833 | |
| Operating Expenses: | | | | | |
| 2. Operation | 2,2, | 1297181 | | 1297181 | |
| 3. Maintenance | 2,3, | 49792 | | 49792 | |
| 4. Depreciation | 2,4, | 103346 | | 103346 | |
| 5. Depletion | 2,5, | 0 | | 0 | |
| 6. Amort. Charged to Operation | 2,6, | 10285 | | 10285 | |
| 7. Property Losses Charged to Operation | 2,7, | 0 | | 0 | |
| 8. Taxes | 2,8, | 41946 | | 41946 | |
| 9.TAXES OTHER THAN INCOME TAXES | 2,9, | 19522 | | 19522 | |
| 10. Total Operating Expenses | 2,10, | 1522072 | | 1522072 | |
| 11. Operating Income | 2,11, | 101761 | | 101761 | |
| 12. Other Operating Income | 2,12, | 0 | | 0 | |
| 13. Total Operating Income | 2,13, | 101761 | | 101761 | |
| 14. A.F.U.D.C | 2,14, | 0 | | | |
| 15.Other Income Less Deductions Net | 2,15, | 11853 | | | |
| 16. | 2,16, | 0 | | | |
| 17. Minority Interest | 2,17, | 0 | | | |
| 18. Income Before Interest Charges | 2,18, | 113614 | | | |
| Interest Charges : | | | | | |
| 19. Interest on Long -Term Debt | 2,19, | 22584 | | | |
| 20. Interest on Short -Term Debt | 2,20, | 0 | | | |
| 21. Amort. Of Debt Disc. Exp. And Prem. (Net) | 2,21, | 444 | | | |
| 22.Other Interest Expense | 2,22, | 40191 | | | |
| 23. Allow for Borrowed funds Used During Constr. Credit | 2,23, | -842 | | | |
| 24. Net Interest Charges | 2,24, | 62377 | | | |
| 25. Income Before Ext. Items and Cumulative Effects | 2,25, | 51237 | | | |
| 26. Ext. Items and Cumulative Effects (Net) | 2,26, | 0 | | | |
| 27.Net Income Before Pfd Dividends | 2,27, | 51237 | | | |
| 28.Pfd and Pfc Dividend Requirements | 2,28, | 0 | | | |
| 29. Net Income Available for Common Stock | 2,29, | 51237 | | | |
| 30. Common Dividends | 2,30, | 0 | | | |
| 31. Net Income After Dividends | 2,31, | 51237 | | | |
| RETAINED EARNINGS | | | | | |
| 32. Balance, January 1 | 2,32, | 53592 | | | |
| 33. Net Income (Line 27) | 2,33, | 51237 | | | |
| 34.Pfd and Pfc Dividends Declared | 2,34, | | | | |
| 35. Common Dividends Declared Cash | 2,35, | | | | |
| 36. Common Dividends Declared Other | 2,36, | | | | |
| 37. Adjustments | 2,37, | | | | |
| 38. Balance, YEAR END | 2,38, | 104829 | | | |

Keyspan Energy Delivery New England

Page 3 - Schedule IV -Functional Details of Operation and Maintenance Expenses

| | | ELECTRIC | | | GAS | | |
|---|---|---|---|---|---|---|---|
| | | Total | Operation | Maintenance | Total | Operation | Maintenance |
| 1. | Fuel (a).. | | | | | | |
| 2. | Purchased Power (Net) | | | | | | |
| 3. | Purchased Gas (Net) (b) | | | | 1112751 | 1112751 | |
| 4. | Other Prod. Expenses ( c) | | | | 7851 | 6407 | 1444 |
| 5. | Total Production | | | | 1120602 | 1119158 | 1444 |
| 6. | Storage & Liquefied Natural Gas (d) | | | | -14494 | 2466 | -16960 |
| 7. | Transmission (e) | | | | 0 | 0 | 0 |
| 8. | Distribution (f) | | | | 100158 | 35201 | 64957 |
| 9. | Customer Accounts (g) | | | | 35782 | 35782 | 0 |
| 10. | Customer Service & Info. (h) | | | | 0 | 0 | 0 |
| 11. | Sales (i) | | | | 13393 | 13393 | 0 |
| 12. | Administrative & General | | | | 91533 | 91182 | 351 |
| 13. | Total | | | | 1346974 | 1297182 | 49792 |
| 14. | Credit Residual included in Line | | | 4,14, | | | |

(a) Includes FERC System of Accounts 501,518 and 547.

(b) Includes FERC System of Accounts 800 (wellhead purchases), 801 (field line purchases), 802 (plant outlet purchases), 803 (transmission line purchases), 804 (city gate purchases) LESS 804.1 (LNG), and 807 (Purchased gas expense)

(c ) Includes FERC System of Accounts 805 (Other gas purchases and purchase gas adjustments), 806 (Exchange gas), 812 (Gas used for other utility operations), and 813 (other gas supply expense)

(d) Includes FERC System of Accounts 814 (Operation supervision and engineering), 815 (Maps and records), 816 (Wells expenses), 817 (Lines Expenses) and 818 (Compressor station expenses)

(e) Includes FERC System of Accounts 850 (Operations, supervision and engineering), 851 (System control and load dispatching), 852 (Communication system expenses), 853 (Compressor station labor and expenses), 854 (Gas for compressor station fuel), 855 (Other fuel and power for compressor stations), 856 (Main expenses), 857 (Measuring and regulating station expenses), 858 (Transmission and compression of gas by others), 859 (Other expenses), 860 (Rents), 861 (Maintenance supervision and engineering), 862 (Maintenance of structures and improvements), 863 (Maintenance of mains), 864 (Maintenance of compressor station equipment), 865 (Maintenance of measuring and regulating station equipment), 866 (Maintenance of communication equipment), 867 (Maintenance of other equipment), and 870 (Operation supervision and engineering)

(f) Includes FERC System of Accounts 871 (Distribution load dispatching), 872 (Compressor station labor and expenses), 873 (Compressor station fuel and power (Major only)), 874 (Mains and sevice expenses), 875 (Measuring and regulating station expenses - General), 876 (Measuring and regulating station expenses - Industrial), 877 (Measuring and regulating station expenses - City Gate Check Stations), 878 (Meter and house regulator expenses), 879 (Customer installation expenses), 880 (Other expenses), 881 (Rents), 885 (Maintenance supervision and engineering), 886 (Maintenance of structure and improvements), 887 (Maintenance of mains), 888 (Maintenance of compressor station equipment), 889 (Maintenance of measuring and regulating station equipment - General), 890 Maintenance of measuring and regulating station equipment - Industrial), 891 (Maintenance of measuring and regulating station equipment - City Gate Check Stations), 892 (Maintenance of services), 893 (Maintenance of meters and house regulators), and 894 (Maintenance of other equipment)

(g) Includes FERC System of Accounts 901 (Supervision), 902 (Meter reading expense), 903 (Customer records and collection expenses), 904(Uncollectable accounts), and 905 (Misc. customer accounts expenses)

(h) Includes FERC System of Accounts 907 (Supervision), 908 (Customer assistance expenses), 909 (Informational and instructional advertising expense),and 910 (Misc customer and informational expense)

(i) (i) Includes FERC System of Accounts 911 (Supervision), 912 Demonstrating and selling expenses), 913 (Advertising expense), and 916 (Misc sales expenses)

Company: Keyspan Energy Delivery New England
Page 4 - Schedule V - Taxes (thousands of $)

ACCRUALS CHARGED TO :

OPERATING EXPENSES TAXES (THOUSANDS OF $)

| | | TOTAL | Electric | Gas | Other Depts. | All Other Accounts (a) |
|---|---|---|---|---|---|---|
| 1.Property, Ad valorem, etc | 5.1 | 24746 | | 24746 | | |
| 2. Franchise | 5.2 | 6870 | | 6870 | | |
| 3. Gross Receipts | 5.3 | 0 | | 0 | | |
| 4. | 5.4 | 0 | | 0 | | |
| 5. Miscellaneous | 5.5 | 45 | | 45 | | |
| 6. Total State & Local Taxes | 5.6 | 31661 | | 31661 | | |
| Misc. Federal Taxes | | | | | | |
| 7. Payroll | 5.7 | 2684 | | 2684 | | |
| 8. | 5.8 | 0 | | 0 | | |
| 9.Total Misc. Federal Taxes | 5.9 | 2684 | | 2684 | | |
| 10.Total Taxes Income | 5.10 | 34345 | | 34345 | | |
| Income Taxes Current | | | | | | |
| 11.Federal Income Taxes | 5.11 | 4058 | | 4058 | | |
| 12.State Income Taxes | 5.12 | 293 | | 293 | | |
| 13.Total Income Taxes | 5.13 | 4351 | | 4351 | | |
| Deferred Income Tax Charges | | | | | | |
| 14.Federal | 5.14 | 3385 | | 3385 | | |
| 15. State | 5.15 | -135 | | -135 | | |
| Deferred Income Tax Credits | | | | | | |
| 16.Federal | 5.16 | | | | | |
| 17.State | 5.17 | | | | | |
| 18.Investment Tax Credit | 5.18 | | | | | |
| 19.Total Taxes (b) | 5.19 | 41946 | | 41946 | | |

(a) Such as Utility Plant, Other Income Deductions, Extraordinary items, Clearing Accounts, Retained Earnings, etc.
(b) Should equal Total of Lines 10, 13, 14, 15, 16, 17 and 18 and agree with line 8, Schedule II.

Company : Keyspan Energy Delivery New England
Page 5 - Schedule VI - Balance Sheet

ASSETS

| | | |
|---|---|---|
| UTILITY PLANT: | | |
| Plant in Service: | | |
| 1. Electric | 6,1 | 0 |
| 2. Gas | 6,2 | 3791498 |
| 3. Common | 6,3 | 0 |
| 4. LAND | 6,4 | 608 |
| 5. Total Plant in Service | 6,5 | 3792106 |
| 6.Accum. Prov. for Depr. & Amort. | 6,6 | 1064123 |
| 7. Construction Work in Progress | 6,7 | 71441 |
| 8. Nuclear Fuel | 6,8 | 0 |
| 9. Accum. Prov. for Amort. Of Nuclear Fuel | 6,9 | 0 |
| 10. HELD FOR FUTURE USE | 6,10 | 516 |
| 11. | 6,11 | 0 |
| 12. Net Utility Plant | 6,12 | 2799940 |
| 13. Gas Stored Underground | 6,13 | 0 |
| 14. CAPITAL LEASES (NET) | 6,14 | 9725 |
| 15.Other Property and Investments (Net) | 6,15 | 3796 |
| 16. Decommissioning Funds | 6,16 | 0 |
| Current and Accrued Assets: | | |
| 17. Cash, Spec. Dep., Wkg. Funds & Temp.Cash Investments | 6,17 | 4849 |
| 18.Gas Stored Underground (Current) | 6,18 | 0 |
| 19. LNG Held and Stored for Processing | 6,19 | 0 |
| 20. Notes Receivable | 6,20 | 0 |
| 21. Customer Accounts Receivable (Net) | 6,21 | 155643 |
| 22. Receivables from Investor Owned Elec. Cos. | 6,22 | 0 |
| 23. Other Receivables | 6,23 | 48289 |
| 24. Accrued Unbilled Revenues | 6,24 | 127003 |
| 25. Materials and Supplies | 6,25 | 87983 |
| 26. Prepayments | 6,26 | 121678 |
| 27. Other Current and Accrued Assets | 6,27 | 4856 |
| 28. RECOVERABLE FUEL | 6,28 | 95785 |
| 29. Total Current & Accrued Assets | 6,29 | 646086 |
| Deferred Debits: | | |
| 30. Regulatory Assets | 6,30 | 0 |
| 31. Unamortized Debt Expense | 6,31 | 5851 |
| 32. Extraordinary Property losses | 6,32 | 0 |
| 33. Other Deferred Debits | 6,33 | 471337 |
| 34. | 6,34 | 0 |
| 35. Total Deferred Debits | 6,35 | 477188 |
| 36. Total Assets | 6,36 | 3936735 |

CAPITALIZATION AND LIABILITIES

| | | |
|---|---|---|
| Capitalization: | | |
| 37. Common Stock | 6,37 | 76389 |
| 38. OTHER COMPREHENSIVE INCOME | 6,38 | -6120 |
| 39. Premium on Common Stock (if not in Line 40) | 6,39 | 420069 |
| 40. Other Paid-In Capital | 6,40 | 1069000 |
| 41. Retained Earnings | 6,41 | 92641 |
| 42. Total Common Stock Equity | 6,42 | 1651979 |
| 43. | 6,43 | 0 |
| 44. Preferred and Preference Stock not subject to mandatory Redemption | 6,44 | 0 |
| 45. Preferred and Preference Stock subject to Mandatory Redemption | 6,45 | 0 |
| Long Term Debt: (Ex.amt.due within 1 yr) | | |
| 46. Mortgage Bonds | 6,46 | 0 |
| 47. Debentures | 6,47 | 278000 |
| 48. Other | 6,48 | 9725 |
| 49. CAPITAL LEASE OBLIGATIONS | 6,49 | 0 |
| 50. Total Long-Term Debt | 6,50 | 287725 |
| 51. Total capitalization(Excl.amt. due with in one year) | 6,51 | 1939704 |
| Other Non-Current Liabilities: | | |
| 52. Accum. Prov. for Rate Refunds | 6,52 | 0 |
| 53. | 6,53 | 0 |
| 54. Total Other Non Current Liabilities | 6,54 | 0 |
| Current and Accrued Liabilities: | | |
| 55. Amounts Due within one year | 6,55 | |
| 56. Short Term Debt | 6,56 | |
| 57. Accts. Payable (Excl.amt. in Line 58) | 6,57 | 149644 |
| 58. Payables to Investor Owned Elec. Cos. | 6,58 | 0 |
| 59. Taxes Accrued | 6,59 | 3255 |
| 60.Other Current and Accrued Liabilities | 6,60 | 1354627 |
| 61. Total Other Non-Current Liabilities | 6,61 | 1507526 |
| Deferred Credits: | | |
| 62. Accumulated Deferred Income Taxes | 6,62 | 0 |
| 63. Accum. Deferred Investment Tax Credits | 6,63 | 0 |
| 64. Regulatory Liabilities | 6,64 | 0 |
| 65. Customer Advances for Construction | 6,65 | 217 |
| 66. Other Deferred Costs | 6,66 | 140006 |
| 67. Total Deferred Credits | 6,67 | 140223 |
| 69. Total Capitalization and Liabilities | 6,69 | 3936735 |

Company: Keyspan Energy Delivery New England
Page 6 - Schedule VIII - Utility Plant by Functional Accounts (thousands of $)

| | | UTILITY PLANT BY FUNCTIONAL ACCOUNTS (THOUSANDS Of $) | | CONSTRUCTION EXPENDITURES |
|---|---|---|---|---|
| | | Utility Plant | Accum. Prov. for Amort and Depl. | For Reported Year |
| ELECTRIC | | | | |
| 1. Intangible Production Plant | 8.1 | | | |
| 2. Steam | 8.2 | | | |
| 3. Nuclear | 8.3 | | | |
| 4. Hydro | 8.4 | | | |
| 5. Pumped Storage | 8.5 | | | |
| 6. Gas Turbine | 8.6 | | | |
| 7. Other | 8.7 | | | |
| 8. Total Prod. Plant | 8.8 | | | |
| 9. Transmission Plant | 8.9 | | | |
| 10. Distribution Plant | 8.10 | | | |
| 11. General Plant | 8.11 | | | |
| 12.Subtotal | 8.12 | | | |
| 13. Miscell. Plant | 8.13 | | | |
| 14. Construction Work in Progress | 8.14 | | XXXXXXXXXX | XXXXXXXXXX |
| 15. Plant Held for Future Use | 8.15 | | | |
| 16. Plant Acq Adj & Other Adj | 8.16 | | | XXXXXXXXXX |
| 17. Ele Plant Excl Nucl | 8.17 | | | |
| 18. Nuclear Fuel | 8.18 | | | |
| 19. Total Electric Plant | 8.19 | | | |
| GAS | | | | |
| 20. Intangible Plant | 8.20 | 1394448 | | |
| 21. Production | 8.21 | 58365 | | |
| 22. Underground Storage | 8.22 | 0 | | |
| 23. Other Storage | 8.23 | 17661 | | |
| 24. LNG.Stor., Term. & Proc | 8.24 | 0 | | |
| 25.Transmission | 8.25 | 0 | | |
| 26. Distribution | 8.26 | 2249281 | | |
| 27.General | 8.27 | 71739 | | |
| 28.Subtotal | 8.28 | 3791494 | | |
| 29. Misc. Plant | 8.29 | 0 | 1064123 | |
| 30. Const. Work in Progress | 8.30 | 71441 | XXXXXXXXXX | XXXXXXXXXX |
| 31. Plant Held for Future Use | 8.31 | 516 | | |
| 32. Plant Acq Adj & Other Adj | 8.32 | 0 | | XXXXXXXXXX |
| 33. Total Gas Plant | 8.33 | 3863451 | 1064123 | |
| OTHER UTILITY PLANT | | | | |
| 34. LAND | 8.34 | 608 | | |
| 35. | 8.35 | | | |
| 36. Total Other Utility Plant | 8.36 | 608 | | |
| 37. Common Plant | 8.37 | | | |
| 38. Total Utility Plant | 8.38 | 3864059 | 1064123 | |

Company: Keyspan Energy Delivery New England

Page 7 - Schedule XII - Statement of Cash Flows

| | | |
|---|---|---|
| | OPERATING ACTIVITIES | |
| 1. | Net Income | 51237 |
| 2. | Depreciation, Depletion and Amortization | 113631 |
| 3 | Deferred Income taxes (Net) | 22190 |
| 4 | Deferred Investment Tax Credits | 0 |
| 5 | Allowance for Funds Used During Construction (Equity) | 0 |
| 6 | | 0 |
| 7 | | 0 |
| 8 | Materials and Supplies, Fuel Inventories, Gas in Storage | -4494 |
| 9 | Accounts Receivable (Net) | 96946 |
| 10 | | 0 |
| 11 | Other Current Assets | -13458 |
| 12 | Accounts Payable | 2608 |
| 13 | Accrued Taxes | 0 |
| 14 | | 0 |
| 15 | | 0 |
| 16 | Other Current Liabilities | -34838 |
| 17 | | 0 |
| 18 | Net Cash Provided by (Used For) Operational Activities | 233822 |
| | INVESTING ACTIVITIES | |
| 19 | Construction Expenditures (excl. AFDC-Equity) | -149059 |
| 20 | Purchase of other Investments | 4 |
| 21 | Sale of other Investments | 0 |
| 22 | COST OF REMOVAL | -15988 |
| 23 | | 0 |
| 24 | | 0 |
| 25 | Net Cash Provided by (Used For) Investing Activities | -165043 |
| | FINANCING ACTIVITIES | |
| 26 | Common Stock Dividends | 0 |
| 27 | Preferred/Preference Stock Dividends | 0 |
| 28 | Issuance of Long-Term Debt (Net Proceeds) | -12000 |
| 29 | Issuance of Preferred/Preference Stock (Net Proceeds) | |
| 30 | Issuance of Common Stock (Net Proceeds) | |
| 31 | Increase (Decrease) in Short-Term Debt (Net) | |
| 32 | Redemption of Long-Term Debt (Net Payments) | |
| 33 | Redemption of Preferred/Preference Stock (Net Payments) | |
| 34 | INTERCOMPANY (NET) | -56588 |
| 35 | | |
| 36 | Net Cash Provided By (Used For) Financial Activities | -68588 |
| 37 | Increase (Decrease) in Cash and Cash Equivalents | 191 |
| 38 | Cash and Cash Equivalents at Beginning of Year | 4660 |
| 39 | Cash and Cash Equivalents at End of Year | 4851 |

Company: Keyspan Energy Delivery New England

Page 8 - Schedule XIII- Employee Data

Allocate to Electric, Gas and Other common employees who devote part of their time to Electric and part to Gas, and/or Other Departments.

Estimate Splits on basis of payroll dollars or any other reasonable basis.

When submitting gas utility data and your utility is a subsidiary/affiliate with shared employees, financial statements, etc., please utilize the employee allocation methodology you would employ when providing data in a gas utility rate case filing.

| NUMBER OF EMPLOYEES | ELECTRIC | GAS | OTHER | TOTAL |
|---|---|---|---|---|
| 1. Average for the Year * (IMPORTANT NOTE) | | 1106 | | 1106 |
| 2. At Year End * (IMPORTANT NOTE) | | 1093 | | 1093 |
| SALARIES AND WAGES (THOUSANDS of $) (a) | | | | |
| 3. Operation and Maintenance | | 87478 | | 87478 |
| 4. Construction | | 37411 | | 37411 |
| 5. Other (describe) | | 14620 | | 14620 |
| 6. Total | | 139509 | | 139509 |
| PENSIONS AND BENEFITS (THOUSANDS of $) | | | | |
| 7. Operation and Maintenance | | | | |
| 8. Construction | | | | |
| 9. Other (describe) | | | | |
| 10. Total | | | | |

(a) Do not include pensions and benefits

* FOR ANY COMPANIES WISHING TO RECEIVE THE AGA FINANCIAL BENCHMARKING RESULTS BOTH YEAR END AND AVERAGE EMPLOYEE DATA MUST BE COMPLETED

CLASSIFICATIONS OF GAS VOLUMES, REVENUES AND CUSTOMERS
Company: Keyspan Energy Delivery New England

Companies operating in more than one state should complete this schedule for each state in which they operate.
Note: Report Data for All Types of Gases EXCEPT BOTTLED GAS.
Customers: Average number of bills rendered should be based on twelve monthly figures. Utilities not reading all meters each month should make allowance for unread meters of active customers. Enter count of customers who fall into more than one category only in category of greater usage.
Residential Heating Data: Furnish estimates, if figures are not available directly from company records, of all residential heating customers should include amounts associated with other appliance usage of these customers.
Other Sales (Columns 1 and 2, Lines 11, 12, 13, and 14): Include Data Pertaining to sales and revenues in FERC Accounts 482 and 484.Other Operating Revenues (Line 19): Include total FERC Accounts 485 through 496.

| | | Volumes (a) Dekatherms | Revenues ($000s)(b) | Customers Average |
|---|---|---|---|---|
| Residential Sales | | | | |
| 1. With Heating | 20,1, | 59522 | 1016231 | 659309 |
| 2. Without Heating | 20,2, | 2975 | 64349 | 154410 |
| Commercial Sales | | | | |
| 3. Firm | 20,3, | 18787 | 297745 | 67285 |
| 4. Interruptible | 20,4, | 0 | 0 | 0 |
| Industrial Sales | | | | |
| 5. Firm-Excluding Electric Generation | 20,5, | 11493 | 170856 | 7122 |
| 6. Interruptible-Excluding Electric Generation | 20,6, | 217 | 2595 | 30 |
| Electric Generation | | | | |
| 7. Electric Utilities-Firm | 20,7, | 0 | 0 | 0 |
| 8. Electric Utilities-Interruptible | 20,8, | 0 | 0 | 0 |
| 9. Nonutility Generation-Firm | 20,9, | 0 | 0 | 0 |
| 10.Nonutility Generation-Interruptible | 20,10, | 0 | 0 | 0 |
| Other Sales | | | | |
| 11. Refueling Stations for Vehicular Fuel | 20,11, | 0 | 0 | 0 |
| 12. Municipal and Other Public Authorities | 20,12, | 115 | -4397 | 0 |
| 13. Interdepartmental | 20,13, | 0 | | 0 |
| 14. Other | 20,14, | 0 | | 0 |
| 15. TOTAL SALES LINES 1 THRU 14 | 20,15, | 93109 | 1547379 | 888156 |
| 16.Gas Utilities(for Resale) | 20,16, | 4537 | 30729 | |
| 17. TOTAL GAS SALES,REVENUES,CUSTOMERS | 20,17, | 97646 | 1578108 | 888156 |
| 18. Transportation Volumes to End Users | 20,18, | 3031 | 88880 | |
| 19. Other Operating Revenues | 20,19, | | -43155 | |
| 20. Less Provision for Rate Refund | 20,20, | | | |
| 21.TOTAL GAS OPERATING REVENUES ( c) | 20,21, | | 1623833 | |
| 22. Average BTU as Distributed | 20,22, | 1 | | |

(a) If billed at different Btu value from that shown on Line 22, indicate Btu value for billing: per cubic foot.
(b) Includes unbilled revenues of m$ for___ on line(s)
(c) Should agree with Schedule II, Gas Column, Line 1.

CLASSIFICATIONS OF GAS VOLUMES, REVENUES AND CUSTOMERS
Company: Keyspan Energy Delivery New England

Companies operating in more than one state should complete this schedule for each state in which they operate.
Note: Report Data for All Types of Gases EXCEPT BOTTLED GAS.
Customers: Average number of bills rendered should be based on twelve monthly figures. Utilities not reading all meters each month should make allowance for unread meters of active customers. Enter count of customers who fall into more than one category only in category of greater usage.
Residential Heating Data: Furnish estimates, if figures are not available directly from company records, of all residential heating customers should include amounts associated with other appliance usage of these customers.
Other Sales (Columns 1 and 2, Lines 11, 12, 13, and 14): Include Data Pertaining to sales and revenues in FERC Accounts 482 and 484.Other Operating Revenues (Line 19): Include total FERC Accounts 485 through 496.

| | | Volumes (a) Dekatherms | Revenues ($000s)(b) | Customers Average |
|---|---|---|---|---|
| Residential Sales | | | | |
| 1. With Heating | 20,1, | 59522 | 1016231 | 659309 |
| 2. Without Heating | 20,2, | 2975 | 64349 | 154410 |
| Commercial Sales | | | | |
| 3. Firm | 20,3, | 18787 | 297745 | 67285 |
| 4. Interruptible | 20,4, | 0 | 0 | 0 |
| Industrial Sales | | | | |
| 5. Firm-Excluding Electric Generation | 20,5, | 11493 | 170856 | 7122 |
| 6. Interruptible-Excluding Electric Generation | 20,6, | 217 | 2595 | 30 |
| Electric Generation | | | | |
| 7. Electric Utilities-Firm | 20,7, | 0 | 0 | 0 |
| 8. Electric Utilities-Interruptible | 20,8, | 0 | 0 | 0 |
| 9. Nonutility Generation-Firm | 20,9, | 0 | 0 | 0 |
| 10.Nonutility Generation-Interruptible | 20,10, | 0 | 0 | 0 |
| Other Sales | | | | |
| 11. Refueling Stations for Vehicular Fuel | 20,11, | 0 | 0 | 0 |
| 12. Municipal and Other Public Authorities | 20,12, | 115 | -4397 | 0 |
| 13. Interdepartmental | 20,13, | 0 | | 0 |
| 14. Other | 20,14, | 0 | | 0 |
| 15. TOTAL SALES LINES 1 THRU 14 | 20,15, | 93109 | 1547379 | 888156 |
| 16.Gas Utilities(for Resale) | 20,16, | 4537 | 30729 | |
| 17. TOTAL GAS SALES,REVENUES,CUSTOMERS | 20,17, | 97646 | 1578108 | 888156 |
| 18. Transportation Volumes to End Users | 20,18, | 3031 | 88880 | |
| 19. Other Operating Revenues | 20,19, | | -43155 | |
| 20. Less Provision for Rate Refund | 20,20, | | | |
| 21.TOTAL GAS OPERATING REVENUES ( c) | 20,21, | | 1623833 | |
| 22. Average BTU as Distributed | 20,22, | | | |

(a) If billed at different Btu value from that shown on Line 22, indicate Btu value for billing: 0 per cubic foot.
(b) Includes unbilled revenues of m$ for___ on line(s)
(c) Should agree with Schedule II, Gas Column, Line 1.

Page 10 - Schedule XXVII - Construction and Financing Program
Company: Keyspan Energy Delivery New England

CONFIDENTIAL INFORMATION

Construction Expenditures (THOUSANDS OF $)

| All TYPES OF GAS | | Actual | Estimated | | | |
|---|---|---|---|---|---|---|
| | | | 2008 | 2009 | 2010 | 2011 |
| 1.Intangible Plant | 27.1 | | 23151 | 17836 | 8943 | 9007 |
| 2. General and Miscellaneous Plant | 27.2 | | 8237 | 8237 | 8237 | 8237 |
| Production | | | | | | |
| 3. SNG Plant | 27.3 | | | | | |
| 4. LNG Plant | 27.4 | | | | | |
| 5. LNG Ships | 27.5 | | | | | |
| 6. Propane Plant | 27.6 | | | | | |
| 7. Exploration & Drilling | 27.7 | | | | | |
| 8. Other (Specify) | 27.8 | | | | | |
| 9. TOTAL PRODUCTION | 27.9 | | | | | |
| Transmission | | | | | | |
| 10. New & Replacement Pipelines | 27.10 | | | | | |
| 11. Compressor Stations | 27.11 | | | | | |
| 12. Other (Specify) | 27.12 | | | | | |
| 13. TOTAL PRODUCTION | 27.13 | | | | | |
| Storage | | | | | | |
| 14. Underground Storage | 27.14 | | | | | |
| 15. LNG Storage, Terminaling, & Processing | 27.15 | | 4200 | 4200 | 4200 | 4200 |
| 16. Other (Specify) | 27.16 | | | | | |
| 17. TOTAL STORAGE | 27.17 | | | | | |
| Distribution | | | | | | |
| 18. New & Replacement Main and Service Lines | 27.18 | | 168300 | 168300 | 168300 | 168300 |
| 19. Compressor Stations | 27.19 | | | | | |
| 20. Other (Specify) | 27.20 | | 8875 | 8875 | 8875 | 8875 |
| 21. TOTAL DISTRIBUTION | 27.21 | | 177175 | 177175 | 177175 | 177175 |
| 22. TOTAL CONSTRUCTION EXPENDITURES | 27.22 | | 212763 | 207448 | 198555 | 198619 |
| 23. Additional Funds Necessary in excess of Construction Expenditure | 27.23 | | | | | |
| 24. Total Funds Required (Line 22 + 23) | 27.24 | | 212763 | 207448 | 198555 | 198619 |
| Method of Financing Funds (Percent) | | | | | | |
| 25. Internal Sources (a) | 27.25 | | | | | |
| 26. Equity Issues (a) | 27.26 | | | | | |
| 27. Debt Issues (a) | 27.27 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |
| 28. Bonds (if available) (b) | 27.28 | | | | | |
| 29. Debentures (if available) (b) | 27.29 | | | | | |
| 30. Long Term Notes (if available) (b) | 27.30 | | | | | |
| 31. Short Term Notes (Net, if available) (b) | 27.31 | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

* If Figures are in Constant Dollars, Please give adjustment factor used 27.32 ____________

(a) Sum of Lines 25,26 and 27 should equal 100%

(b) Sum of Lines 28,29,30 and 31 should equal 100% and represent percentage breakdown of Debt Issues Total on Line 27

Page 11 - Schedule XXI Residential Gas Househeating Survey
Company: Keyspan Energy Delivery New England

| Schedule XXI Residential Gas Househeating Survey | OPERATING STATE | MA |
|---|---|---|
| A. RESIDENTIAL CUSTOMER DATA | | |
| Percentage of all homes in service area with gas service | 49 | % |
| Percentage of your gas customers that use gas for space heat | 84 | % |
| B. 2005 RESIDENTIAL GAS APPLIANCE INFORMATION | | |
| Annual consumption per unit furnace/boiler (Mcf) | 70 | mcf/yr |
| Annual consumption per unit Water Heater (Mcf) | 25 | mcf/yr |
| Annual consumption per unit Gas Range (Mcf) | 6 | mcf/yr |
| Annual consumption per unit Gas Clothes Dryer (Mcf) | 5 | mcf/yr |
| Annual consumption per unit Gas Fireplace/Hearth products (Mcf) | 11 | mcf/yr |
| GAS SPACE HEATING UNIT INVENTORY | | |
| ADDITIONS from New Construction | 6392 | |
| Total Conversions TO Natural Gas | 16835 | |
| Conversions to Natural Gas from Existing electric heated units | 581 | |
| Conversions to Natural Gas from Existing oil heated units | 6942 | |
| Conversions to Natural Gas from other/unknown | 9312 | |
| Total Losses from Demolition and Conversions | 0 | |
| Estimated 1% of new residential customers from conversions | 38 | % |
| COMPETITIVE FUEL PRICES | | |
| Propane residential price (cents/gallon) | 2.3800 | |
| Distillate oil (#2) residential price (cents/gallon) | 2.4500 | |

GLOSSARY

CONVERSIONS- Existing housing units, which formerly consumed an energy other than natural gas (oil, propane, electricity, coal, wood or renewables)to meet space heating requirements, that converted to operate on natural gas. Do not include conversion from one type of natural gas equipment to another.
NEW CONSTRUCTION- new single-family residential gas homes that were COMPLETED.
SERVICE AREA Defined as the territory in which a utility system is required or has the right to supply gas service to all potential customers
GAS HEARTH/FIREPLACE PRODUCTS Refers to products that burn natural gas and include stoves, ventless, and gas logs. Not wood burning products.

**Summary Work Papers**
**(1604.01(a)(28))**

These documents will be submitted under separate cover