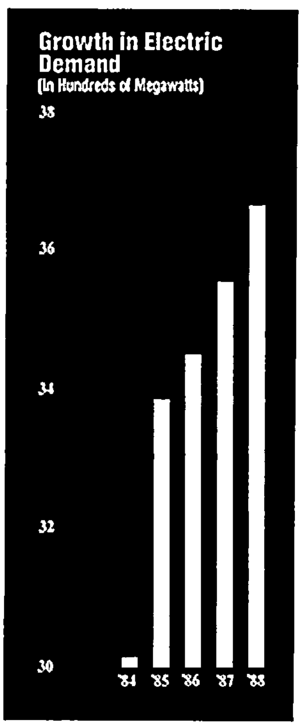
1988 Annual Report

Long Island Lighting Company

1988

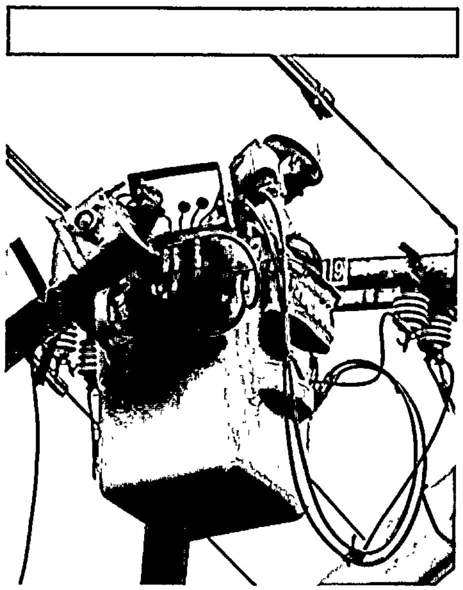
A Year Of High Energy Sales And Improved Service

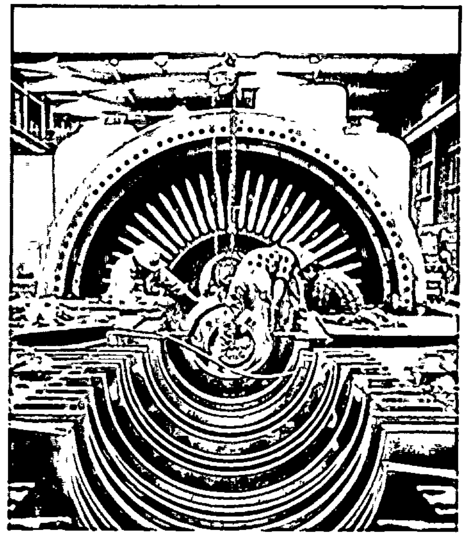
In 1988, LILCO made significant strides to improve service to its customers and provide Long Island with a reliable energy supply despite serious power shortages and a record demand for electricity. The company achieved these results under a new and energetic senior management which together with its employees is dedicated to continue improving the company. This annual report discusses some of the programs LILCO has implemented to achieve these ends.



To Our Shareowners
In this report to all shareowners, Chairman and Chief Executive Officer William J. Catacosinos describes how LILCO has responded to the extraordinary challenges facing the company.

New Records Set For Power Use
For the fifth straight year, Long Islanders set a new all-time record for peak power use. On August 15, 1988, a record 3,822 megawatts were used, up 246 megawatts from 1987's record-breaking demand. In addition, a new winter peak was established on January 4, 1989 when LILCO customers used 3,017 megawatts of electricity. Meanwhile, the average Long Island household continues to increase its power use, up 12 percent over the past three years.



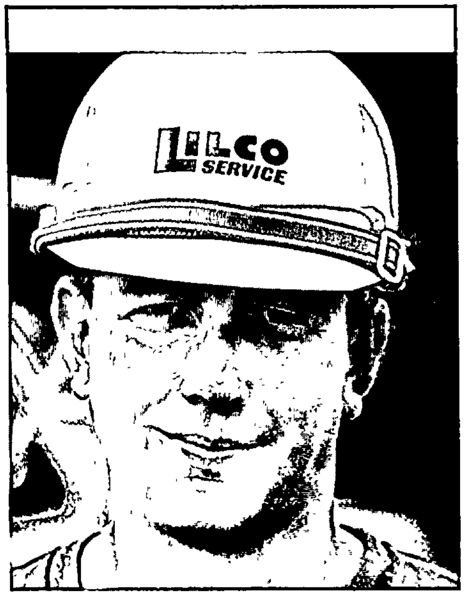


LILCO Power Plants Operate At 98% Availability During Summer Heat Wave
With no additional generating facilities, LILCO must rely on importing electricity from other utilities and upgrading its aging power plants to increase their performance during the hottest days of the year. During last summer's peak, 98 percent of LILCO's plant capacity was available to produce power—exceeding the industry average of 85 percent.

New Consumer Programs
Customer satisfaction with LILCO service is at an all-time high as measured by complaint data from the New York State Public Service Commission (PSC). LILCO's new consumer programs are tailored to serve the individual needs of customers.

Gas Operations Continue To Expand
In 1988, LILCO installed more than 65 miles of new gas pipelines and connected 7,200 new customers. The company now has 421,429 gas customers. A comprehensive marketing program offers customers an easy way to find out whether converting to gas heat will save them money on their energy costs.

Working For A Better Long Island
The people at LILCO are the company's greatest resource. The dedication of LILCO employees to the community they serve reaches beyond providing electric and gas service.



About the Cover

Meter Reader Philip Clark takes a minute out of a hot summer day to talk with a customer and her daughters about LILCO's many new consumer programs. Through an enhanced customer service program, the people at LILCO have demonstrated a commitment to their neighbors across Long Island. Last August, employee efforts paid off as LILCO became number one in customer satisfaction by recording the lowest complaint rate in New York State.

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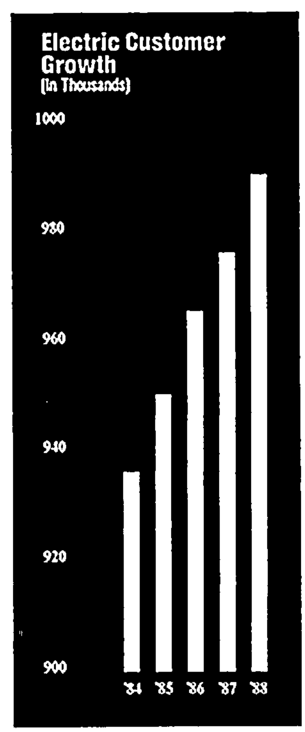


To Our Shareowners

On behalf of the Board of Directors, I am pleased to present LILCO's 1988 Annual Report. In addition, presented in this letter are a number of recent developments concerning the company.

In 1988, we pursued a three-track strategy to resolve the controversy over the Shoreham Nuclear Power Station and return the company to financial health. We simultaneously (1) sought a full-power license for Shoreham from the Nuclear Regulatory Commission (NRC); (2) negotiated a settlement with the state of New York to transfer Shoreham to a state agency; and (3) evaluated offers from the Long Island Power Authority (LIPA) to acquire the company. We believed that any one of these three alternatives could have presented a satisfactory resolution for our shareowners. We made significant strides to resolve the controversy which I will briefly describe in this letter.

Shoreham License
On March 3, 1989, the NRC dismissed New York State and Suffolk County from the Shoreham licensing proceedings for acting in bad faith by obstructing the licensing process. The NRC ruling, if upheld on appeal, removes the major obstacles in the proceedings and paves the way for a full-power license. The NRC has instructed its staff to commence a final review of the plant, to evaluate the remaining state and county contentions and to report their findings to the NRC.

Status of Settlement with New York State
In June 1988, LILCO entered into an agreement with the state of New York, the New York State Public Service Commission (PSC), the New York Power Authority (NYPA) and the Long Island Power Authority which stipulated that the company would transfer the Shoreham plant to LIPA for $1, that NYPA, at our request, would construct power plants to meet the energy needs of Long Island, and that the company would return to financial health with guaranteed rate increases of approximately 5 percent for three years, and targeted rate increases of 4.5 percent to 5 percent for the next seven years. Although the PSC and LILCO's shareowners overwhelmingly approved the settlement, the New York State Legislature failed to approve the agreement which prevented it from taking effect.

Approximately nine months later, Governor Cuomo decided to proceed without the legislature and entered into a new agreement with LILCO on February 28, 1989, which does not require legislative approval. Although the February agreement is similar to the previous agreement in most respects, the new agreement does not require elected officials to endorse future electric rate increases. The PSC will determine and grant rate increases. The agreement requires the approval of LIPA, NYPA, the PSC and LILCO's Board of Directors by April 15, 1989. LILCO's shareowners must then approve the agreement before it becomes effective. As called for in the agreement, LILCO will use its best effort to conduct its shareowners' meeting on this matter by June 15, 1989.

William J. Catacosinos
Chairman and Chief Executive Officer

Long Island Power Authority
In 1988, LIPA made three conditional proposals to acquire the company at $8.75, $10 and $12 per common share plus, in each case, the redemption price plus accrued dividends for each class of preferred stock outstanding. Your board's evaluation committee, comprised of non-management directors, rejected these conditional proposals as not fair to the company and all its shareowners. In June, LIPA subsequently endorsed the governor's settlement agreement. The LIPA Board, which has met only once in the past eight months, has not made any new offers to acquire the company.

Suffolk County Suit
On December 5, 1988, a jury in a civil suit brought by Suffolk County, under the Federal Racketeer Influenced and Corrupt Organization Act (RICO), found LILCO and a former president jointly and severally liable for approximately $7.6 million which, under the provisions of the RICO Act, would be trebled to approximately $23 million. Further, the certification of the suit as a class action on behalf of all ratepayers would have increased the potential damages to an estimated $4.3 billion. If the jury had ruled against the company on all allegations in the suit, the company's potential liability from the class action could have been as high as $8.7 billion. The lawsuit, which is concerned with prior management of the company, alleged that the company and several of its former officers had misled the PSC about expected completion dates for Shoreham and had obtained rate increases as a result.

On February 11, 1989, a federal judge dismissed the suit, ruling that the complex process of setting electric rates belonged before the PSC — and not in the federal courts. While dismissing the suit, the trial court certified the class of all ratepayers. If the trial court's dismissal order were reversed on appeal, the jury verdict could be reinstated. The trial court urged the parties to reach a settlement in order to avoid appeals.

On February 14, 1989, the company and the class representatives entered into an agreement for a proposed settlement which would reduce future rate increases by $390 million over a 10-year period starting in June 1990. We believe the settlement with the class, which must be approved by the court and sustained on appeal, eliminates the risk of bankruptcy which could have resulted from an adverse appellate court ruling. LILCO's board also made the settlement conditional upon shareowner approval.

Financial Condition
On February 15, 1989, the PSC granted the company its request for a temporary 5.4 percent electric rate increase, resulting in additional revenues of approximately $97.7 million — the company's first rate increase in more than three years. In granting the increase, the PSC stipulated that the company could not operate the Shoreham plant while the temporary rate increase remained in effect. The PSC is expected to consider the company's request for a permanent rate increase in the next several months. The PSC has also given the company permission to issue an additional $375 million of debt.

Also on February 15, 1989, LILCO's banks extended to the company a $200 million line of credit which expires February 1990. Under the terms of the agreement, the company has borrowed $112 million from the line of credit to prepay principal payments on the company's $595 million bank term loan. The balance of the line of credit may be borrowed after May 19, 1989, and after the public issuance of the $375 million of debt.

The rate increase, the bank line of credit and a successful issuance of $375 million of debt, which is planned for the near future, will provide sufficient cash to operate the company through the first quarter of 1990, but a resolution of the Shoreham controversy and of the RICO matter are necessary in order for the company to return to full financial health.

Company Operations
Long Island continues its economic expansion indicating that our electric and gas business will continue to grow in the coming years. The company has made great strides in meeting the demand for electricity on Long Island by operating power plants efficiently and by implementing a comprehensive conservation program. We are also providing better service to our customers as reflected in a significant reduction in complaints and increases in complimentary letters. We attribute the improved service to our highly dedicated and skilled workforce and to the introduction of many innovative programs.

Management Changes
Mr. Russell C. Youngdahl will retire as president and chief operating officer of the company on April 1, 1989, when he reaches the company's normal retirement age. I am deeply grateful to Mr. Youngdahl for his contribution to the company.

Mr. Anthony F. Earley, Jr. has been appointed president and chief operating officer of the company to succeed Mr. Youngdahl effective April 1, 1989. Mr. Earley has been the company's general counsel since 1985 and its executive vice president since January 1988. Mr. Victor A. Staffieri, the company's deputy general counsel, has been appointed general counsel.

In addition, Mr. James T. Flynn will become group vice president for engineering and operations on April 1, 1989. Mr. Flynn has been the company's vice president of fossil production since October 1, 1986.

Mr. P. Alan Gambill was appointed group vice president for commercial operations effective March 1, 1989. Mr. Gambill had been a senior executive with AT&T.

Over the past five years, your board has attracted a new senior management to the company which, together with the company's employees, is dedicated to improving service, meeting the energy needs of Long Island, and ending the controversy over Shoreham. We appreciate your continued interest and support as we strive to return the company to financial health.

On behalf of the Board of Directors, I would like to express my deep appreciation for your continued understanding and support during these difficult times.

Sincerely,

W. J. Catacosinos

William J. Catacosinos
Chairman and Chief Executive Officer

The People at LILCO: Working and Caring

Although working under extraordinarily difficult circumstances, the people at LILCO have demonstrated a commitment to their neighbors across Long Island through an enhanced customer service program.

They have worked long and hard to maintain the flow of energy to LILCO's customers and keep pace with the expanding electric and gas demands of Long Island's growing economy. Through their dedication, LILCO employees have shown competence and a commitment to the company and its customers. Despite all these demands, the people at LILCO continue to enhance the quality of life on Long Island by involving themselves in many worthwhile community projects.

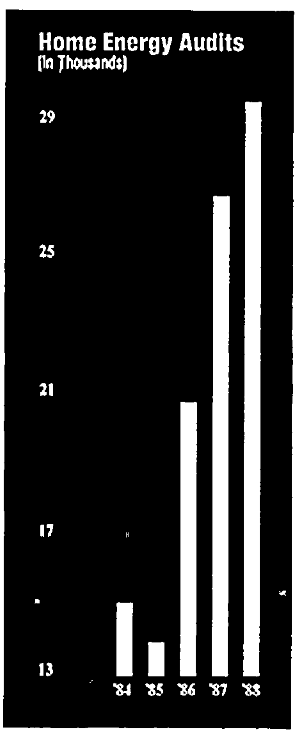
Community Service
Volunteers from the company are involved in every aspect of community life. Their spirit led to the formation of the Lamplighters—a voluntary organization of LILCO employees. Since this group was formed in 1987, nearly 2,000 employees have donated their time and skills to 21 charitable events.

Last September, for example, LILCO Lamplighters were the largest corporate contingent at a walkathon to raise funds for the Fidelco Guide Dog Foundation, a non-profit group that trains canines for the blind. Company employees walked 12 kilometers to raise money for this cause.

During 1988, LILCO employees also pledged the most money of any company its size to the March of Dimes, and over the last three years donated almost nine tons of food to the needy through Long Island churches.

In addition, LILCO employees have donated their time and skills as literacy volunteers to teach basic reading and writing to illiterate adults. They have participated in various blood drives, donating more than 1,600 gallons of blood in 1988, and made the holidays brighter for Long Island children in orphanages, shelters and hospitals by donating gifts through the U.S. Marine Corps' "Toys for Tots" program.

Whether volunteering through the Lamplighters organization, or individual efforts, LILCO employees are dedicated neighbors in the communities where they live and work on Long Island.



LILCO volunteers are involved in every aspect of community life on Long Island. Their spirit led to the formation of the Lamplighters, a voluntary organization of employees who donate their time and skills to worthy causes. Last September, Bob Benson and Dottie Thomsen (right) were part of the Lamplighters contingent at a walkathon to raise funds for the Fidelco Guide Dog Foundation.

Educating customers about conserving energy and saving money is the thrust of LILCO's "Housewarmer" and "Saving Power" energy audit programs. During a home audit, an energy specialist surveys a customer's home and points out various energy-saving techniques and equipment that can be installed. Since 1984, LILCO has performed more than 105,000 audits—nearly 30,000 last year alone. LILCO energy specialist Mike Brown (above) tests the efficiency of a customer's heating system during a "Saving Power" energy audit.

Special Energy Experts

LILCO retains a large, specially trained staff of energy experts to help its customers use electricity and gas as efficiently as possible. These dedicated people go the extra mile to meet the special needs of customers.

The company offers a variety of conservation services to help educate customers and build interest in saving energy. LILCO's Energy Works Center, located in the Sunrise Mall, Massapequa, is staffed seven days a week to provide Long Islanders individualized help on energy use. This personalized assistance is supported by a wide range of displays and exhibits that help turn complicated energy management processes into easy-to-apply information.

Displays showing high-efficiency lighting, appliances and heating units allow customers to discover how to save energy while LILCO specialists are on hand to answer any questions. In addition, customers can get advice from the company's energy experts by calling a toll-free telephone number.

During spring and summer months, a mobile version of the Energy Works Center travels to home improvement stores, schools and various community fairs. In 1988, approximately 18,000 customers received information from the Energy Works Center.

Through the company's "Housewarmer" and "Saving Power" home energy audit programs, customers receive house calls from LILCO. During a home audit, a LILCO energy specialist surveys a customer's home and points out various energy saving techniques and equipment. The LILCO energy experts also discuss low-interest conservation grants with the homeowner. In 1988, the company performed 29,000 "Saving Power" home energy audits.

LILCO customer relations representatives at our eleven business offices across Long Island are also prepared to guide customers on energy use matters, while also handling inquiries on billing and business matters.

Trained Workforce

Making sure LILCO's workforce is the best-trained in the business is an ongoing commitment to a standard of excellence that ensures its customers receive high quality service.

Every year, more than two-thirds of LILCO's workforce receive detailed training to enhance their professional development, job performance and improve service. In all, fifteen departments within the company conduct on-the-job training—from electric linemen to customer representatives. During 1988 alone, LILCO devoted some 380,000 hours to employee training, the equivalent of 200 work years.

The dual commitment to LILCO customers and employees is embodied in the J.W. Dye, Jr. Training Center. The 110,000-square-foot facility in Hauppauge opened in 1987. The center has 38 classrooms and laboratories, 11 shop areas, a 140-seat auditorium along with audiovisual and computer facilities for individualized instruction.

Customer Service: Reaching Out

Two years ago, LILCO announced 50 major programs to improve customer service in what became known as the "Year of the Customer." In 1988, the company continued to aggressively improve customer service. This effort resulted in the lowest complaint rate, as measured by the Public Service Commission (PSC), in LILCO's history.

Adding New Programs

LILCO's customer representatives are now available 24 hours a day, seven days a week—a service that symbolizes the company's effort to make doing business with LILCO easier for customers.

"LILCO became the first utility in New York State to launch 24-hour, seven-day-a-week phone service," said Walter Wilm, vice president of customer relations. "Customers can now call LILCO anytime, day or night, with business or billing questions."

Last year, LILCO answered approximately 200,000 calls during the increased business hours.

Special Customer Needs

Many programs have been designed to meet the special needs of various customer groups. To meet the needs of Long Island's growing senior citizen community, the company established a program of "Golden Link" services. Through this free program, LILCO is able to identify seniors for special protection assistance and provide them information tailored to their needs through a quarterly newsletter. Nearly 35,000 senior citizens have already signed up for this voluntary service.

Other new programs such as "Peace of Mind" give hospitalized customers the extra time they need to make LILCO bill payments, and the "Safety First" program helps parents educate their children about electric safety. LILCO has introduced a special service for the hearing impaired and plans to have large print and braille bills available for the visually impaired.

LILCO's residential tree trimming service continues to be one of the company's most successful programs. Since the program started three years ago, the company has trimmed trees for about 120,000 customers. In 1988 alone, LILCO crews pruned the trees of nearly 30,000 customers to prevent branches from interfering with electric wires.

In 1987, LILCO became the first utility in New York State to offer 24-hour, seven-day-a-week phone service. To meet the special needs of the company's diverse customer groups, LILCO added many new programs such as "Golden Link" services for senior citizens, and the "Peace of Mind" program to give hospitalized customers more time to pay their LILCO bills. In addition, customer account representatives such as Aida Torres (above) are able to assist Spanish-speaking customers with their accounts.

Commitment To Customers

In addition to introducing new service programs, LILCO employees improved their understanding of customers' needs and concerns. Each employee—from the company's top executives right down the line—has participated in intensive customer sensitivity training.

As a result, customer satisfaction with LILCO service has been steadily improving. Last August, customer complaints to the New York State Public Service Commission fell to 4.8 per 100,000 customers—the best mark among New York State utilities and the lowest ever recorded by LILCO. Since 1985, LILCO's annual complaint rate has fallen from 32.9 per 100,000 customers to 6.2 per 100,000 for 1988.

To ensure that LILCO's programs remain customer driven, the company developed a sophisticated tracking system to evaluate customer phone calls. By itemizing these contacts into nearly 400 categories, the company can analyze trends and customer concerns. In addition, every operating area of LILCO randomly calls customers who have had work done to assure that they are satisfied. During 1988, more than 50,000 customers were called or surveyed by LILCO.

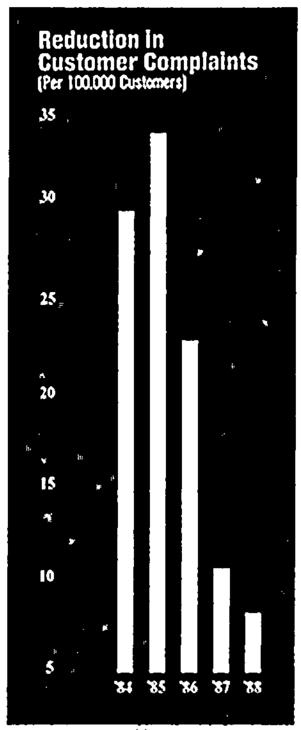
Community Outreach

Last year, LILCO became one of the first utilities in New York State to start a consumer advocate program. These advocates counsel customers with economic hardships and recommend steps to help them gain financial stability. To help low-income families take advantage of government-subsidized home heating programs, LILCO has made arrangements with Suffolk County Social Services to station personnel in each other's offices.

In 1988, LILCO held 260 meetings, or consumer forums, with local community organizations, service agencies and church groups to help evaluate and improve service to customers who rely on these groups for aid.

"By working more closely with these local organizations," added Wilm, "the company is better prepared to assist needy customers."

LILCO's residential tree trim service continues to be one of the company's most successful programs. Nearly 30,000 customers had their tree branches pruned by LILCO in 1988. Customers who call the company's free tree trim hotline are contacted by LILCO within 48 hours and are promised action on their request within two weeks of their call.



Electric Operations: Record Customer Use

During a two-week heat wave in August, the energy needs of Long Island's booming economy shattered the LILCO record for peak electricity use four times. These record power demands were successfully met because the company's generating plants performed at near perfect levels and customers cooperated by reducing their electric use at critical supply times.

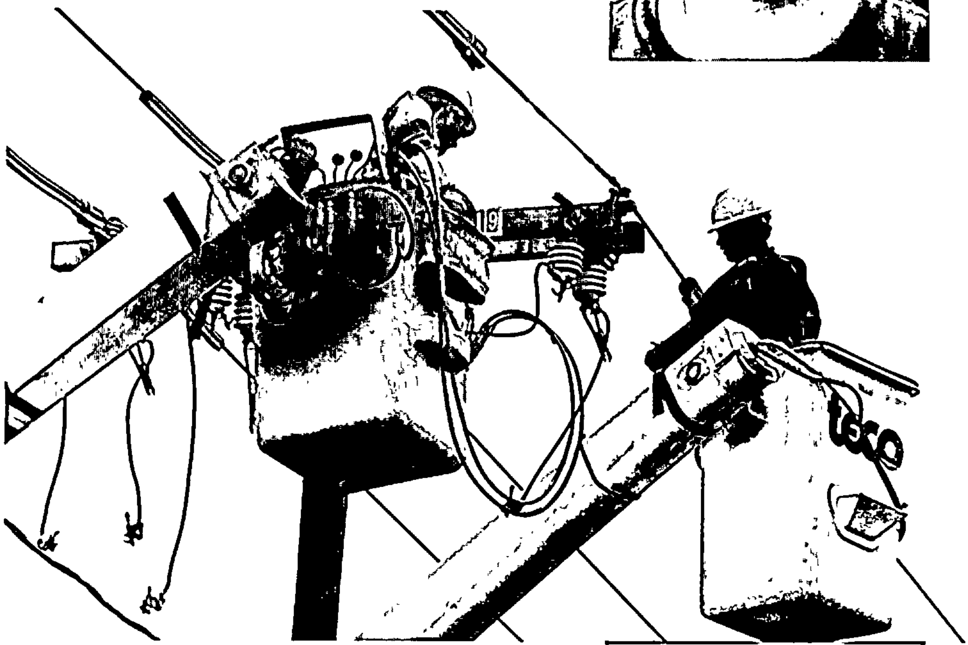
An extensive preventative plant maintenance program and the skilled work of LILCO plant operators had the company's aging plants operating like new. The staffs of LILCO's power plants kept their units running at a remarkable 98 percent availability level—far exceeding the industry average of 85 percent.

Demand Outstrips Supply
Long Island's record electric use is powered by strong economic growth. Overall electric consumption grew by 3.8 percent in 1988 and peak demand has risen 23 percent in the last five years. More than 13,000 new electric customers were added to the LILCO system during the year.

Last summer, for the first time ever, Long Islanders demanded more power than the company's electric system could produce. LILCO was more than 500 megawatts short of the power needed to meet customer demand and have an adequate reserve level. This shortage is equal to the capacity of LILCO's Port Jefferson Power Station, one of the company's major generating plants.

To close the gap, the company had to purchase approximately 400 megawatts from other utilities and power agencies. Another 200 megawatts were supplied from LILCO's 18 percent ownership of the Nine Mile Point 2 nuclear power plant in upstate New York.

Improved Power Plant Efficiency
To get ready for the summer squeeze, LILCO embarked on a system-wide power plant maintenance program two years ago. Periodic overhauls were performed on units ranging in size from a 12-megawatt combustion turbine to the mammoth 1,500-megawatt Northport Power Station—the largest oil-fired plant in the United States.



"The goal of the maintenance program is to pinpoint possible failures before they occur and rebuild the units so that they are as close to new as possible," said James Flynn, group vice president of engineering and operations.

Maintenance overhauls are scheduled during periods when power demand is low such as the fall and spring when the work load of the shutdown units can be more easily absorbed by LILCO's system. However, as year-round energy demand continues to grow, it is becoming increasingly difficult for the company to find a time during the year to take a power plant out of service for maintenance.

Demand Reduction Programs
Customer participation in LILCO demand reduction energy management programs played a key role in getting Long Island through the critical summer power supply periods. In 1988, the company launched the most comprehensive energy management program in the Northeast. And for 1989, LILCO's $35 million conservation plan contains 22 separate energy-saving programs designed to cut 109 megawatts from peak summer demand.

During 1988, LILCO customers experienced four percent fewer service interruptions than in 1987. The company has budgeted about $60 million through 1992 with the long-term goal of cutting customer outages by 40 percent. These improvements are being made by employees such as first class linemen Scott Foglia (above) and his co-workers.

The bulk of the summer power savings comes from programs the company offers its commercial/industrial customers. Last year, the LILCO Energy Cooperative—168 commercial customers—each agreed to shave 100 kilowatts or more during peak demand and saved 40 megawatts. This year LILCO is expanding eligibility by offering the program to any commercial customer that can cut back 50 kilowatts of demand.

Other programs offer cash incentives to both residential and commercial customers to replace existing equipment with high-efficiency air conditioners, lighting and motors. The programs help customers save on their energy costs and provide LILCO with an economic alternative to building new power plants.

In addition, on days when the power supply is tight, LILCO declares "Power Alerts," requesting commercial and residential customers to voluntarily curtail use of appliances and machinery. Issuing these alerts can reduce demand by as much as 70 megawatts.

Imported Power

Imported electricity is delivered to the LILCO system across four power cables that link Long Island to energy sources outside the area. These power lines were used to capacity last summer.

To bring more power to the area, we have contracted with the New York State Power Authority to install a 600-megawatt cable across Long Island Sound in 1992. To help meet short-term power needs, LILCO is installing 238 megawatts of oil-fired internal combustion generators in Brookhaven Town. The company plans to have the generators in operation during the summer of 1989.

Improved Service Reliability

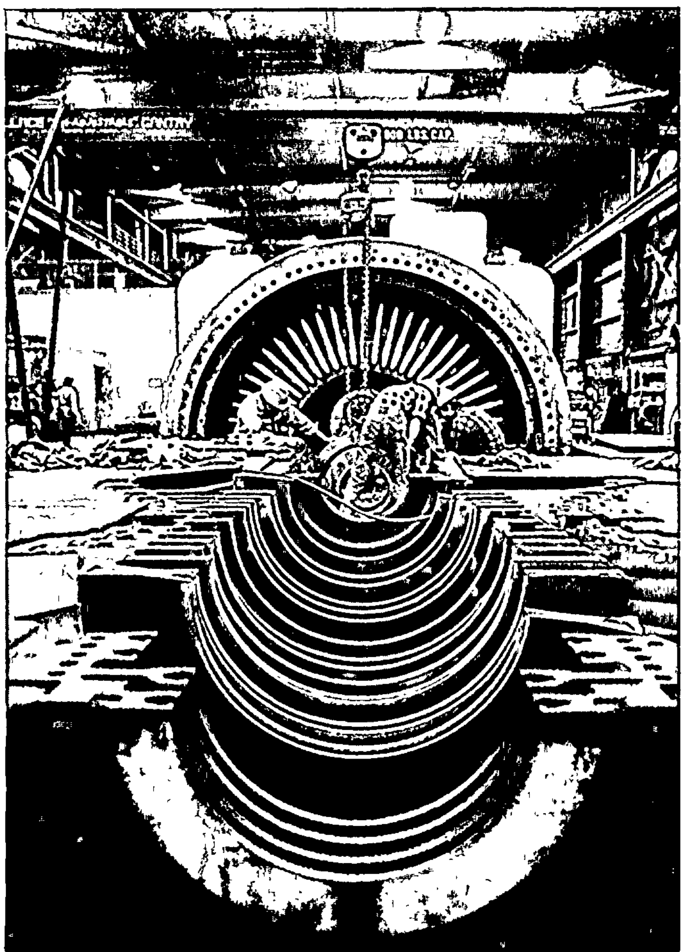
In 1988 the company put into place a variety of programs to make electric service more reliable then ever.

"The company has budgeted about $60 million through 1992 for reliability improvements," said William Museler, vice president of electric operations. "Additional measures are being considered beyond this at a cost of $25 million annually, with the long-term goal of cutting the number and length of customer outages by 40 percent."

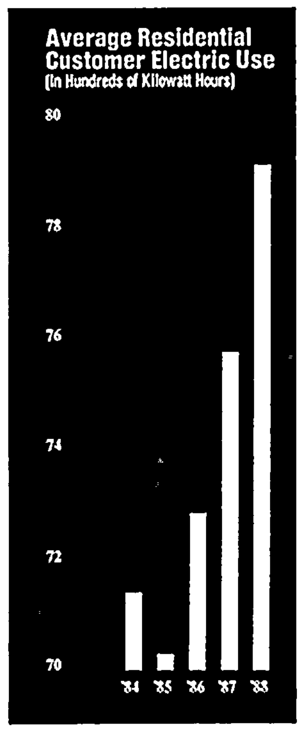
The new programs include installation of radio-controlled switches throughout the company's 45,000 miles of electric lines. These devices will allow electric line problems to be isolated remotely and will help restore power to affected areas more quickly.

Other improvements include further replacement of uninsulated wire with storm resistant plastic covering, increased use of sophisticated scanning equipment to find trouble spots on power lines, more frequent tree trimming along primary distribution lines and installing a computerized system to identify customers who experience repeated power interruptions.

During 1988, LILCO customers experienced four percent fewer interruptions than in 1987. For the last several years, LILCO has been one of the top performers among New York State overhead utilities as measured by the time required to respond to power outages.



To meet the summer peak, LILCO embarked on a system-wide power plant maintenance program two years ago. A complete overhaul (left) is performed on one of the turbines at the 1,500 megawatt Northport Power Station. This extensive program, and the skilled work of LILCO plant operators, had company power plants running at a remarkable 98 percent availability level during the summer heat wave.



Gas Operations: The Growing Gas Heat Market

More and more Long Islanders are realizing that gas heat offers them convenience, cleanliness and significant cost savings. To meet growing demand, LILCO is expanding its gas system to make this premium fuel available to more Long Island communities.

The company expects to add about 130,000 new gas space-heating customers in the next decade. Only about half of LILCO's 420,000 gas customers use the fuel for home heating and that means there is a prime market of 180,000 homes that could be converted to gas heat with minimal capital investment.

Future Pipelines

To take advantage of that market, LILCO must ensure that enough natural gas supplies can be brought to Long Island. At present, about 60 percent of LILCO's annual gas supply of nearly 72 billion cubic feet is supplied by the Trans-Continental Gas Pipeline, which originates in Texas.

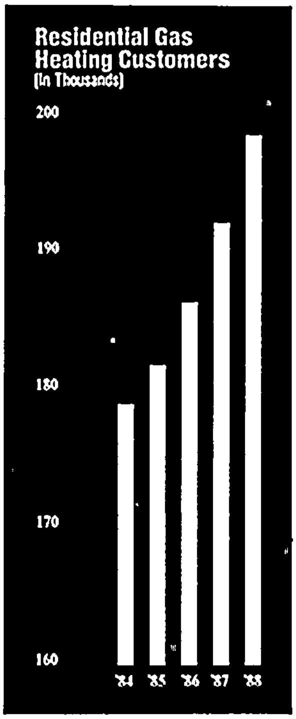
The new Iroquois Pipeline, extending 369 miles from Canada to Long Island, is expected to be completed by 1992. The new pipeline will supply Long Island with 35 million cubic feet of Canadian gas per day—a 15 percent increase in LILCO's supply. The availability of that Canadian gas will play a major role in LILCO's gas expansion program.

Another key factor will be LILCO's ability to install new gas, or venture, mains in eastern Long Island to bring the gas from the interstate pipeline to businesses and homes in areas where gas is currently not available. One such venture main was recently completed through a four-mile stretch in Manorville on eastern Long Island which will bring gas to more than 3,000 new customers.

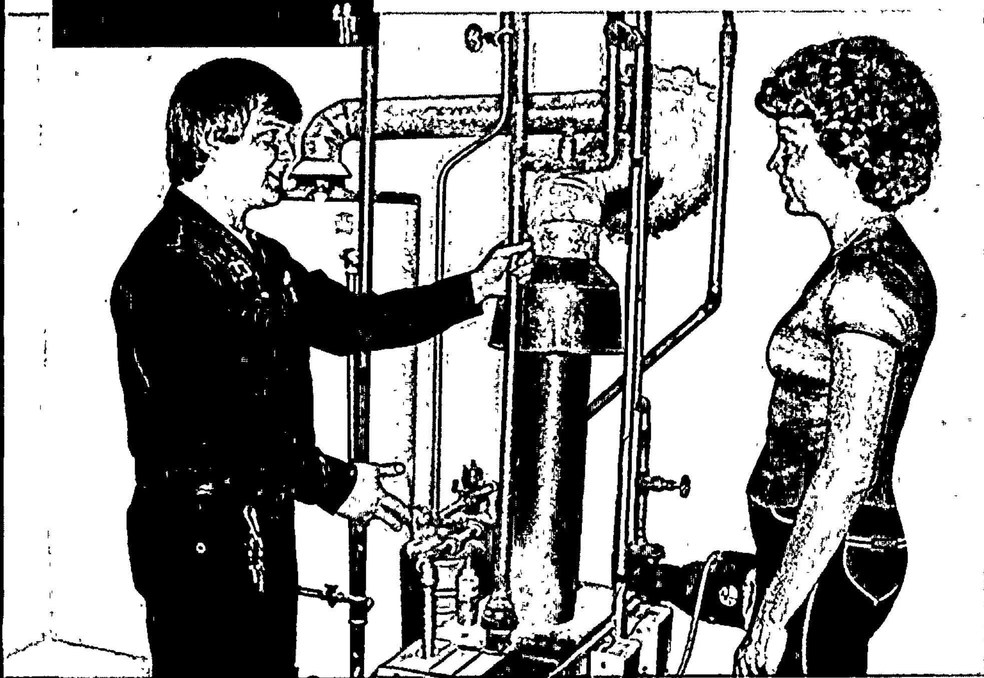
"The company plans to install about 25,000 feet of venture mains during the next several years," said Jay Kessler, vice president of gas operations. "These new pipelines are expected to serve thousands of new gas customers."

Switching To Natural Gas

In 1988, more than 9,400 Long Island homes and businesses became new gas heat customers. Marketing efforts to bring the many advantages of gas heat to the public's attention is increasing our share of the home heating market. Gas has greater consumer appeal than oil in both economy and cleanliness. Over the last three years, the company has added more than 28,000 gas heating customers.



Last year, LILCO gas crews installed more than 65 miles of new gas pipeline and connected more than 7,200 new customers. The company expects to add about 130,000 new gas space-heating customers in the next decade.



All LILCO gas customers get free 24-hour service. As part of a special preventative maintenance program, the company also provides a free safety check with every heating installation. Gas Serviceman Andrew Chiasera (above) shows a customer how to keep her home's gas system running safely and efficiently.

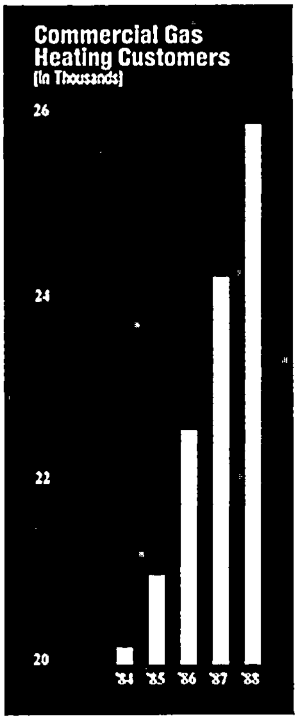
Heating is the largest energy cost for most homes, and converting to natural gas heat offers customers a major advantage in helping them control their energy costs. Last year, LILCO introduced a free home heating analysis program for its customers. LILCO energy experts do an in-house heating analysis that allows customers to evaluate the cost-effectiveness of gas heat for their particular home. They can then decide if conversion to gas will benefit them.

The company has highlighted this service in an extensive marketing campaign. The campaign includes television, radio commercials and an innovative cooperative advertising plan with manufacturers and installers.

Unique New Customers

At Belmont Park in Elmont, LILCO gas crews are converting the famous horse racing course from oil to natural gas heat. The race track, like many commercial businesses on Long Island, must remove old oil tanks in the ground to meet new environmental standards. Converting to gas is a cost-saving alternative to adding new oil tanks.

In addition to Belmont, other large, high-profile customers that have recently switched to gas include Stony Brook University and the New York Institute of Technology. Last year, LILCO added nearly 2,400 commercial gas customers through conversions and new service hook-ups.



Financial Condition

Overview

In recent years, the financial integrity of the Company has been threatened by uncertainty concerning the licensing of the Shoreham Nuclear Power Station (Shoreham). Since 1982, the State of New York (the State) and Suffolk County (the County) have refused to participate in planning and testing an offsite emergency response plan and also have opposed the Company in the licensing proceedings before the Nuclear Regulatory Commission (NRC). The delays and uncertainties in this licensing process have jeopardized the Company's financial viability since it has not been permitted to recover a significant portion of its investment in Shoreham from ratepayers in this period.

In order to maintain its financial viability in an environment of such adversity, the Company implemented a number of steps starting in 1984.

- To conserve cash, the Company cut its operating and maintenance expenses and suspended Common and Preferred Stock dividends.
- To assure interim operating capability, the Company employed long-term borrowings instead of short-term borrowings in order to build cash reserves.

As a result of these actions and others, the Company has maintained its financial viability to date. In 1987 and 1988, its operating and maintenance expenses, as well as capital and refunding requirements, were funded from cash generated from operations and from cash balances that had as their source long-term borrowings undertaken in 1986. On December 31, 1988, 1987 and 1986, cash balances totaled $93 million, $211 million and $366 million, respectively.

The Company's financial viability will continue to be threatened so long as the political and regulatory uncertainties remain unresolved. Unless a sufficient amount of external financing can be obtained to meet its operating and capital requirements, the Company estimates that it will run out of cash during the second quarter of 1989.

The Company's continued financial viability is dependent upon various factors, including (a) continued access to the capital markets to meet its obligations as they mature, (b) receipt of adequate and timely rate relief, whether or not Shoreham operates, and (c) the satisfactory resolution of certain contingencies identified in Note 6 of Notes to Financial Statements.

The Company cannot predict at this time either its ability to access the capital markets or obtain such rate relief or the outcome of those contingencies, which, if resolved adversely, would have a material effect on the Company's financial viability. Under the most adverse circumstances, the Company might seek the protection of federal bankruptcy laws while it continues its operations.

Rates and Agreements with the State

On February 15, 1989,the Public Service Commission of the State of New York (PSC) granted the Company temporary annual electric rate relief, subject to refund, of $97.7 million, or 5.4%. The temporary rates have become effective. In its implementing order, the PSC conditioned the rates upon the Company not operating Shoreham while the temporary rates are in effect. Although the PSC has indicated the temporary rates will remain in effect for approximately 90 days, no assurance can be given respecting when or what actions, if any, the PSC will take. The Company is reviewing its options with respect to the restriction in the PSC order not to operate Shoreham. This rate relief is the first such relief granted by the PSC in more than three years. The PSC had last granted the Company electric rate relief totaling $245 million annually in 1984 and $69 million annually in January 1986. This rate relief enabled the Company to obtain additional credit, permitted access to the capital markets, and has provided a portion of the cash needed for the Company's operating and capital requirements.

In December 1987, the PSC denied the Company a 5.4% increase in electric rates citing, among other reasons, the continuing "deadlock" over Shoreham, and further stating that the economic interests of the Company and the desires of its customers must be recognized if the deadlock was to be broken within the context of regulation of the Company "short of bankruptcy."

Also, in December 1987, the Company and New York State resumed long stagnant negotiations and, in June 1988, definitive agreements (the 1988 Settlement) were signed by the Company, the Governor of the State and others, addressing, among other issues, energy alternatives for Long Island, the cost of electricity for its residents, the future of Shoreham, and the Company's financial health.

The 1988 Settlement provided, among other things, that Shoreham be transferred to the Long Island Power Authority (LIPA) for $1 and that the New York Power Authority (NYPA) construct up to five new power plants on Long Island at the request of the Company. The 1988 Settlement also would have provided the Company with annual rate increases of 4.9% in December 1988 and 5.0% in October 1989 and 1990 and targeted rate increases of approximately 4.5% to 5.0% each year for the following seven years, with any variations to be determined by the PSC.

The 1988 Settlement also contemplated that the Company would have the ability to issue new debt to refund certain of its outstanding high-interest rate debt and to resume payment of dividends.

The 1988 Settlement was subject to a number of conditions, including approval by the Company's shareowners and the PSC. The Company's shareowners approved the 1988 Settlement on November 4, 1988 and the PSC gave its approval on November 18, 1988. However, one of the conditions that was not met was the requirement for legislative approval for the construction of power plants by NYPA.

The failure of the New York State legislature to enact legislation prior to recessing on December 1, 1988 prevented the 1988 Settlement from becoming effective. Accordingly, on December 2, 1988, the Company applied to the PSC for temporary annual rate relief of approximately $97.7 million, or 5.4%, to become effective in January 1989. At the same time, the Company also requested that a schedule be set for the review of its application, filed in April 1988, for the same amount of rate relief on a permanent basis.

On February 28, 1989,the Company and the Governor of the State entered into an agreement (the 1989 Issues Agreement) which is intended to resolve certain of the same issues sought to be resolved by the 1988 Settlement, principally the future of Shoreham. Similar to the 1988 Settlement, the 1989 Issues Agreement provides for the transfer of Shoreham to LIPA for $1.

One of the objectives stated in the 1989 Issues Agreement is the return of the Company to investment-grade financial condition. However, unlike the 1988 Settlement, the 1989 Issues Agreement does not commit the State to support rate increases in any particular amount, nor does it specifically provide for rate relief for the Company. It is the Company's position that a rate structure similar to that approved by the PSC in connection with the 1988 Settlement must be authorized by the PSC before the Company's Board of Directors will act with respect to the 1989 Issues Agreement.

The Company has been informed by the PSC that the rate relief contemplated by the 1989 Issues Agreement will be considered by the PSC prior to April 15, 1989. However, the Company can give no assurance that the PSC will act by that date, predict what action the PSC will take with respect to rate relief,or give assurance that the rate relief, if any, authorized by the PSC will return the Company to investment-grade financial condition.

The effectiveness of the 1989 Issues Agreement is conditioned upon approval on or before April 15, 1989 by the Company's Board of Directors, the PSC, LIPA and NYPA. The effectiveness of the 1989 Issues Agreement is also conditioned upon approval of a majority of the Company's shareowners and the Company has committed itself to use its best efforts to obtain such approval by June 15, 1989. During the period of time in which approvals are being sought, the Company has agreed not to operate Shoreham above 5% if licensed to do so by the NRC. However, the Company intends to continue its vigorous pursuit of a full power license for Shoreham.

Shoreham and the Licensing Process

The construction of Shoreham is complete and it has been successfully operated and tested at levels up to 5% of full power pursuant to a license issued in July 1985 by the NRC. The Company continues to face strong political opposition to the licensing of Shoreham from the State and the County.

In June 1988, the Federal Emergency Management Agency (FEMA) held a review of a full scale exercise of the Company's offsite emergency response plan and, in September 1988, issued a favorable evaluation of the Company's performance at this exercise. Also, in September 1988, an Atomic Safety and Licensing Board (ASLB) of the NRC dismissed the State and County as a sanction for their conduct in proceedings before the NRC relating to the Company's application for the Shoreham license. This decision was partially reversed by the Appeal Board and subsequently appealed to the full NRC.

In November 1988, a presidential executive order was signed allowing FEMA to substitute its own resources whenever state or local governments decline or fail to prepare offsite emergency response plans that are sufficient to satisfy NRC requirements or to participate adequately in the preparation, demonstration, testing, exercise or use of such plans.

On March 3, 1989, the NRC affirmed the dismissal of the State and County from all proceedings before the NRC relating to Shoreham and instructed the staff of the NRC to review all remaining open licensing issues. The review process by the NRC staff could be completed within approximately one month but there is no guarantee of the length of time it will take. Moreover, the Company can give no assurance that the staff of the NRC will reach a conclusion in favor of the Company on all matters before it. Furthermore, the decision of the NRC may be appealed to the courts for review. The Company expects that the NRC's decision in this matter will be appealed, but can give no assurance as to the outcome of such appeal or estimate the time required for such appellate process.

Liquidity and Financial Viability

In contemplation of the 1988 Settlement becoming effective, the Company had arranged a refinancing of its 1986 Restructuring Credit Agreement (1986 RCA) and a new credit agreement designed to replace the 1984 Revolving Credit Agreement (1984 RCA) which has now expired. In addition, the Company had contemplated issuing up to $1.1 billion of debentures in the first quarter of 1989, approximately $500 million of which would have been used to refund certain of its outstanding high interest rate General and Refunding Bonds (G&R Bonds), with the remainder used to reimburse the Company's treasury for expenditures incurred for construction of utility plant and to provide working capital. Because the 1988 Settlement did not become effective, these financing arrangements have had to be set aside and alternative financing plans pursued.

The Company and certain of its lending banks have entered into a credit agreement (the 1989 Credit Agreement) which expires in February 1990. Under its terms, the Company is provided with up to $200 million of credit, secured by a first lien upon the Company's accounts receivable and fuel oil inventory. Of this amount, approximately $112 million was used to prepay the March, June and September 1989 quarterly payments of approximately $37 million each, which represents three of the remaining 15 equal quarterly installments associated with the 1986 RCA. See Note 4 of Notes to Financial Statements. The Company paid the first installment, when due, on December 30, 1988. The approximately $88 million remaining under the 1989 Credit Agreement will be available not sooner than May 19, 1989 and is contingent upon the Company selling approximately $375 million of debentures.

The Company will need to sell such debentures to assist in meeting its operating and capital requirements for 1989. Although the Company has received authorization from the PSC to sell G&R Bonds, its ability to issue and sell debentures is subject to authorization from the PSC, prevailing market conditions and the perception of the credit markets as to the financial viability of the Company. The Company can give no assurance that it will be able to sell debentures.

The Company anticipates that even if it is able to sell debentures and borrow the remaining $88 million available under the 1989 Credit Agreement, the Company's cash resources necessary to meet its operating and capital requirements will be exhausted during the first quarter of 1990 in the absence of rate relief and additional financing, including the extension of or modifications to the Company's bank agreements. Without adequate and timely rate relief and favorable resolution of the contingencies facing the Company, the Company can give no assurance that it will be able to obtain such additional financings.

Capital Requirements and Capital Provided

Capital requirements for 1988 amounted to $532 million, of which total construction was $434 million, and total refundings were $98 million. The construction requirements are exclusive of the equity component of AFC and the reimbursement for certain Nine Mile Point 2 (NMP2) expenditures previously incurred.

Internal cash generation from operations in 1988 was $414 million and provided 78% of the funds necessary to finance construction and refunding requirements. The remaining construction and refunding requirements were funded from the Company's cash balances.

For 1989, total capital requirements are estimated at $730 million, of which total construction is $430 million. Total refundings are estimated at $300 million. Capital requirements and capital provided for 1988 and 1987 were as follows:

Capital Requirements	1988	1987
	(millions of dollars)	
Construction		
Electric		
Nuclear		
Shoreham	$332	$383
NMP2	19	47
Fuel	16	13
Non Nuclear	147	86
Total Electric	514	529
Gas	38	34
Common	9	18
Total Construction	561	581
Less: NMP2 Reimbursement	52	—
AFC (Equity Component)	75	128
Total Construction	434	453
Refundings		
Long Term Debt	43	24
Treasury Stock	18	16
Bank Loans	37	—
Total Refundings	98	40
Total Capital Requirements	$532	$493

Capital Provided	1988	1987
	(millions of dollars)	
Use of Cash Balances	$118	$156
Internal Cash Generation from Operations	414	337
Total Capital Provided	$532	$493

For further information, see the Statement of Cash Flows and Notes 1 and 6 of Notes to Financial Statements.

Dividends, Equity Securities and Capitalization

Dividends: The Company suspended the payment of dividends on its Preferred and Common Stock in 1984. Under the Company's Certificate of Incorporation, the payment of Common Stock dividends is prohibited so long as Preferred Stock sinking fund requirements or dividends are in arrears. At December 31, 1988, the total of all dividend arrearages on Preferred Stock was approximately $341 million. The 1989 Credit Agreement and, to an extent, the 1986 RCA prohibit the payment of dividends on any of the Company's Preferred or Common Stock. See Note 2 of Notes to Financial Statements for a further discussion of dividend restrictions. If the 1989 Issues Agreement becomes effective, the Company intends to seek elimination of such restrictions from its bank agreements, but it can give no assurance that such restrictions will be eliminated.

Equity Securities: The Company believes that the suspension of dividends on its Preferred and Common Stock and the uncertainties facing the Company have adversely affected its ability to raise funds through the sale of any of its equity securities in the public markets, the last such public sale having been in 1983. Consequently, the predominance of the funds raised subsequent to 1983 have been limited to the debt markets and bank credit.

Capitalization: Capitalization (defined as the total of Long-Term Debt, Preferred Stock and Common Shareowners' Equity) was approximately $6.6 billion at December 31, 1988, reduced from $8.0 billion at December 31, 1987. The decrease in capitalization relates to a reduction in retained earnings in 1988 to approximately $680 million from approximately $1.8 billion at December 31, 1987. This decrease was caused by the Company's 1988 loss which resulted from adopting the provisions of Statement of Financial Accounting Standards No. 90 (SFAS No. 90). At December 31, 1988, 1987 and 1986, the components of the Company's capitalization ratios were as follows:

Capitalization Ratios	1988	1987	1986
Long-Term Debt	51.7%	46.4%	48.4%
Preferred Stock	15.4	12.1	11.7
Common Shareowners' Equity	32.9	41.5	39.9
	100.0%	100.0%	100.0%

Results of Operations

Earnings

The Company incurred a loss for Common Stock of $1.1 billion or $10.08 per common share in 1988 as a result of a non-cash write-down of certain disallowed plant costs. This write-down of net assets amounted to $1.3 billion, net of tax effects, or $12.10 per common share. Before this write-down, earnings for Common Stock in 1988 were $224 million, or $2.02 per common share compared with earnings for Common Stock of $192 million or $1.73 per common share in 1987.

The write-down resulted principally from certain costs of Shoreham and NMP2 which the PSC has determined the Company may not recover. The Company recorded the write-down effective January 1988 as a result of adopting SFAS No. 90.

Net Income, Earnings for Common Stock, Earnings per Common Share, AFC and AFC as a percent of Net Income for the years ended 1988, 1987 and 1986 are shown below. The information for 1988 is reflected before the cumulative effect of adopting SFAS No. 90.

	1988	1987	1986
	(in millions, except per share amounts)		
Net Income	$298.5	$269.9	$316.7
Earnings for Common Stock	$224.0	$192.3	$236.9
Earnings Per Common Share	$2.02	$1.73	$2.13
AFC	$150.0	$181.0	$269.0
AFC—% of Net Income	50%	67%	85%

Allowance for Funds Used During Construction (AFC) is a non-cash credit to income that represents the cost of funds borrowed for construction purposes, and a reasonable rate of return upon a utility's equity when so used. The amount of AFC fluctuates from period to period as a result of, among other things, changes in the cost of money, the level of construction activity, and the amount of construction work in progress that is included in the Company's rate base.

Before the write-down, Earnings for Common Stock in 1988 increased approximately $32 million, or 16.5% above 1987 primarily as a result of higher revenues and lower federal income taxes, due primarily to lower tax rates. These increases were partially offset by reductions in AFC and increases in expenses.

Earnings for Common Stock in 1987 declined approximately $45 million, or 18.8% below 1986, due primarily to the Company's ceasing to accrue AFC on the disallowed portion of its investment in Shoreham and on all of its investment in NMP2. In addition, in December 1986, the Company recorded a net provision for loss relating to its investment in Jamesport of $16 million.

Revenues

Total revenues in 1988, including revenues from recovery of fuel costs, were $2.1 billion, which represents an increase of $66 million, or 3.2%, over 1987 revenues. Total revenues for the Company's Electric and Gas operations for 1988, 1987 and 1986 are shown below:

	1988	1987	1986
	(millions of dollars)		
Revenues			
Electric	$1,787	$1,719	$1,612
Gas	351	353	365
Total Revenues	$2,138	$2,072	$1,977

Electric Revenues: In 1988, electric revenues increased $68 million, or 4.0% over 1987. Revenues in 1987 had increased $107 million, or 6.6%, over 1986. The increases in electric revenues resulted primarily from the following factors:

	88/87	87/86
	(millions of dollars)	
Customer Consumption	$ 59	$ 45
Customer Additions	23	23
Unbilled Revenue Accruals	30	3
Fuel Cost Adjustments	(44)	26
Rate Increases	—	10
Total	$ 68	$ 107

The increase in average customer consumption in 1988 was 516 kilowatt hours (kwh), or 3.3%, with approximately 100 kwh attributable to warmer summer weather between 1988 and 1987 and the remainder basically attributable to increased customer usage. The average number of electric customers served in 1988 was approximately 985,900, up nearly 13,200, or 1.4%, over 1987.

Unbilled revenue accruals represent revenues which have been earned on electric service supplied to our customers, but not yet billed to them. See Note 1 of Notes to Financial Statements.

Revenues from fuel cost adjustments were lower in 1988, due primarily to a decline in oil prices. The average cost of oil burned in 1988 was $15.78 per barrel, compared with $18.16 per barrel in 1987. The average cost of oil burned for 1986 was $15.62 per barrel.

Gas Revenues: In 1988, gas revenues decreased by $2 million, or 0.7%, compared to 1987. Revenues in 1987 had decreased $12 million, or 3.3%, compared to 1986. The increases (decreases) in gas revenues resulted primarily from the following factors:

	88/87	87/86
	(millions of dollars)	
Customer Consumption	$ 6	$ 15
Customer Additions	5	5
Fuel Cost Adjustments	(13)	(32)
Total	$ (2)	(12)

The increase in average customer consumption in 1988 was 2.65 dekatherms (dth), or 2.0%, with one-third attributable to colder winter weather between 1988 and 1987 and the remainder basically attributable to increased customer usage. The average number of gas customers served in 1988 was approximately 418,900, up more than 5,600 or 1.4%, over 1987.

Revenues from fuel cost adjustments were lower in 1988, due primarily to a decline in gas prices. The average cost of gas sold in 1988 was $3.10 per dth, compared with $3.12 per dth in 1987. The average cost of gas sold in 1986 was $3.97 per dth.

Operating and Maintenance Expenses

Excluding fuels and purchased power, Operating and Maintenance (O&M) expenses were $358 million in 1988, an increase of $16 million, or 4.6%, over 1987. In 1987, these O&M expenses increased $19 million, or 5.9%, over 1986. The increases, principally relating to the costs of maintaining production plant, were largely a result of efforts to further improve customer service. The success of this effort was evidenced by the extraordinary performance and reliability levels of the Company's electric generation facilities during the past two summer periods. Higher costs for employee wages and medical insurance also contributed to the increases.

Other Items

Federal income taxes in 1988 were $57.0 million lower than in 1987. In 1987, these taxes were $1.5 million lower than in 1986. Changes in federal income taxes are due principally to variations in net income before income taxes, recognition of investment tax credits, and items capitalized for financial statement purposes that are allowed as current deductions on the Company's tax returns. The decrease in 1988 was principally due to lower tax rates in 1988,reflecting the effects of the Tax Reform Act of 1986. The income tax expense recorded in 1987 includes certain adjustments required by the PSC in reflecting the effects of the Tax Reform Act of 1986. See Note 5 of Notes to Financial Statements.

Operating taxes, predominantly property taxes, were $311 million in 1988, compared to $300 million in 1987 and $278 million in 1986.

Depreciation expenses increased by $20 million in 1988 and by $4 million in 1987, primarily attributable to the addition of NMP2 to plant in service in 1988. Interest expense increased by $3 million in 1988 and by $15 million in 1987, due to changes in rates and amounts outstanding.

Selected Financial Data

Additional information respecting revenues, expenses, electric and gas operating income and operations data, capital expenditures, and balance sheet information for the last five years are provided in Tables 1 through 10 of "Selected Financial Data." Information with regard to the Company's business segments for the last three years is provided in Note 7 of Notes to Financial Statements.

Statement of Income

For year ended December 31 *(In thousands of dollars)*	1988	1987	1986
Revenues			
Electric	$ 1,786,933	$1,718,861	$1,611,789
Gas	350,901	353,216	365,332
Total Revenues	2,137,834	2,072,077	1,977,121
Expenses			
Operations — fuel and purchased power	674,429	685,689	666,015
Operations — other	248,698	240,713	220,309
Maintenance	109,198	101,287	102,645
Depreciation, depletion, and amortization	93,596	73,905	70,139
Operating taxes	310,864	300,159	277,992
Federal income tax — current	18,395	83,577	41,347
Federal income tax — deferred and other	181,716	204,143	211,597
Total Expenses	1,636,896	1,689,473	1,590,044
Operating Income	500,938	382,604	387,077
Other Income and (Deductions)			
Allowance for other funds used during construction	75,491	127,958	139,639
Other income and (deductions)	(10,049)	14,885	6,697
Provision for net loss on Jamesport abandoned generating project	—	—	(16,000)
Federal income tax credit (provision) — current	—	80,597	41,347
Federal income tax credit — deferred and other	88,264	38,269	41,232
Total Other Income and (Deductions)	153,706	261,709	212,915
Income Before Interest Charges and Cumulative Effect of Accounting Change	654,644	644,313	599,992
Interest Charges and (Credits)			
Interest on long-term debt	410,966	410,097	397,318
Other interest	19,702	17,404	15,316
Allowance for borrowed funds used during construction	(74,514)	(53,076)	(129,317)
Total Interest Charges and (Credits)	356,154	374,425	283,317
Income Before Cumulative Effect of Accounting Change	298,490	269,888	316,675
Cumulative Effect of Accounting Change For Disallowed Costs (net of applicable taxes of $448,978,000)	(1,345,110)	—	—
Net Income (Loss)	(1,046,620)	269,888	316,675
Preferred Stock dividend requirements	74,508	77,576	79,811
Earnings (Loss) for Common Stock	$(1,121,128)	$ 192,312	$ 236,864
Average Common Shares Outstanding — (000)	111,177	111,129	111,085
Earnings (Loss) per Common Share			
Income before cumulative effect of accounting change for disallowed costs	$ 2.02	$ 1.73	$ 2.13
Cumulative effect of accounting change	(12.10)	—	—
Earnings (Loss) per Common Share	$ (10.08)	$ 1.73	$ 2.13
Dividends Declared per Common Share	$ —	$ —	$ —
Proforma Earnings — with 1988 Accounting Change Applied Retroactively			
Earnings (Loss) for Common Stock	$ 223,982	$ 176,712	$ 30,864
Earnings (Loss) per Common Share	$ 2.02	$ 1.59	$ .28

See Notes to Financial Statements.

Balance Sheet

Assets

At December 31 *(In thousands of dollars)*		1988	1987
Utility Plant	Electric	$2,965,213	$2,018,324
	Gas	476,950	446,607
	Common	128,866	125,032
	Construction work in progress	4,249,845	6,503,606
	Nuclear fuel in process and in reactor	199,379	183,740
		8,020,253	9,277,309
	Less — Accumulated depreciation, depletion, and amortization	1,075,129	983,272
	Total Net Utility Plant	6,945,124	8,294,037
Other Property and Investments	Nonutility property, principally at cost	1,027	1,031
	Investment in subsidiary companies, at equity	334	354
	Other investments and deposits, principally Bokum Resources Corporation	67,910	67,378
	Total Other Property and Investments	69,271	68,763
Current Assets	Cash	13,647	19,995
	Temporary cash investments	78,902	190,786
	Special deposits	17,940	18,858
	Accounts receivable (less allowance for doubtful accounts of $4,239,000 and $4,048,000)	193,083	168,508
	Accrued revenue	96,110	22,801
	Materials and supplies at average cost	46,997	42,231
	Fuel oil at average cost	36,581	40,094
	Gas in storage at average cost	35,971	45,638
	Prepayments and other current assets	52,703	57,668
	Total Current Assets	571,934	606,579
Deferred Charges	Unamortized cost of Jamesport abandoned generating project	98,616	118,484
	Deferred storm damage costs	44,048	44,048
	Other (including deferred taxes of $525,029,000 and $127,061,000)	597,344	191,776
	Total Deferred Charges	740,008	354,308
	Total Assets	$8,326,337	$9,323,687

See Notes to Financial Statements.

Capitalization and Liabilities

At December 31 *(In thousands of dollars)*		1988	1987
Capitalization	Long-term debt	$3,449,821	$3,724,601
	Unamortized premium and (discount) on debt	(25,011)	(26,646)
		3,424,810	3,697,955
	Preferred Stock — redemption required	513,924	520,788
	Preferred Stock — no redemption required	221,050	221,051
	Treasury stock, at cost	(58,430)	(40,881)
	Retained earnings restricted for Preferred Stock dividend requirements	341,008	265,288
	Total Preferred Stock	1,017,552	966,246
	Common Stock	555,965	555,749
	Premium on capital stock	1,001,328	1,001,179
	Capital stock expense	(56,151)	(56,144)
	Retained earnings	679,579	1,801,919
	Total Common Shareowners' Equity	2,180,721	3,302,703
	Total Capitalization	6,623,083	7,966,904
Current Liabilities	Current maturities of long-term debt	274,780	81,195
	Current redemption requirements of Preferred Stock	19,888	13,025
	Accounts payable and accrued expenses	164,977	132,101
	Accrued taxes (including federal income tax of $12,570,000 and $3,909,000)	35,877	26,300
	Accrued interest	70,207	70,604
	Customer deposits	17,288	16,348
	Total Current Liabilities	583,017	339,573
Deferred Credits	Accumulated deferred income tax reductions	963,975	921,397
	Other	144,015	83,217
	Total Deferred Credits	1,107,990	1,004,614
Reserves for Claims, Damages, Pensions, and Benefits		12,247	12,596
Commitments and Contingencies		—	—
	Total Capitalization and Liabilities	$8,326,337	$9,323,687

See Notes to Financial Statements.

Shareowners' Equity

At December 31 *(In thousands of dollars)*	Call Price Per Share December 31, 1988	Call Price Per Share Final	1988	1987	1986
Statement of Retained Earnings					
Balance, January 1			$ 1,801,919	$ 1,609,268	$ 1,480,644
Add (deduct) — Net income (loss) for the year			(1,046,620)	269,888	316,675
Deduct — Retained earnings restricted for preferred stock dividend requirements***			75,720	77,237	188,051
Balance, December 31			$ 679,579	$ 1,801,919	$ 1,609,268
Common Stock					
Par Value $5 per Share					
Shares authorized			150,000,000	150,000,000	150,000,000
Shares issued and outstanding			111,193,008	111,149,818	111,104,995
Increase in shares outstanding			43,190	44,823	46,096
Increase in $5 par value			$ 216	$ 224	$ 230
Increase in Premium on capital stock			149	221	227
Increase in Capital stock expense			7	6	22
Preferred Stock					
Par Value $100 per Share, Cumulative:					
Shares authorized			7,000,000	7,000,000	7,000,000
Shares issued and outstanding			2,715,116	2,793,227	2,863,525
Shares held in treasury**			283,500	205,404	135,130
5.00% Series B	$101.00	$101.00	$ 10,000	$ 10,000	$ 10,000
4.25% Series D	102.00	102.00	7,000	7,000	7,000
4.35% Series E	102.00	102.00	20,000	20,000	20,000
4.35% Series F	102.00	102.00	5,000	5,000	5,000
5 1/8 % Series H	102.00	102.00	20,000	20,000	20,000
5¾ % Series I Convertible	100.00	100.00	4,050	4,052	4,053
8.12% Series J	101.00	101.00	25,000	25,000	25,000
8.30% Series K	103.29	103.29	30,000	30,000	30,000
7.40% Series L*	104.10	100.00	27,650	27,650	27,650
8.40% Series M*	104.48	100.00	33,600	33,600	33,600
8.50% Series R*	103.00	100.00	45,000	45,000	45,000
9.80% Series S*	105.00	100.00	72,562	72,562	72,562
Total Par Value $100			$ 299,862	$ 299,864	$ 299,865
Par Value $25 per Share, Cumulative:					
Shares authorized			30,000,000	30,000,000	30,000,000
Shares issued and outstanding			17,140,000	17,348,600	17,595,900
Shares held in treasury**			1,060,000	851,400	604,100
$2.47 Series O*	$ 25.75	$ 25.25	$ 40,000	$ 40,000	$ 40,000
$2.43 Series P	28.50	27.75	35,000	35,000	35,000
$3.31 Series T*	26.25	25.00	75,000	75,000	75,000
$4.25 Series U*	26.67	25.00	65,000	65,000	65,000
$3.50 Series V*	26.50	25.00	75,000	75,000	75,000
$3.52 Series W	29.00	27.50	65,000	65,000	65,000
$3.50 Series X*	26.50	25.00	100,000	100,000	100,000
Total Par Value $25			$ 455,000	$ 455,000	$ 455,000
Less — Sinking fund requirements			19,888	13,025	6,347
Less — Treasury stock at cost**			58,430	40,881	25,701
Add — Retained earnings restricted for Preferred Stock dividend requirements***			341,008	265,288	188,051
Total Preferred Stock			$ 1,017,552	$ 966,246	$ 910,868

See Notes to Financial Statements.
**Redemption required, see Note 2.*
***Held to meet annual sinking fund requirements.*
****Effective retroactive to 1986, the Company has separately presented retained earnings restricted for Preferred Stock dividend requirements.*

Statement of Cash Flows

For year ended December 31 *(In thousands of dollars)*	1988	1987	1986
Operating Activities:			
Net Income (Loss)	$(1,046,620)	$ 269,888	$ 316,675
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Cumulative effect of accounting change for disallowed costs	1,345,110	—	—
Depreciation, depletion, and amortization	93,596	73,905	70,139
Federal income taxes — deferred and other	93,452	165,874	170,365
Amortization of New Haven abandoned generating project	—	10,853	16,280
Allowance for other funds used during construction	(75,491)	(127,958)	(139,639)
Provision for net loss on Jamesport abandoned generating project	—	—	16,000
Other	29,450	15,264	68,725
Changes in operating assets and liabilities:			
Accounts receivable	(24,766)	2,991	7,282
Accrued revenue	(31,185)	(1,585)	1,406
Accounts payable and accrued expenses	11,814	3,249	(22,756)
Materials and supplies, fuel oil and gas in storage	8,414	(26,256)	8,918
NMP2 deferred revenue and carrying charge	13,881	—	—
Other	(3,221)	(48,736)	16,097
Net Cash Provided by Operating Activities	414,434	337,489	529,492
Investing Activities:			
Construction and nuclear fuel expenditures	(561,157)	(581,175)	(713,144)
Less-Allowance for other funds used during construction	75,491	127,958	139,639
Construction and nuclear fuel expenditures, less allowance for other funds used during construction	(485,666)	(453,217)	(573,505)
Advance payments for construction	—	—	71,377
Nine Mile Point 2 settlement	52,200	—	—
Other	(532)	(434)	4,308
Net Cash Used in Investing Activities	(433,998)	(453,651)	(497,820)
Financing Activities:			
Proceeds from issuance of long-term debt	—	—	1,250,804
Redemption of long-term debt	(81,195)	(24,000)	(874,799)
Acquisition of treasury stock	(17,549)	(15,179)	(18,047)
Cost of issuing long-term debt	(280)	(601)	(39,104)
Other	356	437	432
Net Cash Provided by (Used in) Financing Activities	(98,668)	(39,343)	319,286
Net Increase (Decrease) in Cash and Cash Equivalents	$ (118,232)	$(155,505)	$ 350,958
Cash and cash equivalents at beginning of year	$ 210,781	$ 366,286	$ 15,328
Net increase (decrease) in cash and cash equivalents	(118,232)	(155,505)	350,958
Cash and Cash Equivalents at End of Year	$ 92,549	$ 210,781	$ 366,286

See Notes to Financial Statements.

Note 1. Summary of Significant Accounting Policies

The Company's accounting policies conform to generally accepted accounting principles (GAAP) as they apply to a regulated enterprise. Its accounting records are maintained in accordance with the Uniform System of Accounts prescribed by the Public Service Commission of the State of New York (PSC) and the Federal Energy Regulatory Commission (FERC).

Utility Plant
Additions to and replacements of utility plant are recorded at original cost, which includes material, labor, overhead, and an allowance for the cost of funds used during construction (AFC). The cost of renewals and betterments relating to units of property is added to utility plant. The cost of property replaced, retired, or otherwise disposed of is deducted from utility plant and, generally, together with dismantling costs less any salvage, is charged to accumulated depreciation. The cost of repairs and minor renewals is charged to maintenance expense. Mass properties (such as poles, wire, and meters) are accounted for on an average unit cost basis by year of installation.

Allowance for Funds Used During Construction
The Uniform System of Accounts defines AFC, which is not an item of current cash income, as the net cost of borrowed funds for construction purposes and a reasonable rate of return upon the utility's equity, when so used. AFC is computed monthly using a rate permitted by FERC on that portion of construction work in progress (CWIP) which is not included in the Company's rate base. It is the Company's policy not to record AFC or interest on costs upon receipt of an order from a regulator disallowing such costs for ratemaking purposes. The portion of AFC relating to borrowed funds is included in the Interest Charges and (Credits) section of the Statement of Income. The PSC has ordered that net of tax AFC rates be applied to the Shoreham Nuclear Power Station (Shoreham) CWIP.

The average annual AFC rate, without giving effect to compounding or the reduced net of tax rate, was 12.12%, 13.53%, and 13.56% for the years 1988, 1987, and 1986, respectively. The average net of tax annual AFC rate, without giving effect to compounding, was 9.95%, 11.78%, and 11.54% for the years 1988, 1987, and 1986, respectively.

Depreciation
The provisions for depreciation result from the application of straight-line rates to the original cost, by groups, of depreciable properties in service. The rates are determined by age-life studies performed annually on depreciable properties. Depreciation was equivalent to approximately 3.6%, 3.5%, and 3.4% for electric and 2.8%, 2.7%, and 2.5% for gas of respective average depreciable plant costs for the years 1988, 1987, and 1986, respectively.

Revenues
Effective January 1, 1988, the Company recorded on its Balance Sheet an asset for electric unbilled revenue, for all customers through December 31, 1987, and a corresponding liability amounting to $63.2 million in order to conform to the opinion of the PSC in its December 1987 rate decision. Pursuant to the same order, the Company is amortizing the liability and, therefore, increasing electric revenues by approximately $1.8 million per month, subject to any changes which the PSC may subsequently make to the level of amortization. The recognition of electric unbilled revenue, in conformity with the PSC order, including the liability amortization, increased the 1988 electric revenues over 1987 electric revenues by approximately $29.5 million. The net after tax effect, for the year ended December 31, 1988, was an increase in earnings of approximately $19.5 million. Previously, unbilled revenue was recognized only for customers billed on a bi-monthly cycle basis for the month in which they are normally not billed.

Deferred Fuel Cost Adjustments
The Company's electric and gas tariffs include fuel cost adjustment clauses representing the difference between actual fuel costs and the fuel costs allowed in the Company's base tariff rates. The Company, to achieve a proper matching of costs and revenues, defers these adjustments, net of related income tax effects, to those future periods in which they will be billed or credited to customers.

Federal Income Taxes
The Company provides deferred federal income taxes with respect to certain differences between net income before income taxes and taxable income in certain instances when approved by the PSC, as disclosed in Note 5. The Company defers the benefit of 60% of pre-1982 gas and pre-1983 electric and 100% of all other investment tax credits when realized on its tax returns.

For ratemaking purposes, certain accumulated deferred federal income taxes are deducted from rate base and amortized or otherwise applied as a reduction (increase) in federal income tax expense in future years. Accumulated deferred investment tax credits are amortized ratably over the lives of the related properties.

The tax effects of other differences between income for financial statement purposes and for federal income tax purposes are accounted for as current adjustments in federal income tax provisions.

In December 1987, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 96, Accounting for Income Taxes, effective for fiscal years beginning after December 15, 1988. The FASB subsequently issued SFAS No. 100, Accounting for Income Taxes—Deferral of the Effective Date of FASB Statement No. 96, which defers the effective date of SFAS No. 96 to fiscal years beginning after December 15, 1989. SFAS No. 96 will require, among other matters, (a) recognition of the amount of current and deferred taxes payable or refundable at the date of the financial statements as a result of all events that have been recognized in the financial statements and (b) adjustment of deferred income taxes for an enacted change in tax laws. For regulated enterprises, SFAS No. 96 will (a) prohibit net of tax accounting and reporting and (b) require recognition of a deferred tax liability for (1) the tax benefits which are flowed through to its customers and (2) the equity component of AFC. A regulatory asset or liability should be recognized

relating to such items if it is probable that the future increase or decrease in taxes payable thereon shall be recovered from or returned to customers through future rates. The Company does not expect to adopt SFAS No. 96 prior to January 1, 1990, which will provide additional time for the Company to complete its evaluation and analysis of SFAS No. 96. The impact of SFAS No. 96 on the Statement of Income is not expected to be material; however, the Company estimates that had it adopted SFAS No. 96 at December 31, 1988, the Company would have recorded on its Balance Sheet deferred tax and other liabilities of approximately $1.7 billion, and corresponding offsetting regulatory assets of approximately $1.2 billion and additional CWIP of approximately $500 million. These estimates could be materially affected by the outcome of uncertainties affecting the Company as discussed in Note 6.

Reserves for Claims, Damages, Pensions, and Benefits
Losses arising from claims against the Company are partially self-insured. Extraordinary storm losses are fully self-insured. Provisions credited to the reserves are based upon experience, risk of loss, actuarial estimates, and/or specific orders of the PSC.

Capitalization-Premiums, Discounts, and Expenses
Premiums or discounts and expenses related to the issuance of long-term debt are amortized over the lives of the issues. "Capital stock expense" related to that portion of Preferred Stock required to be redeemed is written-off as an adjustment to retained earnings or, if the Preferred Stock is redeemed below par value, any gain net of the related "Capital stock expense" is recorded as additional "Premium on capital stock." Through December 31, 1988, such gain was $3,637,000.

Statement of Cash Flows
In November 1987, the FASB issued SFAS No. 95, Statement of Cash Flows, effective for fiscal years ending after July 15, 1988. The Company has adopted the provisions of SFAS No. 95 in its 1988 financial statements and restated previously reported statements of changes in financial position for 1987 and 1986. The Company considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents. The Company made federal income tax payments of $17,090,000, $13,044,000, and $9,649,000 during the years 1988, 1987, and 1986, respectively. Additionally, the Company received refunds of federal income taxes for the years 1984 through 1986 of $7,827,000, $15,650,000, and $3,037,000 during the years 1988, 1987, and 1986, respectively. The Company made interest payments totaling $422,780,000, $418,065,000, and $395,606,000, during the years 1988, 1987, and 1986, respectively.

Regulatory Accounting
In December 1986, the FASB issued SFAS No. 90, Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs, effective for fiscal years beginning after December 15, 1987. SFAS No. 90 requires, among other matters, that a loss be recognized when it becomes probable that (1) costs of a plant will be disallowed for ratemaking purposes or (2) the cost of an abandoned plant is in excess of the present value of the future revenues expected to be realized relative to the abandoned plant. At December 31, 1988, the amount of investments in Shoreham, Nine Mile Point 2 (NMP2) and Jamesport Generating Station (Jamesport) reflect a write-down resulting from the Company's adoption, effective January 1, 1988, of SFAS No. 90. As a result of adopting SFAS No. 90, the Company's 1988 financial statements reflect a write-down of net assets, amounting to approximately $1.3 billion, net of tax effects, or $12.10 per common share, which is accounted for as the cumulative effect of a change in accounting principle. This write-down relates principally to certain costs of Shoreham determined to be imprudent by the PSC in 1985 and to the estimate as of January 1, 1988 of the Company's share of NMP2 costs in excess of the amount provided in the settlement among the cotenants of NMP2, all of which are discussed in Note 6. Further, the Company has recorded in 1988 an adjustment reflecting revised estimated NMP2 disallowed project costs that are included within the settlement agreement. This adjustment reduced the write-down recorded effective January 1988 by $3.2 million, net of tax effects, and is reported in the Other Income and (Deductions) section of the Statement of Income.

In August 1987, the FASB issued SFAS No. 92, Regulated Enterprises—Accounting for Phase-in Plans. A Rate Moderation Plan (RMP) ordered by the PSC on June 12, 1986, in conjunction with Shoreham and which has never been implemented, does not meet the criteria set forth in SFAS No. 92, which would provide for capitalization of costs which the regulator has permitted the utility to defer for future recovery. If the 1989 Settlement, as discussed in Note 6, does not become effective, the Company intends to request that the PSC modify the RMP so as to meet the criteria established by SFAS No. 92 for capitalization of such costs if Shoreham enters commercial operation. However, the Company can give no assurances that the required modifications will be ordered by the PSC. Furthermore, SFAS No. 92, which is applicable to the recovery of the costs of certain operating facilities, would not apply to Shoreham if the 1989 Settlement becomes effective.

Since 1984, the PSC has authorized the Company to collect additional revenues, designated as Financial Stability Adjustment (FSA) revenues, in excess of the amounts to which the Company would be entitled under conventional ratemaking. The effect of the FSA is to provide the Company with current cash and reduce the cost of construction through a decrease in non-cash AFC. The total amount of such cash flow revenues, net of tax effects, was $203, $185, and $161 million during 1988, 1987, and 1986, respectively. The PSC has ordered that the FSA would be terminated in the event of bankruptcy. Additionally, effective May 1984, the PSC ordered the Company to provide for an equity earnings cap adjustment which is an accounting mechanism established to defer certain cost savings for possible distribution to its customers.

Note 2. Capital Stock

Preferred Stock Sinking Funds
Redemption of various series of Preferred Stock is effected through the operation of various sinking fund provisions. However, the Company's Certificate of Incorporation prohibits the retirement of Preferred Stock so long as dividends are in arrears; accordingly, the sinking fund requirements for 1988, 1987, and 1986 which totaled $19,888,000, $16,888,000, and $13,637,500, respectively, were not satisfied. The Company has purchased, but not yet retired, an aggregate number of shares of its Preferred Stock equivalent to the number of shares of such series scheduled to be redeemed by way of sinking funds through 1988. The aggregate par value of Preferred Stock required to be redeemed in each of the years 1989 through 1993 is $23,888,000.

Preferred Stock Dividends
Preferred Stock dividends are cumulative. The Company and certain of its lending banks have entered into a credit agreement (the 1989 Credit Agreement) which expires in February 1990. Under the 1989 Credit Agreement payment of all dividends is prohibited. Under the 1986 Restructuring Credit Agreement (1986 RCA) payment of Preferred Stock dividends accruing after December 31, 1987 is limited by a formula tied to internal cash generation. No Preferred Stock dividends can currently be declared pursuant to this formula except arrearages prior to January 1, 1988, which totaled $265 million and whose payment is not limited by the aforementioned formula. Arrearages for the year ended December 31, 1988 totaled $76 million and may not be paid under the formula.

Preference Stock
None of the authorized shares of nonparticipating Preference Stock, par value $1 per share, which ranks junior to the Preferred Stock, are outstanding.

Common Stock
Of the 150,000,000 shares of authorized Common Stock at December 31, 1988, 1,956,892 shares were reserved for sale to employees, 6,802,247 shares were committed to the Automatic Dividend Reinvestment Plan, and 236,099 shares were reserved for conversion of the Series I Convertible Preferred Stock at a rate of $17.15 per share.

Common Stock Dividends
As discussed above, the 1989 Credit Agreement, which expires in February 1990, prohibits the payment of all dividends. Under the 1986 RCA, the payment of Common Stock dividends, subject in any event to the Company's Certificate of Incorporation which prohibits the payment of Common Stock dividends so long as Preferred Stock dividends and sinking fund payments are in arrears, is limited by the same formula, described above, which is applicable to Preferred Stock dividends. At December 31, 1988, no Common Stock dividends could be declared pursuant to this formula. Dividend limitations contained in the mortgage securing the Company's First Mortgage Bonds are not material. The Company's General and Refunding Indenture (G&R Mortgage) does not restrict the payment of dividends.

Election of Board of Directors
The Company's Certificate of Incorporation states that Preferred Stockholders have the right to elect the smallest number of members of the Board of Directors so as to constitute a majority, should the Company be in arrears for a total of four quarterly dividend payments in any one series of Preferred Stock. This right will continue so long as Preferred Stock dividends remain in arrears. The current Board of Directors consists of nine members, five of whom have been elected either by holders of Preferred Stock or by Directors elected by holders of Preferred Stock and four of whom have been elected by holders of Common Stock.

Note 3. Retirement Benefit Plans

The Company maintains a primary defined benefit pension plan (Primary Plan) which covers substantially all employees and a supplemental plan (Supplemental Plan) which covers key executives. All pension costs are borne by the Company.

The Company's funding policy is to contribute annually to the Primary Plan, a minimum amount consistent with the requirements of the Employee Retirement Income Security Act (ERISA) plus such additional amounts as the Company may determine to be appropriate from time to time. Pension benefits are determined by crediting the employee with an amount determined using the base salary for each year the employee is a participant in the plan, plus an additional amount credited for each year the employee remains a participant beyond the age of 50. To comply with changes in pension plan requirements under the Tax Reform Act of 1986, starting in 1989, employees will be vested in the pension plan after five years of service with the Company.

The Supplemental Plan provides, without contribution from such employees, supplemental death and retirement benefits for officers and other key executives. Death benefits are currently provided by insurance. Retirement benefits totaling approximately $688,000 and $690,000 have been recognized as expense in 1988 and 1987, respectively, but are unfunded.

The Primary Plan's funded status and amounts recognized in the Balance Sheet at December 31, 1988 and 1987 are as follows:

	1988	1987
	(Thousands of Dollars)	
Actuarial present value of benefit obligation—		
Vested benefits	$344,000	$320,040
Nonvested benefits	11,000	11,608
Accumulated benefit obligation	$355,000	$331,648
Plan assets at fair value	$406,400	$379,166
Actuarial present value of projected benefit obligation	381,184	355,933
Projected benefit obligation less than plan assets	25,216	23,233
Unrecognized January 1, net obligations	14,351	15,376
Unrecognized net gain	(42,006)	(41,444)
Net accrued pension cost	$ (2,439)	$ (2,835)

Net periodic pension cost for 1988 and 1987 for the Primary Pension Plan included the following components:

	1988	1987
	(Thousands of Dollars)	
Service cost—benefits earned during the period	$ 9,800	$10,858
Interest cost on projected benefit obligation and service cost	29,004	26,759
Actual return on plan assets	(34,061)	(23,490)
Net amortization and deferral	8,773	(847)
Net periodic pension cost	$13,516	$13,280

Assumptions used in accounting for the Primary Plan in 1988 and 1987, respectively, were:

	1988	1987
Discount rate	8.0%	8.0%
Rate of future compensation increases	6.0%	6.0%
Long-term rate of return on assets	7.0%	7.0%

As a result of adopting, in 1987, SFAS No. 87 Employers' Accounting for Pensions, and in conjunction with certain other actuarial assumption changes, 1987 pension cost was reduced by approximately $2.9 million. In addition, pursuant to an order issued by the PSC in September 1987, the

Company has deferred $2.1 million and $4.6 million in 1988 and 1987, respectively, which represents the excess of pension expense collected from its ratepayers over that determined under SFAS No. 87.

The plan assets at fair value primarily include cash, cash equivalents, group annuities, bonds, and listed equity securities.

During 1986, the cost of both plans totaled $15,838,000. The cost of the Primary Plan was determined as the amount needed to meet the current service costs and the amount needed to amortize unfunded past service costs over a 30 year period.

In addition to providing pension benefits, the Company provides certain health care and life insurance benefits for retired employees. Substantially all of the Company's employees may become eligible for these benefits if they reach retirement age while working for the Company. These and similar benefits for active employees are provided through insurance companies whose premiums are based on the benefits paid during the year. The cost of providing these benefits was $23,298,000, $20,638,000, and $17,476,000, for 1988, 1987, and 1986, respectively. The cost of providing those benefits for 2,020, 1,952, and 1,899 retirees, is not separable from the cost of providing benefits for the 5,931, 6,033, and 5,866 active employees in 1988, 1987, and 1986, respectively.

Note 4. Debt At December 31

See Note 6 under the heading Financial Viability for a discussion of contingencies respecting the Company's continuing financial viability.

Each of the Company's three mortgages is a lien on substantially all of the Company's properties.

First Mortgage
All of the bonds issued under the First Mortgage, including those issued after June 1, 1975, and pledged with the Trustee of the G&R Mortgage as additional security for General and Refunding Bonds (G&R Bonds), are secured by the lien of the First Mortgage. First Mortgage Bonds pledged with the G&R Trustee do not represent outstanding indebtedness of the Company. Amounts of such pledged bonds outstanding were $469 million at December 31, 1988 and 1987. The annual First Mortgage depreciation fund and sinking fund requirements for 1988, due not later than June 30, 1989, are estimated at $171 million and $12 million, respectively. The Company expects to meet all of these requirements with property additions.

G&R Mortgage
The lien of the G&R Mortgage is subordinate to the lien of the First Mortgage. The annual G&R Mortgage sinking fund requirement for 1988, due not later than June 30, 1989, is estimated at $26 million.

Third Mortgage
The Third Mortgage, which is a lien on substantially all of the Company's properties, is subordinate to the liens of the First Mortgage and the G&R Mortgage and was created in 1984 to secure certain bank debt. The bank debt serviced by the Third Mortgage was restructured and combined in April 1986, and is described immediately below under the heading 1986 Restructuring Credit Agreement.

1986 Restructuring Credit Agreement (1986 RCA)
In April 1986, when the Company entered into the 1986 RCA with its lending banks whereby the Company restructured its bank debt, including the former trust obligations outstanding under the Third Mortgage, the Company issued $525 million of G&R Bonds and, with a portion of the proceeds, permanently prepaid $400 million, on a pro-rata basis, of the $1.0 billion of debt outstanding under the Third Mortgage. The remaining $600 million of bank debt was restructured into several funding segments, each of which provides for a different interest rate. The average interest rate on the outstanding balance at December 31, 1988 was 10.54%. Mandatory payments on the remaining bank loan balances, which totaled $558 million at December 31, 1988, are to be made in quarterly installments through September 30, 1992. On December 30, 1988, the Company paid the first installment of approximately $37 million.

Under certain circumstances in connection with the payment of Preferred and Common Stock dividends, the Company would be required to make mandatory prepayments to reduce the bank loan balances by up to a total of $250 million pursuant to the formula discussed in Note 2.

The following Funding Segments are outstanding:

Variable Rate Segment:
Pursuant to this segment, the Company has the option to commit to one of three interest rates including: (i) Adjusted Certificate of Deposit Rate which is a rate based on the certificate of deposit rates of certain of the lending banks, (ii) Base Rate which is generally a rate based on Citibank's prime rate, and (iii) Eurodollar Rate which is a rate based on LIBOR. At December 31, 1988, the Company had $516 million outstanding at the Base Rate which was 10.5% per annum at that date.

Eurodollar Segment:
The Company had $42 million outstanding at December 31, 1988, pursuant to the Eurodollar Rate which was 10.97% per annum at that date.

Other Long Term Debt

1989 Credit Agreement
The Company and certain of its lending banks recently entered into the 1989 Credit Agreement pursuant to which up to $200 million of credit secured by a first lien upon the Company's accounts receivable and fuel oil inventory has been made available to the Company. Under the terms of this agreement, which expires in February 1990, the Company immediately applied approximately $112 million to prepay the March, June and September 1989 payments of approximately $37 million each associated with the Company's 1986 RCA. The balance of the credit will be made available when and if the Company sells approximately $375 million of Debentures (the New Debentures), but not sooner than May 19, 1989. The Company can give no assurance that it will be able to sell the New Debentures.

Authority Financing Notes

The Company issued $217 million of Authority Financing Notes (Notes) to the New York State Energy Research and Development Authority (NYSERDA). Of this amount, $150 million was issued in 1985 and $17 million was issued in 1982 to secure the Pollution Control Revenue Bonds (PCRBs) which are subject to periodic tender. The remaining $50 million of Notes were issued at varying fixed rates and are not subject to tender.

The $150 million of PCRBs issued by NYSERDA in 1985 are deemed to be tendered by the holders each March 1 thereafter and are remarketed at such tender date. The interest rate for these PCRBs is subject to redetermination at each tender date. These PCRBs were issued with an initial 6.5% interest rate and were remarketed at interest rates of 5.6% effective February 28, 1986, 3.875% effective March 1, 1987, 5.125% effective March 1, 1988, and 7.0% effective March 1, 1989. Under arrangements made when the 1985 PCRBs were issued, letter of credit banks have agreed to pay the principal, interest and premium on the tendered PCRBs, in the aggregate, up to approximately $165 million in the event of default. Should the Company fail to reimburse the letter of credit banks, Niagara Mohawk is obligated under a guarantee to pay the letter of credit banks on the Company's behalf. The Company has agreed to repay Niagara Mohawk up to $165 million in consideration of Niagara Mohawk's guarantee to the letter of credit banks in connection with the Notes and certain amounts of interest and premium thereon. The Company's obligation under this guarantee is evidenced by a promissory note, under which there was no outstanding indebtedness at December 31, 1988, and is secured by an interest in the Third Mortgage in the amount of $85 million pari passu with other debt secured by the Third Mortgage. The Company is obligated to repay Niagara Mohawk in three equal installments payable on October 31, 1992, January 31, 1993 and March 16, 1993 in the event Niagara Mohawk is required to honor its guarantee. The Company has also agreed to pay Niagara Mohawk certain fees and expenses in connection with their guarantee of the extended letters of credit. These letters of credit, which were to have expired on March 16, 1989, have been extended to March 16, 1991, at which time the Company is required to obtain either an extension of the letters of credit or substitute credit backup. If neither can be obtained, the PCRBs must be redeemed unless the Company purchases the PCRBs in lieu of redemption and subsequently remarkets them.

The $17 million of PCRBs issued by NYSERDA in 1982 may be tendered by the holders every three years. The next such tender will occur in October 1991. The interest rate on the 1982 PCRBs is fixed at 8.25%.

Long-Term Debt at December 31 *(In thousands of dollars)*

	1988	1987
First Mortgage Bonds (excludes Pledged Bonds)		
4 1/8% Series J Due 1988	—	$ 20,000
5% Series L Due 1991	$ 25,000	25,000
4.40% Series M Due 1993	40,000	40,000
4 5/8% Series N Due 1994	25,000	25,000
4.55% Series O Due 1995	25,000	25,000
5 1/4% Series P Due 1996	40,000	40,000
5 1/2% Series Q Due 1997	35,000	35,000
8.20% Series R Due 1999	35,000	35,000
9 1/8% Series S Due 2000	25,000	25,000
7 1/4% Series U Due 2001	40,000	40,000
7 1/2% Series V Due 2001	50,000	50,000
7 5/8% Series W Due 2002	50,000	50,000
8 1/8% Series X Due 2003	60,000	60,000
Total First Mortgage Bonds	450,000	470,000
Less Current Maturities	—	20,000
Total Less Current Maturities	450,000	450,000
General and Refunding Bonds		
17 1/2% Series Due 1989	100,000	100,000
15 3/4% Series Due 1991	60,000	80,000
16 3/4% Series Due 1991	50,000	50,000
17% Series Due 1991	50,000	50,000
12 5/8% Series Due 1992	75,000	75,000
13 1/4% Series Due 1995	225,000	225,000
11 1/4% Series Due 1996	250,000	250,000
9.75% Series Due 1999	80,000	84,000
9 5/8% Series Due 2006	70,000	70,000
8 5/8% Series Due 2006	50,000	50,000
8 5/8% Series Due 2007	85,000	85,000
9.20% Series Due 2008	75,000	75,000
14 1/4% Series Due 2010	50,000	50,000
17 1/8% Series Due 2012	100,000	100,000
15 1/4% Series Due 2012	100,000	100,000
13 1/2% Series Due 2013	105,000	105,000
11 7/8% Series Due 2015	275,000	275,000
Total General and Refunding Bonds	1,800,000	1,824,000
Less Current Maturities	126,000	24,000
Total Less Current Maturities	1,674,000	1,800,000
Third Mortgage		
1986 RCA	557,926	595,121
Less Current Maturities	148,780	37,195
Total Less Current Maturities	409,146	557,926
Other Long-Term Debt		
Authority Financing Notes		
5 1/8% to 8 1/4% Due 2006-2016	216,675	216,675
Debentures		
11 1/2% to 11 3/4% Due 1993-2014	700,000	700,000
Total Other Long-Term Debt	916,675	916,675
Less Current Maturities	—	—
Total Less Current Maturities	916,675	916,675
Total Long-Term Debt Less Current Maturities	$3,449,821	$3,724,601

The aggregate of the Company's long-term debt due in the next five years is $274,780,000 (1989), $175,781,000 (1990), $297,781,000 (1991), $196,585,000 (1992), and $219,000,000 (1993).

Note 5. Federal Income Taxes

The federal income tax amounts included in the Statement of Income differ from the amounts which result from applying the statutory federal income tax rate to net income before income taxes. The reasons are as follows:

(In thousands of dollars)	1988		1987		1986	
	Amount	% of Pre-tax Income	Amount	% of Pre-tax Income	Amount	% of Pre-tax Income
Federal income tax, per Statement of Income — current	$ 18,395		$ 83,577		$ 41,347	
Included in other income and deductions—current	0		(80,597)		(41,347)	
Total Current	18,395		2,980		0	
Deferred and other (see Note 1)						
Accelerated tax depreciation	47,926		150,833		74,702	
Capitalized overheads	55,504		62,531		43,131	
TRA 86 benefits	1,659		27,756		—	
Interest capitalized	185		2,796		53,636	
Fuel cost adjustments	1,448		2,236		(12,959)	
Westinghouse settlement	(111)		(59)		(2,477)	
Call premiums	(221)		(538)		6,305	
Cancelled generating projects	—		(2,153)		(3,230)	
Accrued utility revenues	8,131		(13,585)		—	
Nine Mile Point 2 deferred revenues	(4,151)		—		—	
Deferred tax credits	(13,611)		(67,642)		5,487	
Other items, net	(3,307)		3,699		5,770	
Total Deferred	93,452		165,874		170,365	
Total federal income tax expense	111,847		168,854		170,365	
Income before cumulative effect of accounting change	298,490		269,888		316,675	
Income Before Cumulative Effect of Accounting Change and Income Taxes	$410,337		$438,742		$487,040	
Statutory federal income tax	$139,515	34.0%	$175,277	39.95%	$224,038	46.0%
Additions (reductions) in Federal income tax resulting from:						
TRA 86 benefits	1,659	0.4	27,756	6.3	—	—
Tax credits	4,153	1.0	24,303	5.5	5,485	1.1
Interest capitalized	8,066	2.0	9,354	2.1	45,563	9.4
Excess of book depreciation over tax depreciation	10,014	2.4	6,304	1.4	7,646	1.5
Cancelled generating projects	—	—	2,466	0.6	11,618	2.4
Costs charged to plant but deducted currently	—	—	(1,384)	(0.3)	(7,039)	(1.4)
Lien date property taxes	(2,673)	(0.6)	(4,840)	(1.1)	(1,794)	(0.4)
Allowance for funds used during construction	(54,899)	(13.4)	(72,035)	(16.4)	(115,639)	(23.7)
Other items, net	6,012	1.5	1,653	0.4	487	0.1
Total Federal Income Tax Expense	$111,847	27.3%	$168,854	38.45%	$170,365	35.0%

The amount of investment tax credit (ITC) carryforward for financial statement purposes after 1988 is approximately $328 million. These credits expire by the year 2002. In accordance with the Tax Reform Act of 1986 (TRA 86), ITC allowable as credits to tax returns for years after 1987 must be reduced by 35%. The amount of the reduction will not be allowed as a credit for any other taxable year.

The Company has not provided deferred taxes on approximately $886 million of various other deductions and depreciation method differences for property placed in service prior to 1981 which, in conformity with the ratemaking practices of the PSC, have been flowed through. These various other flow-through tax deductions, which are deductible currently for tax purposes but capitalized for accounting and ratemaking purposes, include certain taxes, a portion of AFC, pensions and certain other employee benefits. See Note 1 with respect to SFAS No. 96 which the Company must adopt by no later than 1990.

The PSC required the Company to defer certain TRA 86 tax changes, including the lower corporate federal income tax rate, for future disposition. This resulted in recording an additional $1.7 million and $27.8 million of income tax expense in 1988 and 1987, respectively.

Note 6. Commitments and Contingencies

The adverse resolution of certain of the matters discussed herein would have a material impact on the Company's financial viability. Under the most adverse circumstances, the Company might seek the protection of federal bankruptcy laws while it continues its operations.

Financial Viability
The Company's financial viability will be materially adversely affected if the Company is unable to obtain needed financing, including the sale of New Debentures, as discussed in Note 4, for its operating and capital requirements. Such financial viability is also dependent upon, among other things, (a) the receipt of adequate and timely rate relief and (b) the satisfactory resolution of the other matters discussed herein. In the absence of the proceeds from the sale of New Debentures planned to take place in early 1989, the Company estimates that, in the second quarter of 1989, its operating and capital requirements will exceed the total of the cash expected to be generated from operations and the cash and short-term investments that were on hand at December 31, 1988. The Company estimates that it will need the proceeds of the New Debentures to meet its operating and capital requirements for 1989.

The Company anticipates that even if it is able to consummate the sale of New Debentures, and, contingent upon such sale, borrow the remaining $88 million available under the 1989 Credit Agreement, the Company's cash resources to meet its capital and operating requirements will be exhausted during the first quarter of 1990 in the absence of additional financing (including the extension or modification of the Company's bank agreements) and rate relief. The Company's ability to sell the New Debentures is subject to market conditions generally and to the perception of the credit markets as to the financial viability of the Company. The sale of the New Debentures is intended to provide the Company with the flexibility to maintain financial viability during a period in which it awaits the outcome of the following matters: (i) final resolution of matters relating to a proposed settlement of the Federal Racketeer Influenced and Corrupt Organizations Act (RICO Act) litigation discussed below; (ii) resolution of open issues before the staff of the Nuclear Regulatory Commission (NRC) concerning the Company's application for licenses to operate Shoreham at full power; (iii) the restoration of the Company to financial health through the effectiveness of the settlement discussed under the heading "The 1989 Settlement;" (iv) action by the PSC respecting the Company's request for permanent rate relief; and (v) some combination of any of these matters or of others not yet proposed for the resolution of the problems facing the Company.

The Company can give no assurance as to the outcome of any of the foregoing matters or as to its ability to sell the New Debentures. Information respecting these matters is summarized below.

RICO Act Litigation and Related Matters
On February 14, 1989, the Company, certain of its former Officers, all of its ratepayers (the class) acting through counsel for the class certified by a federal trial court in the RICO Act lawsuit and counsel for the plaintiffs in a civil lawsuit brought under the Federal False Claims Act, entered into a proposed agreement settling both lawsuits (the Class Settlement). The Class Settlement provides for rate reductions aggregating $390 million to be reflected as adjustments to the ratepayers' monthly electric bills over a ten-year period as follows: $20 million beginning on each of June 1, 1990, 1991 and 1992; $30 million beginning on each of June 1, 1993 and 1994; $40 million beginning on June 1, 1995; $50 million beginning on June 1, 1996; and $60 million beginning on each of June 1, 1997, 1998 and 1999. The Class Settlement also provides for payment of up to $10 million for reasonable attorneys' fees and expenses and certain other costs associated with the Class Settlement. In December 1988, a federal jury in the RICO Act lawsuit found the Company and one of its former Officers jointly and severally liable to Suffolk County for approximately $7.6 million, which under the RICO Act is trebled to approximately $23 million. Subsequently, the trial judge dismissed the claims asserted by Suffolk County. Suffolk County, which is not a party to the Class Settlement, may opt out of the class and may pursue an appeal. If Suffolk County were to be successful on all of its grounds for appeal and, upon a new trial, the Company were to be found liable for claims on which Suffolk County did not prevail in the earlier trial, the Company could be liable to Suffolk County for as much as $72 million. The Company can give no assurance as to the outcome of any such appeal.

In general, Suffolk County claimed that, from approximately 1974 to the present, the Company fraudulently failed to make adequate disclosures or alternatively made false and misleading statements (i) with respect to the projected completion dates for the nuclear projects at Shoreham and Jamesport in connection with rate applications and applications relating to the construction of both projects and (ii) with respect to Shoreham in a prudence investigation conducted by the PSC. All of the ratepayers of the Company have been certified as a class with respect to the matters in this litigation. Should the Class Settlement not be approved by the trial court and the Company's shareowners or if, in any of a number of possible appeals, all determinations were to be adverse to the Company and, in a new trial, the Company were to be found liable for claims upon which Suffolk County did not prevail in the earlier trial, the Company's ultimate liability could be as large as $2.9 billion, which under the RICO Act could be trebled to approximately $8.7 billion. The Company is unable to predict whether the trial court and the Company's shareowners will approve the Class Settlement or, if appeals are taken, the outcome of such appeals. Thus, the Company's liability could be within a range from zero to as much as $8.7 billion. Judgments against the Company in material amounts would have a material adverse effect on the financial condition and results of operations of the Company. Under the most adverse circumstances, the Company might seek the protection of federal bankruptcy laws while it continues its operations. The Company may be required at the discretion of the court to post a bond in order to take the appeal from any adverse judgment or to stay its enforcement. The Company cannot predict the amount of such bond and therefore it cannot predict its ability to post a bond in the required amount. None of the Company's mortgages or its credit facilities permit a judgment lien in excess of $5 million. Judgment liens in such amounts, if not satisfied, could, under certain circumstances, lead to an event of default under those mortgages and credit facilities. Such a default, in turn, could lead to an acceleration of the debt outstanding under the mortgages and the credit facilities.

The Class Settlement would also terminate a lawsuit filed against the Company and certain of its former Officers on behalf of the United States under the Federal False Claims

Act by two former employees of Stone & Webster Engineering Corp., the architect-engineer and construction manager at Shoreham. The action sought to recover damages of $60 million trebled under the Federal False Claims Act for a total of $180 million allegedly sustained by the United States Government (U.S.) as a result of the Company's alleged conspiracy to defraud the U.S. by the submission of utility bills calculated using rates which include costs arising from the planning, engineering, procurement, construction and financing of Shoreham and Jamesport. In addition, plaintiffs sought a penalty which, according to plaintiffs' court filings, could have exceeded $100 million. The allegations in this lawsuit are similar to the claims asserted by the plaintiffs in the RICO Act litigation discussed above. The Company is unable to predict the outcome of this litigation if it is not terminated by the Class Settlement. Should the Class Settlement not be approved by the trial court and the Company's shareowners or if, in any number of possible appeals, all determinations were to be adverse to the Company, the outcome could have a material adverse effect on the financial condition and results of operations of the Company.

The conditions and approvals which must be met before the Class Settlement becomes effective give rise to uncertainties as to the ultimate liability of the Company, if any. Accordingly, the impact, if any, of the Class Settlement has not been reflected in the Company's results of operations during 1988.

The Company is aware of an inquiry made by a United States Attorney or United States Attorneys respecting allegations that the Company engaged in possible criminal activity in connection with "scheduling cover-ups" and "document alterations" concerning Shoreham. The Company does not know whether this inquiry is continuing and cannot predict what effect, if any, the jury's verdict in the RICO Act litigation, the trial court's dismissal of Suffolk County's claims or the Class Settlement, described above, may have upon this inquiry. In addition, even if the jury's verdict in the RICO Act litigation were to be reinstated, it would not be a finding of criminal liability and would not be binding in a criminal matter. Criminal allegations require a more stringent level of proof than that required under the civil RICO Act provisions described above.

The Company has received a demand from a law firm representing a client, identified as a shareowner of the Company, that the Company commence a lawsuit seeking recovery from the defendants in the RICO Act litigation for alleged waste of corporate assets. The Company has been unable to ascertain the identity of the shareowner.

Shoreham

Through December 31, 1988, the Company had expended approximately $4.2 billion for Shoreham, including AFC and $96 million for nuclear fuel, after giving effect to a write-down of $1.4 billion recorded effective January 1, 1988. The Company estimates that subsequent expenditures for Shoreham, including AFC on its prudent costs, will be approximately $25 to $35 million each month through the date of commercial operation should it be permitted to operate. Almost all of these expenditures are for carrying charges, including financing charges, insurance, taxes and other overhead expenses. The overhead expenses include maintenance expenses and plant personnel salaries and wages.

Shoreham has been successfully operated and tested at levels up to 5% of full power pursuant to a license issued in July 1985 by the NRC. Operation at levels above 5% is dependent upon further regulatory approval. Operation of Shoreham is also subject to the outcome of efforts by its opponents who seek to have the licensing effort cease and to have Shoreham decommissioned. In addition, the PSC's February 15, 1989 order authorizing temporary rate increases, discussed below, is conditioned upon the Company not operating Shoreham so long as those temporary rates are in effect.

Without Shoreham, the Company believes it will be difficult to meet the energy requirements of Long Island, and that alternatives to Shoreham which have been proposed, both by the Company and others, may not be implemented in sufficient time to provide adequate energy in 1989 or in the next several years.

Two events have occurred subsequent to December 31, 1988 which will significantly affect the future of Shoreham. One is a decision on March 3, 1989 by the NRC determining that all adjudicatory proceedings before it relating to Shoreham have been completed and that, as a consequence, all open matters relating to the licensing of Shoreham are to be reviewed by the staff of the NRC as in an uncontested proceeding, a process which, including a public hearing, could be completed within approximately one month. The Company cannot, however, give any assurance as to the length of time which this process will actually take or as to the outcome of the appeals which the State of New York, Suffolk County and the Town of Southampton (all of which have been dismissed by the NRC from all proceedings before it relating to Shoreham) have publicly stated they will take. The other event which has occurred which could significantly affect the future of Shoreham is an agreement entered into on February 28, 1989 between the Company and the State of New York (by its Governor) settling certain issues relating to the Company (the 1989 Issues Agreement) and providing, among other matters, for Shoreham to be transferred to the Long Island Power Authority (LIPA) and decommissioned. Additional information respecting the licensing of Shoreham and the 1989 Issues Agreement are discussed below.

Licensing: The Company has been unable thus far to obtain a license from the NRC to operate the completed Shoreham plant at full power because of strong political opposition from the State of New York, the County of Suffolk and the Town of Southampton (the Intervenors). However, on September 23, 1988, an Atomic Safety and Licensing Board (ASLB) of the NRC dismissed the Intervenors as a sanction for their conduct in proceedings before the NRC relating to the Company's application for the Shoreham license. The ASLB also authorized issuance of a full-power license. This decision was partially reversed by the NRC's Atomic Safety and Licensing Appeal Board (the Appeal Board) and subsequently appealed to the NRC Commissioners. On March 3, 1989, the NRC affirmed the dismissal of the Intervenors from all proceedings before the NRC relating to Shoreham and instructed the staff of the NRC to review all remaining open licensing issues. The Company intends to continue its vigorous pursuit of the full-power license for Shoreham. The review process by the NRC staff could be completed within approximately one month but there is no guarantee of the length of time it will take. Moreover, the Company can give no assurance that the staff of the NRC will reach a conclusion in favor of the Company on all matters before it. The Company expects that the NRC's decision in this matter will be appealed, but can give no assurance as to the outcome of such appeal or estimate the time required for such appellate process.

Prudence: In December 1985, the PSC issued an order finding that the Company had imprudently managed the construction of Shoreham. The PSC concluded that approximately $1.4 billion of Shoreham expenditures were incurred as a result of the Company's imprudence and could not be recovered in rates. Pursuant to this PSC order, the Company, as of March 1, 1986, ceased to accrue AFC on Shoreham expenditures disallowed by the PSC. The Company will continue to accrue AFC on the costs not found to be imprudent until, provided the 1989 Settlement discussed below does not become effective, following authorization from the NRC, levels of operation of Shoreham have ascended substantially above 5% for a period sufficient to indicate that Shoreham will be a reliable source of base power. At that time, the Company may declare Shoreham to be in commercial operation (an event which may occur prior to operation at full power) and will cease to accrue AFC.

In December 1987, the Appellate Division, Third Department, of the New York Supreme Court, affirmed approximately $640 million of the PSC's determination that $1.4 billion of Shoreham's expenditures had been imprudently incurred. With respect to the remaining $759 million, the court remanded the matter to the PSC in order that it might further consider and explain the basis upon which it determined that delay costs for the period from August 1, 1982 to March 1, 1986, totaling $1.518 billion, were to be shared equally between shareowners and ratepayers. Upon remand, the Company will seek to reduce the amount of costs determined to be imprudent while intervenors might seek to have such amount increased. The Company is unable to predict the outcome of the remanded proceeding before the PSC or the outcome of further judicial appeals, if any, that might be taken from the court's decision. The appellate decision is also subject to further appeal by the Company or by intervenors. The Company has moved for leave to take such an appeal. There has been no determination of prudence respecting the costs of Shoreham subsequent to March 1, 1986. The Company plans to take the position before the PSC that all of such costs have been prudently incurred. The Company cannot predict whether the PSC will conduct further proceedings relating to prudence or, if held, whether the PSC will agree with the Company's position in such proceedings or whether further disallowances would result.

If the 1989 Settlement does not become effective and PSC precedent is followed, the Company expects to recover a carrying charge on any prudent costs not included in rate base until, over a period of years in future rate cases, all of such costs have been included in the rate base. The Company also expects, should Shoreham become operational, that it will be permitted to continue to receive in rates, through the partial inclusion in rate base of Shoreham's prudent costs, an amount equivalent to at least the amounts now generated by Shoreham CWIP in rates and the FSA. Such Shoreham-related revenues currently provide approximately $375 million annually. Because of the substantial uncertainties relating to Shoreham, the Company is unable at this time to determine when Shoreham will go into commercial operation, if ever, or, if Shoreham does not go into commercial operation, what rate treatment, if any, will be accorded the Company's investment.

If the Company is not permitted by the NRC to operate Shoreham and if the Company is unable to recover its prudent costs of Shoreham, the total write-off of these costs would exceed the Company's net worth and the Company might seek the protection of federal bankruptcy laws while it continues its operations.

The Company has initiated litigation against certain of the companies which participated in the construction of Shoreham. At some future time, the Company may also initiate litigation against other Shoreham contractors and suppliers. The Company cannot predict what recovery, if any, will result from this litigation.

Used and Useful: A New York statute adopted in 1986 which would have prohibited rate recovery of any costs incurred in connection with a nuclear generating station owned by a single utility that fails to commence or continue commercial operation has been declared unconstitutional by a United States District Court. An appeal of this decision has been dismissed without prejudice to reinstatement prior to April 18, 1989. If the decision were to be reversed on appeal and the provisions of the statute determined to be applicable to Shoreham, the Company believes that the loss of Shoreham-related revenues, currently providing approximately $375 million annually, would have a material adverse effect on the Company's financial viability. For additional information respecting these Shoreham-related revenues, see the discussion in Note 1 concerning FSA revenues.

Other: The costs of Shoreham include real property taxes capitalized during construction. The Company is seeking a judicial review of the assessments upon which those taxes were based in certain years. In 1984 and 1985, the Company withheld payment of the taxes because it believed that if the Company were to be successful in the pending tax litigation reflecting the claimed overassessments, it would be unable to enforce a judgment directing a refund of the taxes already paid. Subsequently, the Company paid the taxes. During the period of non-payment, charges for non-payment were assessed by Suffolk County against the Company and included by the Company in capitalized plant costs. FERC, as part of an audit by its staff of the Company's books and records for the period from January 1, 1979 through December 31, 1984, has directed the Company to take corrective action by charging to expense those capitalized Shoreham costs which were incurred as a result of withholding the taxes. The amount of such costs recorded on the Company's books and records at December 31, 1988 was $15 million. The Company requested FERC to conduct an administrative proceeding to review the directed accounting treatment. An Administrative Law Judge (ALJ) has rendered a decision on this issue which upholds the position of the staff of FERC. However, a final disposition of the controversy will be made by FERC itself, which may accept, reject or modify the ALJ's decision. The Company cannot predict the outcome of this issue before FERC. In the event of an adverse decision by FERC, the Company will determine whether to pursue an appeal to the federal courts. Pending consideration of the 1988 Settlement by the Company's shareowners, the PSC and the New York State Legislature, the Company requested FERC to defer action on its administrative review. Although the 1988 Settlement did not become effective on December 1, 1988 as contemplated, the Company has requested FERC to continue to defer action on its review. If the 1989 Settlement becomes effective, the issues before FERC will become moot.

The 1989 Settlement

General: The Company's inability to obtain a license to operate Shoreham has caused the Company severe financial problems. A settlement to which the Company, the State of New York, LIPA, the New York Power Authority (NYPA) and others were parties (the 1988 Settlement), was intended to achieve, among other things, the restoration of the Company to financial health through rate increases which were to provide, among other things, recovery of and on a regulatory asset (the Financial Resource Asset or FRA), which would have totaled approximately $3.843 billion at December 31, 1988, over 40 years. As part of the 1988 Settlement, the Company agreed that, should the 1988 Settlement become effective, it would not operate Shoreham, would reflect its retirement on its books and would seek a "possession only" license from the NRC. The 1988 Settlement also provided that, following an NRC-approved transfer to it of Shoreham, LIPA would decommission Shoreham. The 1988 Settlement did not become effective because of, among other reasons, the failure of the New York Legislature to give its approval, in part, through the adoption of certain legislation. It is the Company's intention that the 1989 Settlement discussed below, which is intended to resolve the same issues sought to be resolved by the 1988 Settlement, should provide substantially the same benefits as those provided by the 1988 Settlement which the Company's shareowners approved on November 4, 1988.

The 1989 Settlement is expected to consist of the following documents: (i) an agreement dated February 28, 1989 between the Company and the State of New York (the 1989 Issues Agreement); (ii) a Rate Order; (iii) the Asset Transfer Agreement; and (iv) the Power Supply Memorandum. The Asset Transfer Agreement and the Power Supply Memorandum, both of which initially formed part of the 1988 Settlement, must be amended to reflect the passage of time subsequent to their execution in June 1988 and to reconcile them to the terms of the 1989 Issues Agreement. The Company does not know the extent of such changes. Neither LIPA nor NYPA are parties to the 1989 Issues Agreement and have not yet given their approval to it and have not yet agreed to make the required amendments to the Asset Transfer Agreement or the Power Supply Memorandum. The Company can give no assurance that LIPA and NYPA will approve the 1989 Issues Agreement or enter into the required amendments to the Asset Transfer Agreement and the Power Supply Memorandum.

The 1989 Issues Agreement: The principal issues which the 1989 Issues Agreement is intended to resolve relate to: (i) the operation, the transfer of ownership and the decommissioning of Shoreham; (ii) the settlement of certain pending litigation and administrative proceedings; and (iii) the implementation of certain recommendations contained in two PSC-directed management audits. The 1989 Issues Agreement does not specifically provide for rate relief for the Company or commit New York State to support rate increases in any particular amount. However, the 1989 Issues Agreement recites the intention of the parties that the Company shall be returned to investment grade financial condition and recites that the Company and the State of New York anticipate that the PSC shall ensure that the future impacts on rates are to be minimized to the maximum extent practicable.

Conditions to the 1989 Issues Agreement: Effectiveness of the 1989 Issues Agreement is conditioned upon approval on or before April 15, 1989 by the PSC, LIPA, NYPA and the Company's Board of Directors and upon approval by the holders of a majority of the Company's outstanding shares of Preferred and Common Stock voting at the 1989 Annual Meeting of Shareowners, with the Company using its best efforts to obtain such approval by June 15, 1989. To date, none of these approvals have been obtained. If authorized by its Board of Directors, the Company will include a resolution for approval of the 1989 Settlement among the matters to be considered at the Company's 1989 Annual Meeting of Shareowners. The Company can give no assurance that the required approvals can be obtained or, with respect to the Company's 1989 Annual Meeting of Shareowners, the date when such meeting will be held. Pending receipt of these approvals, the Company is continuing to vigorously pursue a full-power operating license before the NRC.

The Rate Order: Because of the Company's increasingly precarious financial condition and because provisions for rate relief were omitted from the 1989 Issues Agreement, it is the position of the Company that a rate structure similar to that approved by the PSC pursuant to the 1988 Settlement must be authorized by the PSC, on or prior to April 15, 1989, before the Company's Board of Directors acts with respect to the 1989 Settlement. The 1988 Settlement provided that the Company would have received guaranteed rate increases of approximately 5% each year for three years and targeted increases of approximately 4.5% to 5% each year for the following seven years.

In determining whether to approve the 1989 Settlement, the Company's Board of Directors will consider whether the Rate Order will provide the Company with rate relief adequate and timely enough to achieve one of the objectives of the 1989 Issues Agreement, namely, the return of the Company to investment grade financial condition. The Company has been informed by the PSC that the rate relief contemplated by the 1989 Issues Agreement will be considered by the PSC prior to April 15, 1989. However, the Company cannot give any assurance: (i) that the PSC will act by April 15, 1989; (ii) as to the action, if any, which the PSC will take with respect to rate relief; (iii) that appeals, if any, from the Rate Order will be resolved in favor of the Company; (iv) that the provisions of the Rate Order will be similar to those in the rate provisions of the 1988 Settlement; (v) that the rate relief, if any, authorized by the PSC will return the Company to investment grade financial condition; or (vi) that the Company will realize the full measure of the benefits contemplated by the 1989 Settlement.

Disposition of Litigation: The Company and the State of New York, both of which are also parties in certain litigation and in certain administrative proceedings before the PSC, have agreed to stipulate to a discontinuance of that litigation and those proceedings. It is the Company's understanding that if LIPA (which is a party to the Asset Transfer Agreement but is not a party to the 1989 Issues Agreement) and NYPA (which is a party to the Power Supply Memorandum but is not a party to the 1989 Issues Agreement) approve the 1989 Issues Agreement, they will also agree to the disposition of litigation and administrative proceedings described herein. These matters, including among others, the litigation and proceedings described more fully under the headings (i) "Shoreham: Prudence," (ii) "Shoreham: Used and Useful" and related litigation in the New York courts and (iii) various proceedings before the PSC including a petition described under the heading "Investments: Bokum Resources Corporation" which the Company may file with the PSC and the recovery of storm

damage costs associated with Hurricane Gloria discussed under the heading "Rate Relief," will be settled upon the effectiveness of the 1989 Issues Agreement. In the event the 1989 Issues Agreement does not become effective, all of such matters will proceed without prejudice to any of the parties.

The 1989 Issues Agreement also recites the intention of the Company and New York State that the signing of the 1989 Issues Agreement will facilitate the settlement of the RICO Act litigation discussed above and the Brookhaven tax certiorari proceedings discussed under the heading "Shoreham: Other." The State is not a party to either action.

Transfer of the Shoreham Assets: The 1989 Issues Agreement provides that Shoreham is to be transferred to LIPA and decommissioned by NYPA pursuant to the Asset Transfer Agreement if the 1989 Issues Agreement becomes effective. The Company agrees, in the 1989 Issues Agreement, not to operate Shoreham above 5% of full power if licensed to do so by the NRC provided that the approvals required by the 1989 Issues Agreement, except shareowner approval, are received by April 15, 1989. If all such approvals have been received by April 15, 1989, the Company agrees not to operate Shoreham above 5% of full power even if licensed until the Company's shareowners have considered the 1989 Issues Agreement.

Future Generating Facilities: The 1989 Issues Agreement incorporates the Power Supply Memorandum by reference. The Company and the State have agreed to request that the PSC expressly agree to review and act on any agreement, such as those contemplated by the Power Supply Memorandum, for future electric generation facilities, within three months of submission of any such agreement to the PSC. In connection with financing certain of such facilities, New York State has agreed in the 1989 Issues Agreement to make available to NYPA a sufficient amount of the State's federally allocated private activity bond volume "cap" to permit it to finance the entire anticipated cost of such facilities. In addition, the 1989 Issues Agreement assumes that the Company is to be allocated a minimum of $100 million per year of the New York State private activity volume "cap" for a minimum of five years to permit the issuance of tax-exempt securities. New York State has agreed to support the Company's requests for such allocations. Tax-exempt financing, if available, is expected to reduce the cost of such projects and, therefore, the cost of electricity produced by such facilities and generated or purchased by the Company.

Enforceability of the 1989 Settlement: Because the parties to the 1989 Settlement, other than the Company, are governmental entities, a question arises as to whether the terms of the 1989 Settlement and the obligations of such parties, as embodied therein, would be enforceable against them. Because of their nature, governmental entities may have legal obligations or limitations that circumscribe their ability to be irrevocably bound by contract. The PSC, for example, may, in general, determine just and reasonable rates in accordance with certain procedures notwithstanding that a higher or lower rate has previously been established by contract, franchise or other agreement. In addition, the PSC may generally fix rates only for a maximum period of three years. Consequently, the PSC may take the position in the future that it is not legally bound by the rate increases contemplated by the 1989 Settlement and may seek to modify or avoid the provisions of the 1989 Settlement pursuant to its statutory authority. The power of the PSC to claim that it is not bound by the 1989 Settlement may be limited, however, as a result of the provisions in the 1989 Settlement that permit the 1989 Settlement and the PSC's decision approving the 1989 Settlement to be submitted to the appropriate courts for approval and enforcement, if necessary, as part of the settlement of certain of the litigation pending before such courts.

Even if the PSC abides by the terms of the 1989 Settlement, there can be no assurance that other persons authorized by statute to make a complaint about the Company's rates may not seek to set aside or mitigate the contemplated rate increases, or seek to reduce rates. Nor can there be any assurance that New York State will not enact subsequent legislation or that any other party to the 1989 Settlement will not take or refrain from taking some action which will in some way impair or alter the rights of the Company pursuant to the 1989 Settlement.

In the event any party fails to perform in accordance with its obligations under the 1989 Settlement, the Company may be able to contend, in a judicial proceeding or otherwise, that such failure impairs the Company's contract rights as set forth in the 1989 Settlement, and that it violates the terms of certain proposed judicial settlements which are to incorporate the 1989 Settlement. However, the Company is unable to provide assurance that the Company will prevail in any judicial or other proceeding, or that the Company will realize the full benefits of the 1989 Settlement.

Certain Federal Tax Consequences of the 1989 Settlement: In connection with the 1988 Settlement, the Company received a private letter ruling from the Internal Revenue Service (IRS) confirming that the Company would be entitled, for federal income tax purposes, to a deduction for its abandonment loss associated with Shoreham upon effectiveness of the 1988 Settlement. The Company is reviewing with its special counsel whether there will be a need, when the rate provisions of the 1989 Settlement are known, to seek a further ruling from the IRS.

Based on an abandonment loss deduction which the 1988 Settlement assumed would be taken in 1988, the Company estimated that the abandonment loss would have been approximately $2.8 billion and would have resulted in an immediate tax refund of approximately $11 million generated by a recalculation of the Company's 1987 alternative minimum tax payment. The 1988 Settlement provided that approximately 70% of the resulting tax benefits would have been allocated to ratepayers and the balance to shareowners. Also as a result of the abandonment of the Shoreham Assets, the Company would have lost an estimated $93 million of investment tax credits otherwise available to offset its federal income tax liability.

Accounting Treatment of the 1989 Settlement: Inasmuch as the rate provisions relating to the 1989 Settlement have not as yet been determined, the accounting treatment of the 1989 Settlement cannot be determined either. However, such accounting treatment may be similar to that contemplated for the 1988 Settlement, but the Company can give no assurance to that effect. If the 1988 Settlement had taken place as contemplated, the Company, upon effectiveness of the 1988 Settlement, would have simultaneously recorded on its Balance Sheet the retirement of certain portions of its investment in Shoreham and Bokum Resources Corporation (Bokum) and the establishment of the FRA. The FRA had two components — the Base Financial Component (BFC)

and the Rate Moderation Component (RMC). The FRA was to be equal to the present value of the future net-after-tax cash flows that the 1988 Settlement was to have provided to the Company. At December 31,1988, the Company's recorded costs for those portions of its investment in Shoreham and Bokum to be retired were approximately $4.2 billion and are continuing to increase at a rate of approximately $25 million to $35 million per month as additional costs, including AFC, are incurred. At January 1, 1989, the BFC of the FRA would have been $3.843 billion and would have increased monthly at an annual rate of 10% until the effectiveness of the 1988 Settlement. The BFC, which would have been afforded rate base treatment under the terms of the 1988 Settlement, would have been included in the Company's revenue requirements through an amortization included in rates over 40 years on a straight-line basis commencing with the effective date of the 1988 Settlement. The BFC would have earned a return on the unamortized balance at the overall rate of return earned on rate base. The RMC would have reflected the difference between the revenue requirements and the revenues resulting from the implementation of the rate moderation plan provided for in the 1988 Settlement. Such rate moderation plan was designed to hold electric rate increases to the levels provided for in the 1988 Settlement, subject to the adjustments provided for therein. The RMC would have first increased as revenues, together with a carrying charge equal to the allowed rate of return on rate base, were deferred; it would have subsequently decreased and was expected to be fully amortized by approximately 1998 as the deferred revenues were recovered.

The Company would have recognized a loss (and therefore a decrease in shareowner equity) for financial statement reporting purposes as a result of the 1988 Settlement. This loss would have primarily reflected the difference between the recorded costs of the Company's investment in Shoreham and Bokum and of the FRA, after adjustment for tax effects. If the 1988 Settlement had become effective on December 31, 1988, the Company estimates that the loss resulting therefrom would have been approximately $250 million, after adjustment for tax effects.

The accounting treatment proposed by the 1988 Settlement for regulatory purposes would have been subject to review by FERC which might have concurred, rejected or modified the accounting treatment for regulatory purposes ordered by the PSC. Based upon a review, the Company believes that the FRA and the accounting treatment afforded the FRA under the 1988 Settlement would have conformed to GAAP. For purposes of administering its uniform system of accounts, FERC has adopted the GAAP provisions of SFAS No. 90 which sets forth the criteria for recognition of regulatory-created assets resulting from abandonments. Accordingly, the Company believes that the proposed accounting treatment for the FRA would have conformed to FERC's standards for accounting and asset recognition of regulatory-created assets.

Effect of the 1989 Settlement on Holders of the Company's Securities: One of the objectives of the 1989 Settlement is to improve the credit rating of the Company's debt securities as determined by independent rating agencies. If the Company is successful in achieving this objective, it expects that it will be able to borrow money at lower rates of interest than it has been able to in the recent past and to raise debt capital more readily. This objective was also an objective of the 1988 Settlement. There can be no assurance that this objective for the 1989 Settlement will be achieved.

One of the assumptions underlying the 1988 Settlement was that the objective of improving the Company's debt security credit rating would be met and that the Company would refinance certain of its outstanding high interest series of G&R Bonds and high dividend bearing series of Preferred Stock. Another objective of the 1988 Settlement was to permit the Company, subject to action by the Board of Directors, and to other factors, to become current on all Preferred dividends during the first quarter of 1989, including payment of arrearages, and to resume payment of dividends on the Company's Common Stock. It is the Company's intention, should the 1989 Settlement become effective and market conditions and other economic factors permit, to refinance high interest series of G&R Bonds and high dividend series of Preferred Stock and, subject to action by the Company's Board of Directors and other factors including the Company's financial condition, its ability to comply with provisions of the Company's Restated and Amended Certificate of Incorporation, restrictions in the 1989 Credit Agreement and 1986 RCA, and the availability of retained earnings, capital surplus, future earnings, and cash, to pay the arrearages in Preferred Stock dividends and resume the payment of Preferred and Common Stock dividends. However, the Company can give no assurance that it will be able to refinance such series of G&R Bonds and Preferred Stock or to pay such dividends. If the 1989 Settlement becomes effective, the Company will reflect the retirement of Shoreham in certain calculations made pursuant to covenants under its long term secured debt. Due to the uncertainties surrounding the effectiveness of the 1989 Settlement, the Company has not made a determination as to what actions, if any, it might take if the implementation of the 1989 Settlement raises questions as to the Company's ability to comply with those covenants.

Rate Relief

In December 1987, the PSC denied an application then pending for rate relief, indicating that it would review in April 1988 the Company's entitlement to its current rates. The Company filed a new application for rate relief in April 1988, but consideration of the application was delayed while the PSC evaluated the 1988 Settlement.

On February 15, 1989, the PSC granted the Company temporary annual electric rate relief, subject to refund, of $97.7 million, or 5.41%. The temporary rates, the first increase in rates approved by the PSC for the Company in over three years, have become effective. In its implementing order, the PSC conditioned the rates upon the Company not operating Shoreham while the temporary rates are in effect. The PSC has indicated that it will rule on the Company's request to make the temporary rates permanent in approximately 90 days. No assurance can be given, however, that the PSC will, in fact, act in 90 days or what action it may take. The Company is reviewing the PSC's order to determine its options, including an immediate judicial appeal challenging the restriction in the order relating to the operation of Shoreham. In addition, as part of its deliberation in connection with the rate relief to be provided under the 1989 Settlement, the PSC will review the effect of such rate relief on those temporary rates.

The Class Settlement of the RICO Act and Federal False Claims Act lawsuits prohibit the Company from recovering any of the contemplated rate reductions, which will aggregate $390 million, from its ratepayers. The rate reductions will not be applied to the Company's rates until June 1, 1990.

The PSC's action on February 15, 1989 was in response to a request made by the Company on December 2, 1988. On December 2, 1988, responding to the failure of the New York State Legislature to adopt legislation which might have permitted the 1988 Settlement to become effective, the Company applied to the PSC for temporary rate relief. In response, on December 28, 1988 and again on January 25, 1989 and on February 8, 1989, the PSC stated that it would not then grant the Company's requests for temporary rate increases. In its December 28, 1988 statement, the PSC urged the Company, LIPA and NYPA to reaffirm the 1988 Settlement or consider an alternative agreement encompassing the 1988 Settlement's principal components. The PSC identified those components as (1) the end to the Shoreham controversy, (2) rates and a financial plan adequate to return the Company to financial health at the minimum cost to its customers and consistent with fully disallowing imprudent expenditures, (3) plans for major energy efficiency investments on Long Island, (4) plans for additional power supplies as needed, (5) implementation of outstanding management audit recommendations and (6) resolution of all major rate-related items in controversy between the PSC and the Company. The PSC also took notice of the uncertainties created by the verdict in the RICO Act litigation and reminded the parties of the costs to ratepayers which would continue, regardless of temporary rates, so long as the 1988 Settlement issues and the RICO Act litigation remain unresolved.

At the same time that it requested temporary rate relief, the Company also requested that a schedule be set for the review of its application, filed in April 1988, for the same amount of rate relief on a permanent basis. The New York State Consumer Protection Board (CPB), which had supported the rate relief provided for in the 1988 Settlement, is opposing the granting of any other rate relief to the Company.

The Company filed testimony in February 1988 demonstrating the reasonableness of storm damage costs associated with Hurricane Gloria. The Company is currently deferring these costs, has not sought recovery to date, and cannot predict when, if ever, the PSC will permit them to be recovered through rates. Consequently, the Company can give no assurance as to the action which the PSC will take respecting their recovery but believes that recovery is appropriate.

Nine Mile Point 2

Niagara Mohawk declared NMP2, in which the Company has an 18% undivided interest, to be in commercial operation on March 11, 1988. Had the 1988 Settlement become effective, NMP2 would have been considered to have been placed in commercial operation by the Company for ratemaking purposes on April 5, 1988. The 1989 Issues Agreement contains no provision relating to NMP2.

The PSC has approved a settlement (the NMP2 settlement), tendered by the Company, the four other cotenants of NMP2 and the staff of the PSC, of an investigation of the prudence of the costs incurred in the construction of NMP2 which limited the amount of NMP2 expenditures which may be included in the rate bases of the cotenants. The Company's share of this maximum amount of NMP2 expenditures, which the Company expects to recover from its ratepayers, is $725 million. The order of the PSC approving the settlement has been appealed in the courts. The Company is unable to predict the outcome of the appeal. The NMP2 settlement provides that each cotenant may seek to recover its share of allowed costs in separate rate proceedings and each cotenant would be permitted to recover an accumulated deferred carrying cost on the portion of the allowed costs not yet included in rates. Substantially all of the costs of NMP2 allowed the Company pursuant to the NMP2 settlement are currently included in the Company's rates as cash flow revenues under the December 1987 Rate Order. Such cash flow revenues, amounting to approximately $113 million annually, would cease in the event of the Company's bankruptcy prior to the PSC declaring NMP2 to be in commercial operation for the Company's ratemaking purposes.

The Company can give no assurance as to the precise date on which the commercial operation of NMP2 will commence for ratemaking purposes. However, as a result of the PSC's decision determining April 5, 1988 as the commercial operation date of NMP2 for the ratemaking purposes for Niagara Mohawk, the Company believes that an April 1988 date is also appropriate for the Company. Accordingly, the Company is accounting for its NMP2 operations based on this date. If the date on which NMP2 entered commercial operation for the Company's ratemaking purposes is determined by the PSC to be other than in April 1988, the Company has estimated that a reduction of net income of approximately $4 to $5 million could result for each month's delay.

Niagara Mohawk, manager and a cotenant in NMP2, and the sole owner of Nine Mile Point 1, another nuclear generating unit located at the same site, has been notified by the NRC that NMP2, along with Nine Mile Point 1, had been categorized "as requiring close monitoring." The Company is unable to predict what effect, if any, such close monitoring will have on its financial condition and results of operations. The requirement for close monitoring imposed in late 1988 by senior managers of the NRC during their bi-annual review of the performance of nuclear power plants licensed by the NRC, was based on a current assessment of the overall performance of NMP2 during the first year of its operation. Niagara Mohawk has advised the Company that the completion of the normal first-year-of-operation outage of NMP2, which has been delayed, is now scheduled to be completed in mid-March 1989. Thereafter, NMP2 is scheduled to resume normal operation. The Company can give no assurance that the scheduled resumption of operation will not be further delayed or what action, if any, the PSC may take with respect to the length of the outage of NMP2.

The Company and the other cotenants have initiated litigation against certain of the companies which participated in the construction of NMP2. At some future time the Company and the other cotenants may also initiate litigation against other NMP2 contractors and suppliers. The Company cannot predict what recovery, if any, will result from this litigation.

Investments

Jamesport: In the 1970s, the Company and another New York utility company sought regulatory approval for the construction of two nuclear generating units at Jamesport, New York but subsequently abandoned their plans to build the units. On April 5, 1988, the PSC approved a settlement agreement between the Company and the staff of the PSC concerning recovery of the costs associated with the abandoned units. No appeal having been taken, the order of the PSC has become final. Under the settlement the Company would be allowed to recover in its electric rates $77.5 million plus accrued carrying charges beginning in November 1987 of approximately $850 thousand per month.

The settlement also provides that this amount will be recovered over a three year period commencing at the effective date of any such new rates with a return on the unamortized amount until recovery is complete. The Company is presently seeking the recovery of the settlement amount as part of the permanent relief requested in its pending rate case. The Company does not yet know what provision will be made for Jamesport under the 1989 Settlement.

Bokum Resources Corporation: Beginning in 1976, the Company began making investments in Bokum which, at December 31, 1988, totaled approximately $144 million. This amount includes $20 million of advance payments made for uranium concentrates and $57 million for financing costs on those advance payments. Both amounts are included in the Balance Sheet under "Nuclear fuel in process and in reactor." The remaining $67 million of the investment consists of $60 million of loans to Bokum, including financing costs, for the completion of a uranium mine and ore-processing mill in New Mexico and $7 million expended since mid-1980 for preservation and maintenance of Bokum's mine and mill. These amounts are included in the Balance Sheet under "Other investments and deposits, principally Bokum Resources Corporation." Bokum is presently in reorganization under Chapter 11 of the United States Bankruptcy Code. The Company ceased accruing interest on its loans to Bokum after the filing of the bankruptcy petition. However, the Company is continuing to capitalize its financing costs on the advance payments for the uranium concentrates.

As part of the FERC staff audit discussed above in connection with a capitalized real property tax penalty, FERC has advised the Company that the capitalization of carrying charges on the advance payments for uranium, subsequent to the declaration of Bokum's bankruptcy in June 1981, is improper because its staff believes that performance by Bokum under the terms of the contract had become doubtful. Accordingly, FERC has directed the Company to expense those carrying charges. The amount of carrying charges recorded on the Company's books and records was $33 million at December 31, 1988. An administrative hearing to review the directed accounting treatment, ordered by FERC at the request of the Company, was held in 1987. An ALJ has rendered a decision on this issue which upholds the position of the staff of FERC. However, a final disposition of the controversy will be made by FERC itself, which may accept, reject or modify the ALJ's decision. The Company cannot predict the outcome of this issue before FERC. In the event of an adverse decision by FERC, the Company will determine whether to pursue an appeal to the federal courts. Pending consideration of the 1988 Settlement by the Company's shareowners, the PSC and the State Legislature, the Company requested FERC to defer action on its administrative review. Although the 1988 Settlement did not become effective on December 1, 1988 as contemplated, the Company has requested FERC to continue to defer action on its review. If the 1989 Settlement becomes effective, these issues before FERC become moot.

On June 12, 1981, the Company and several other creditors of Bokum petitioned the United States Bankruptcy Court for the District of New Mexico (the Bankruptcy Court) for a reorganization of Bokum under Chapter 11 of the United States Bankruptcy Code. Virtually all litigation between the Company and Bokum in the Bankruptcy Court has been concluded. The United States District Court has affirmed, on appeal, all decisions by the Bankruptcy Court with respect to previously litigated matters. The only pending adversary proceeding between Bokum and the Company in the Bankruptcy Court is a mortgage foreclosure by the Company against Bokum. A jury trial of the breach of contract suit by Bokum against the Company ended on February 11, 1988 with directed verdicts in favor of the Company on all issues raised in Bokum's complaint. The Company raised several counterclaims in that litigation which were submitted to the District Court for decision. The District Court ruled on those counterclaims and awarded judgment for the Company in the amount of $33 million with interest. This decision and judgment has been affirmed on appeal by the United States Court of Appeals for the Tenth Circuit. Bokum has petitioned the court for a rehearing. Because of Bokum's bankruptcy, the Company does not expect that this judgment will be satisfied with cash. Furthermore, although the Company intends to initiate foreclosure proceedings, it can give no assurance that it would realize any significant amount in satisfaction of the judgment upon the sale, if any, of the mine and mill properties.

Based upon an analysis by consultants retained to assess the uranium market and the value of the mine and mill, the Company has concluded that the Bokum project is no longer economically viable. The analysis also concludes that the Bokum properties have a current value substantially below the amount of the Company's investment. Consequently, the Company has asked Bokum to dispose of the Bokum properties. Any such transaction would require the approval of the Bankruptcy Court.

The Company believes that the amounts authorized by the PSC for ongoing expenditures and protection of the Company's interests in the properties will be sufficient for such purposes. The Company, which had been in the process of preparing a petition to the PSC requesting the PSC to determine the prudence of the expenditures and to permit the Company to recover in its rates such prudent costs, had determined to delay any filing pending the effectiveness of the 1988 Settlement. The Company has not yet determined, in the light of the failure of the 1988 Settlement to become effective and the pendency of the effectiveness of the 1989 Settlement, whether it will be necessary to resume preparation of its petition to the PSC for recovery of its Bokum costs. Although it is the Company's position that its past expenditures for Bokum have been prudently incurred and that it should be permitted to recover such amounts from its ratepayers, the Company cannot predict what action the PSC will take should a petition seeking such relief be filed.

Due to the many contingencies upon which the outcome of the Bokum transactions, the related litigation, and the ratemaking treatment are dependent, the Company cannot accurately measure either the probability of its realizing a loss on the transactions involving Bokum, or the amount of that loss if it should occur. While under the most adverse circumstances the loss could be material, the Company believes that any loss by itself will not have a material adverse effect on the financial condition and results of operations of the Company.

Litigation

Employment Discrimination Litigation: Currently there are several actions pending against the Company in federal court and before administrative agencies including the Federal Equal Employment Opportunity Commission and the New York State Division of Human Rights, the outcome of some or all of which may be material, alleging employment

discrimination. The Company believes it has meritorious defenses to these matters, but cannot at this time predict their ultimate outcome.

Environmental: The Company has been named as a third-party defendant in an environmental lawsuit which, in general, alleges that the Company, along with others, disposed of chemical and industrial wastes and by-products, including hazardous wastes and substances, at the site named in the complaints. In addition, the Company has been named along with several other utilities by the United States Environmental Protection Agency as a potentially responsible party for PCBs at another site.

The Company believes that it has meritorious defenses to these matters, but cannot at this time predict their ultimate outcome. If, with respect to any one of these unresolved claims or litigation, the Company is found to be liable for damages in amounts which are material, the impact on the Company's financial viability could be material, including the possibility of bankruptcy.

Asbestos Litigation: Beginning in 1987, a total of thirty-seven lawsuits were brought against the Company in New York Supreme Court alleging death and bodily injuries to 607 individuals since the 1930s as a result of exposure to asbestos in buildings. Each of the lawsuits named multiple defendants including one lawsuit in which 142 defendants were named. The damages sought in these suits amount to $6.5 billion plus an additional unspecified amount of punitive damages. Because discovery proceedings relating to these claims are only in their preliminary stages, the Company is presently unable to assess the validity of the complaints or measure the impact, if any, that the ultimate resolution of this litigation may have on its financial condition and results of operations. Should there eventually be a judicial determination against the Company which awards damages approaching the amounts sought by plaintiffs, the result would have a material adverse effect upon the Company's financial viability.

Other Litigation: In December 1987, two shareowners of the Company initiated class action litigation in Nassau County Supreme Court, alleging that the actions by the Company and certain of the Company's Directors, in opposing the takeover of the Company by LIPA, have tortiously interfered with the shareowners' ability to sell their shares to LIPA and are depriving them of the best price obtainable for the Company's shares. Counsel for these two shareowners recently advised the Company that they are willing to enter into a stipulation voluntarily dismissing the action, without prejudice and without costs, as moot. The parties are in the process of preparing an appropriate stipulation for execution. If the action is not dismissed, the Company cannot predict the outcome of this litigation or the impact, if any, that its ultimate resolution will have on the financial viability of the Company. Counsel for two other shareowners have written to the Company objecting to the alleged failure of the Company to give adequate consideration to LIPA's proposal.

Other

Commitments: The Company has entered into substantial commitments for fossil fuel and gas supply. The costs of fuel and gas supply are normally recovered from ratepayers through provisions in the Company's rate schedules. The Company has also entered into a contract with NYPA pursuant to which the Company has obligated itself to pay NYPA for the construction and operation of a new interconnection between Westchester and Nassau Counties. The Company will seek to recover the costs of the interconnection from its ratepayers.

Nuclear Plant Insurance: The maximum amount of property damage insurance coverage currently available at Shoreham is approximately $1.725 billion. The insurable value of Shoreham at December 31, 1988 was $2.2 billion. The maximum amount of property damage insurance currently available at Nine Mile Point, where there are two units, is also approximately $1.725 billion for each unit under certain circumstances. The insurable value of NMP2 at December 31, 1988 was $3.4 billion, of which the Company's 18% share was $612 million. The Company has no interest in Nine Mile Point 1, which is owned and operated solely by Niagara Mohawk.

The NRC requires a minimum of approximately $1.1 billion of property damage coverage to be in effect at each nuclear generating site. For Shoreham, however, the Company was, on May 31, 1988, granted an exemption from the NRC permitting the Company to defer the effective date of, and the related premium for, $723 million of coverage so long as Shoreham does not operate above 5% of full power. Pursuant to this exemption, the Company currently carries $337 million in coverage. Certain of these insurance programs provide for retroactive premium adjustments pursuant to which the Company would be liable for maximum assessments of approximately $20 million in any one policy year in the event of a loss to any other insured utility company. This assessment would only be required if existing premiums and loss reserves were exhausted. When new premium amounts have been established reflecting the recently reduced coverage, the amounts of the possible retroactive premium assessment will also be reduced. For NMP2, the cotenants have approximately $1.575 billion of property damage coverage in effect but, under certain circumstances, only a portion of that amount would be available. The Company's share of the annual premium for the retroactive premium adjustment is currently approximately $1 million.

Amendments to the Price Anderson Act enacted in 1988 extended the statute for 15 years with provisions which increased the limitations upon liability for third-party bodily injury and property damage arising out of a nuclear occurrence at each unit from $720 million to $7.3 billion. Under the provisions of the Price Anderson Act, coverage for this maximum liability is based upon the number of licensed nuclear units in the United States, currently 113, and is provided by insurance carriers and by retroactive premium assessments imposed on the owners of nuclear units. The Company expects that agreements established under the provisions of the Price Anderson Act will be amended to provide that the Company may be assessed up to $74 million per nuclear incident in any one year at other nuclear units, but not in excess of $12 million in payments per year.

Take-or-Pay Costs: FERC has ruled that, subject to its regulations, interstate pipelines may pass on to their customers certain costs which resulted when demand for natural gas from interstate gas pipelines dropped off because of changing market conditions. These costs, known as take-or-pay costs, are substantial. The Company estimates that a total of approximately $49 million in such costs may be billed to it by its pipeline suppliers over the next 5 years. The PSC has commenced a proceeding to investigate how to allocate to the customers of New York State utilities, including the Company, the take-or-pay costs passed on by the interstate

pipeline companies. This proceeding will review these utility purchasing practices in order to determine if such practices imprudently contributed to the take-or-pay costs, and if so, how much of the take-or-pay costs should be recovered by the utilities. The Company has taken the position that its purchasing practices during the time period in question were prudent. The Company is unable to predict the outcome of this proceeding.

Note 7. Segments of Business

The Company is a public utility operating company engaged in the generation, distribution, and sale of electric energy and the purchase, distribution, and sale of natural gas.

	1988			1987			1986		
(In millions of dollars)	Electric	Gas	Total Company	Electric	Gas	Total Company	Electric	Gas	Total Company
Operating Information (Year ended December 31):									
Revenues	$1,787	$351	$ 2,138	$1,719	$353	$2,072	$1,612	$365	$1,977
Expenses (excluding income tax)	1,140	297	1,437	1,101	301	1,402	1,017	320	1,337
Operating income (before income tax)	$ 647	$ 54	$ 701	$ 618	$ 52	$ 670	$ 595	$ 45	$ 640
Allowance for other funds used during construction and other			(65)			(143)			(146)
Provision for net loss on Jamesport abandoned generating project			—			—			16
Interest charges, net			356			374			283
Income taxes—operating			200			288			253
Income taxes—nonoperating (credit)			(88)			(119)			(83)
Income before cumulative effect of accounting change			$ 298			$ 270			$ 317
Cumulative effect of accounting change for disallowed costs (net of taxes)			(1,345)			—			—
Net income (loss) per accompanying Statement of Income			$(1,047)			$ 270			$ 317
Other Information (Year ended December 31):									
Depreciation, depletion, and amortization	$ 83	$ 11	$ 94	$ 64	$ 10	$ 74	$ 61	$ 9	$ 70
Construction and nuclear fuel expenditures	523	38	561	547	34	581	681	32	713
Investment Information (At December 31):									
Assets (a)	$7,153	$410	$ 7,563	$8,128	$370	$8,498	$7,633	$343	$7,976
Nonutility plant			1			1			1
Other investments (b)	67	1	68	67	1	68	66	1	67
Assets utilized for overall Company operations			694			757			814
Total Assets			$8,326			$9,324			$8,858

(a) Includes net utility plant and deferred charges (excluding common), materials and supplies, accrued revenues, gas in storage and fuel.
(b) Principally consisting of the Company's investment in Bokum Resources Corporation.

Note 8. Quarterly Financial Information *(unaudited)*

(In millions of dollars except Earnings per common share)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
1988				
Operating revenues	$ 593	$454	$ 611	$ 480
Operating income	146	100	191	64
Net income (loss)	(1,271) (a)	64	143	17 (b)
Earnings (loss) for Common Stock	(1,290) (a)	44	125	0 (b)
Earnings (loss) per common share	$ (11.61) (a)	$ .40	$1.13	$ .00 (b)
1987				
Operating revenues	$ 569	$452	$ 578	$ 473
Operating income	116	72	124	71
Net income	70	39	108	53
Earnings for Common Stock	50	19	88	35
Earnings per common share	$ .45	$ .17	$ .79	$ .32

(a) As a result of adopting SFAS No. 90 in January 1988, these amounts include the cumulative effect of an accounting change for disallowed costs amounting to approximately $1.345 billion, net of tax effects, or $12.10 per common share.

(b) As a result of the settlement of the 1984 consolidated class action and shareowners' derivative action securities litigation, which became effective in December 1988, the Company has recorded, during the fourth quarter of 1988, a charge to earnings amounting to approximately $21 million or $.19 per common share.

Report of Ernst & Whinney, Independent Auditors

To the Shareowners and Board of Directors
of Long Island Lighting Company
Hicksville, New York

We have audited the accompanying balance sheet of Long Island Lighting Company as of December 31, 1988 and 1987 and the related statements of income, shareowners' equity and cash flows for each of the three years in the period ended December 31, 1988. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Long Island Lighting Company at December 31, 1988 and 1987, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1988 in conformity with generally accepted accounting principles.

As more fully discussed in Note 6 of the Notes to Financial Statements, the Company can give no assurance as to the outcome of certain of the matters discussed therein. The adverse resolution of certain of those matters would have a material impact on the Company's financial viability and, under the most adverse circumstances, the Company might seek the protection of federal bankruptcy laws while it continues its operations.

1. The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. The Company's financial viability will be materially adversely affected if the Company is unable to obtain needed financing, including the sale of new debentures, for its operating and capital requirements. Such financial viability is also dependent upon, among other matters, (a) the receipt of adequate and timely rate relief and (b) the satisfactory resolution of the other matters discussed below. In the absence of the proceeds from the sale of new debentures which the Company plans to issue in early 1989, the Company estimates that, in the second quarter of 1989, its operating and capital requirements will exceed the cash expected to be generated from operations and cash and short-term investments on hand at December 31, 1988. The Company estimates that it will need the proceeds of the $375 million of new debentures to meet its operating and capital requirements for 1989. Furthermore, the Company anticipates that even if it is able to consummate the sale of new debentures and borrow the remaining $88 million available under the 1989 Credit Agreement, which is contingent upon such sale, its cash resources will be exhausted during the first quarter of 1990 in the absence of additional financing (including the extension or modification of the Company's bank agreements) and rate relief. Further, the sale of new debentures is intended to provide the flexibility to maintain financial viability during a period in which the Company awaits the outcome of the following matters: (i) final resolution of matters relating to a proposed settlement of the Federal Racketeer Influenced and Corrupt Organizations Act ("RICO Act") litigation and related matters; (ii) resolution of open issues before the staff of the Nuclear Regulatory Commission ("NRC") concerning the Company's application for licenses to operate the Shoreham Nuclear Power Station ("Shoreham") at full power; (iii) the restoration of the Company to financial health through the effectiveness of the settlement more fully described in Note 6 of the Notes to Financial Statements which would, among other matters, resolve the future of Shoreham and settle certain pending litigation and administrative proceedings (the "1989 Settlement"); (iv) action by the Public Service Commission of the State of New York ("PSC") respecting the Company's request for permanent rate relief; and (v) some combination of any of these matters or of others not yet proposed for the resolution of the problems facing the Company. The Company can give no assurance as to the outcome of any of the foregoing matters or as to its ability to sell the new debentures. If the Company is unable to obtain needed financing or the matters discussed herein are resolved adversely, the Company's financial viability will be materially adversely affected and, under the most adverse circumstances, the Company might seek the protection of federal bankruptcy laws while it continues its operations. The financial statements do not include any adjustments to reflect the possible future effects on the recoverability and classification of assets or the amounts and classifications of liabilities that may result from the inability of the Company to continue as a going concern.

2. The Company is presently unable to predict the final resolution of matters relating to a proposed settlement of the RICO Act litigation and related matters, which provides for, among other matters, rate reductions aggregating $390 million to be reflected as adjustments to its ratepayers' monthly electric bills over a ten-year period. The Company is unable to predict whether the trial court and the Company's shareowners will approve the settlement or, if appeals are taken, the outcome of such appeals. While the Company might have no liability under certain circumstances, if all determinations were to be adverse to the Company the Company's ultimate liability could be as much as $8.7 billion. Accordingly, the Company is unable to determine the impact, if any, that such litigation will have upon the Company and its financial statements.

3. At December 31, 1988, the Company's investment in Shoreham approximated $4.2 billion, and the Company will expend additional amounts through the date of its commercial operation. There is substantial opposition to the licensing of Shoreham from New York State, local governments and others and, accordingly, the Company is unable to predict when, if ever, Shoreham will obtain licenses to operate from the NRC. There are uncertainties with respect to the Company's ability to obtain adequate rate relief during the pendency of the Shoreham controversy and with respect to the ultimate rate treatment of Shoreham costs, including, among other matters, the effect, if any, of the final disposition of the order of the PSC disallowing approximately $1.4 billion of Shoreham costs from rate recovery, which amount was written off effective January 1, 1988. Alternatively, there are uncertainties with respect to the effectiveness of the 1989 Settlement to resolve the Shoreham controversy and to restore the Company to financial health including, among other matters, (i) whether the 1989 Settlement will receive all required approvals from, among others, the Long Island Power Authority, the New York Power Authority, the PSC, the Company's Board of Directors and the Company's shareowners; (ii) what actions the PSC will take with respect to rate relief and whether such rate relief will be realized by the Company; (iii) whether such rate relief, if any, will restore the Company to financial health and return the Company to investment grade financial condition; and (iv) that the Company will realize the full measure of the benefits contemplated by the 1989 Settlement. As a result of the foregoing, the Company is unable to determine the recoverability of its investment in Shoreham and the impact thereof upon the Company and its financial statements.

4. At December 31, 1988, the Company's net investment (an 18% undivided interest) in Nine Mile Point 2 is approximately $700 million. The Company is unable to determine the date on which the commercial operation of Nine Mile Point 2 will commence for its ratemaking purposes and what impact, if any, the appeal of the PSC's approval of the Nine Mile Point 2 settlement, among other matters, will have on the recoverability of the Company's investment.

5. At December 31, 1988, the Company has made advances and loans, including financing costs, of approximately $144 million to Bokum Resources Corporation ("Bokum") and litigation exists between the Company and Bokum. Further, the Company's investment in Bokum will be retired by the Company if the 1989 Settlement becomes effective. The Company is presently unable to determine the amount of loss, if any, that will result from these matters.

6. The Company is presently unable to predict the outcome of the (a) 1987 shareowner class action lawsuit, (b) actions in federal court and before administrative agencies alleging employment discrimination, (c) environmental claims against the Company and (d) asbestos related lawsuits, and the impact, if any, that the ultimate resolution of such litigation will have upon the Company and its financial statements.

As more fully discussed in Note 1 of the Notes to Financial Statements, effective January 1, 1988, the Company adopted Statement of Financial Accounting Standards No. 90, "Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs" and, accordingly, recorded a write-down of its net assets of approximately $1.3 billion, net of tax effects.

Ernst & Whinney

Melville, New York
March 3, 1989

Selected Financial Data

Summary of Operations *(See Note 1, 2, and 6 of Notes to Financial Statements)*

Table 1

	1988	1987	1986	1985	1984
Total revenues (000)	$ 2,137,834	$2,072,077	$1,977,121	$2,050,340	$1,955,230
Total operating income (000)					
Before federal income taxes	$ 701,049	$ 670,324	$ 640,021	$ 627,307	$ 510,993
After federal income taxes	$ 500,938	$ 382,604	$ 387,077	$ 388,140	$ 308,421
Income before cumulative effect of accounting change (000)	$ 298,490	$ 269,888	$ 316,675	$ 524,288	$ 427,788
Cumulative effect of accounting change for disallowed costs (net of taxes) (000)	$(1,345,110)	—	—	—	—
Earnings (loss) for Common Stock (000)	$(1,121,128)	$ 192,312	$ 236,864	$ 440,563	$ 340,264
Average common shares outstanding (000)	111,177	111,129	111,085	110,842	110,120
Earnings per common share before cumulative effect of accounting change	$ 2.02	$ 1.73	$ 2.13	$ 3.97	$ 3.09
Earnings (loss) per common share	$ (10.08)	$ 1.73	$ 2.13	$ 3.97	$ 3.09
Dividends declared per common share	—	—	—	—	—
Book value per common share at year end	$ 19.61	$ 29.71	$ 27.99	$ 25.88	$ 22.05
Common shareowners at year end	93,267	106,117	117,962	143,627	163,354
Ratio of earnings to fixed charges	1.95	2.02	2.17	2.75	2.49
Ratio of earnings to fixed charges and preferred dividends	1.58	1.56	1.68	2.15	1.91
Ratio of earnings to fixed charges excluding AFC	1.60	1.60	1.53	1.62	1.40
Proforma earnings - with 1988 accounting change applied retroactively:					
Earnings (loss) for Common Stock (000)	$ 223,982	$ 176,712	$ 30,864	$ (682,947)	$ 340,264
Earnings (loss) per common share	$ 2.02	$ 1.59	$ .28	$ (6.16)	$ 3.09

Electric Operating Income *(In thousands of dollars)*

Table 2

	1988	1987	1986	1985	1984
Revenues					
Residential	$ 835,584	$ 800,952	$ 744,898	$ 772,861	$ 752,123
Commercial and industrial	883,267	849,626	804,387	844,636	796,543
Other	43,930	56,394	51,447	48,791	40,952
System revenue	1,762,781	1,706,972	1,600,732	1,666,288	1,589,618
Power pools	24,152	11,889	11,057	12,971	23,779
Total Operating Revenue	1,786,933	1,718,861	1,611,789	1,679,259	1,613,397
Expenses					
Operations — fuel and purchased power	501,998	511,079	460,399	629,470	692,515
Operations — other	195,283	187,573	173,702	141,312	136,412
Maintenance	96,599	88,431	91,611	60,154	50,038
Depreciation	82,811	63,840	61,194	58,510	57,198
Operating taxes	262,644	250,047	230,508	224,376	213,691
Federal income taxes	184,951	273,049	242,708	218,521	187,276
Total Expenses	1,324,286	1,374,019	1,260,122	1,332,343	1,337,130
Electric Operating Income	$ 462,647	$ 344,842	$ 351,667	$ 346,916	$ 276,267

Gas Operating Income *(In thousands of dollars)*

Table 3

	1988	1987	1986	1985	1984
Revenues					
Residential — space heating*	$ 201,312	$ 194,303	$ 207,937	$ 190,357	$ 195,035
— other	31,803	32,877	35,393	35,638	35,916
Non-residential, firm — space heating*	68,114	63,267	68,380	62,268	63,442
— other	28,078	28,443	31,473	31,043	31,526
Total firm sales revenue	329,307	318,890	343,183	319,306	325,919
Interruptible	18,821	24,150	22,132	33,446	32,149
Total system sales revenue	348,128	343,040	365,315	352,752	358,068
Other utilities	—	4,970	—	—	—
Total sales revenue	348,128	348,010	365,315	352,752	358,068
Other revenue	2,773	5,206	17	18,329	(16,235)
Total Operating Revenue	350,901	353,216	365,332	371,081	341,833
Expenses					
Operations — fuel	172,431	174,610	205,616	201,458	192,581
Operations — other	53,415	53,140	46,607	41,948	41,097
Maintenance	12,599	12,856	11,034	10,895	10,530
Depreciation, depletion, and amortization	10,785	10,065	8,945	8,232	8,011
Operating taxes	48,220	50,112	47,484	46,678	42,164
Federal income taxes	15,160	14,671	10,236	20,646	15,296
Total Expenses	312,610	315,454	329,922	329,857	309,679
Gas Operating Income	$ 38,291	$ 37,762	$ 35,410	$ 41,224	$ 32,154

**In the heating classifications, the revenues shown cover all gas used, including nonheating use.*

	1988	1987	1986	1985	1984
Electric Operations					**Table 4**
Energy — millions of kWh					
Net generation	15,228	14,004	11,707	12,292	12,159
Power purchased and (sold) — net	1,940	2,516	3,952	2,844	2,689
Total system requirements	17,168	16,520	15,659	15,136	14,848
Company use and unaccounted for	(1,128)	(1,474)	(1,266)	(1,346)	(1,271)
System sales	16,040	15,046	14,393	13,790	13,577
Power pool sales	433	239	244	226	418
Total Sales	16,473	15,285	14,637	14,016	13,995
Peak Demand — mW					
Station coincident demand	3,347	3,333	2,969	2,773	2,528
Purchased or (sold) — net	475	243	472	607	568
System Peak Demand	3,822	3,576	3,441	3,380	3,096
System Capability — mW					
LILCO stations	3,834	3,799	3,743	3,743	3,721
Firm purchase or (sale) — net	482	550	454	171	57
Total Capability	4,316	4,349	4,197	3,914	3,778
Fuel Consumed for Electric Operations					
Oil—thousands of barrels	19,927	18,624	15,625	15,790	15,531
Gas—thousands of dth	29,126	29,762	26,103	29,154	29,149
Total—billions of Btu	153,828	146,536	124,098	128,629	127,468
Dollars per million Btu	$ 2.53	$ 2.86	$ 2.51	$ 3.97	$ 4.47
Cents per kWh of net generation	2.67¢	3.01¢	2.66¢	4.16¢	4.68¢
Heat rate—Btu per net kWh	10,545	10,509	10,600	10,465	10,483

Gas Operations					**Table 5**
Energy—thousands of dth					
Natural gas	58,743	58,832	53,035	53,030	52,558
Manufactured gas and change in storage	(18)	(63)	65	(30)	(15)
Total Natural and Manufactured Gas	58,725	58,769	53,100	53,000	52,543
Total system requirements	58,725	56,551	53,100	53,000	52,543
Company use and unaccounted for	(3,148)	(2,460)	(1,282)	(3,219)	(1,632)
System sales	55,577	54,091	51,818	49,781	50,911
Other utilities	—	2,218	—	—	—
Total Sales	55,577	56,309	51,818	49,781	50,911
Maximum Day Sendout—dth	431,940	404,679	365,991	441,122	359,527
System Capability—dth per day					
Natural gas	411,596	388,400	345,200	335,700	315,400
LNG manufactured, or LP gas	145,600	145,600	145,600	145,600	145,600
Total Capability	557,196	534,000	490,800	481,300	461,000
Calendar Degree Days (62-year average 5,051)	5,162	4,805	4,715	4,638	4,739

	1988	1987	1986	1985	1984
Electric Sales and Customers					**Table 6**
Sales — millions of kWh					
Residential	6,979	6,603	6,251	5,970	6,000
Commercial and industrial	8,566	8,004	7,713	7,369	7,129
Other	495	439	429	451	448
System sales	16,040	15,046	14,393	13,790	13,577
Power pool sales	433	239	244	226	418
Total Sales	16,473	15,285	14,637	14,016	13,995
Customers — monthly average					
Residential	882,962	872,419	861,011	850,683	840,843
Commercial and industrial	98,450	95,871	93,228	90,548	88,459
Others	4,436	4,389	4,362	4,391	4,339
Customers — total monthly average	985,848	972,679	958,601	945,622	933,641
Customers — total at year end	989,097	976,928	963,197	948,797	935,964
Residential					
kWh per customer	7,905	7,569	7,260	7,018	7,136
Revenue cents per kWh	11.97¢	12.13¢	11.92¢	12.95¢	12.53¢
Commercial and Industrial					
kWh per customer	87,005	83,487	82,732	81,382	80,591
Revenue per kWh	10.31¢	10.62¢	10.43¢	11.46¢	11.17¢
System — total revenue per kWh sold	10.97¢	11.35¢	11.12¢	12.08¢	11.71¢

	1988	1987	1986	1985	1984
Gas Sales and Customers					**Table 7**
Sales — thousands of dth					
Residential — space heating*	31,276	29,239	28,438	26,387	27,528
— other	3,589	3,952	3,629	3,642	3,702
Non-residential — space heating*	11,054	10,055	9,711	8,967	9,357
— other	4,580	4,389	4,533	4,510	4,638
Total firm sales	50,499	47,635	46,311	43,506	45,225
Interruptible	5,078	6,456	5,507	6,275	5,686
Total system sales	55,577	54,091	51,818	49,781	50,911
Other utilities	—	2,218	—	—	—
Total Sales	55,577	56,309	51,818	49,781	50,911
Customers — monthly average					
Residential — space heating*	198,949	192,550	186,625	182,593	179,030
— other	181,926	184,411	186,600	188,594	190,507
Non-residential — space heating*	25,979	24,234	22,514	20,935	20,173
— other	11,725	11,778	11,889	11,930	11,973
Total firm customers	418,579	412,973	407,628	404,052	401,683
Interruptible	325	301	289	297	306
Customers — total monthly average	418,904	413,274	407,917	404,349	401,989
Customers — total at year end	421,429	415,629	410,064	405,330	402,430
Degree days — billed	5,074	4,802	4,795	4,444	4,921
Residential					
dth per customer	91.5	88.0	85.9	80.9	84.5
Revenue per dth	$ 6.51	$ 6.84	$ 7.59	$ 7.53	$ 7.40
Non-residential, firm					
dth per customer	414.6	401.1	414.0	410.1	435.4
Revenue per dth	$ 6.15	$ 6.35	$ 7.01	$ 6.92	$ 6.79
System — total revenue per firm dth sold	$ 6.26	$ 6.69	$ 7.41	$ 7.34	$ 7.21

**In the heating classifications, the sales shown cover all gas used, including nonheating use.*

	1988	1987	1986	1985	1984
Operations and Maintenance Expense Details *(In thousands of dollars)*					**Table 8**
Total payroll and employee benefits	$ 333,359	$ 315,114	$ 283,427	$ 257,509	$ 215,373
Less — Charged to construction and other	129,990	115,315	102,987	99,415	66,331
Charged to Operations	203,369	199,799	180,440	158,094	149,042
Fuels — electric operations	410,174	422,997	311,872	511,193	569,528
Fuels — gas operations	172,431	174,610	205,616	201,458	192,581
Purchased power costs	88,465	93,186	134,347	113,867	123,963
Fuel cost adjustments deferred	3,359	(5,104)	14,180	4,410	(976)
Total Fuel and Purchased Power	674,429	685,689	666,015	830,928	885,096
All other	154,527	142,201	142,514	96,215	89,035
Total Operations and Maintenance	$1,032,325	$1,027,689	$ 988,969	$1,085,237	$1,123,173
Employees at December 31	6,281	6,378	6,219	5,676	5,202

Construction Expenditures *(In thousands of dollars)*					**Table 9**
Electric					
Production	$ 419,028	$ 453,544	$ 603,916	$ 807,067	$ 852,774
Transmission	13,379	23,668	6,451	4,971	3,541
Distribution	64,653	32,209	50,847	38,333	31,778
General	1,588	6,470	4,165	(4,132)	1,294
Electric Total	498,648	515,891	665,379	846,239	889,387
Gas Total	37,518	34,270	31,978	19,564	12,354
Common Total	9,352	17,795	5,434	13,198	4,622
Total Construction Expenditures	$ 545,518	$ 567,956	$ 702,791	$ 879,001	$ 906,363
Nuclear Fuel	$ 15,639	$ 13,219	$ 10,353	$ 22,241	$ 14,771

Balance Sheet *(In thousands of dollars)*					**Table 10**
Assets					
Utility plant	$8,020,253	$9,277,309	$8,710,063	$8,167,239	$7,272,544
Less—accumulated depreciation, depletion, and amortization	1,075,129	983,272	919,452	853,071	788,565
Total Net Utility Plant	6,945,124	8,294,037	7,790,611	7,314,168	6,483,979
Other property and investments	69,271	68,763	68,383	139,783	68,639
Current assets	571,934	606,579	702,825	367,967	437,436
Unamortized cost of abandoned generating projects	98,616	118,484	127,590	27,133	44,108
Other	641,392	235,824	168,746	114,215	66,699
Total Assets	$8,326,337	$9,323,687	$8,858,155	$7,963,266	$7,100,861
Capitalization and Liabilities					
Capitalization:					
Long-term debt*	$3,449,821	$3,724,601	$3,805,796	$2,718,192	$3,001,796
Unamortized premium and (discount) on debt	(25,011)	(26,646)	(28,281)	(9,414)	(9,658)
Preferred Stock—redemption required	513,924	520,788	527,465	527,612	530,662
Preferred Stock—no redemption required	221,050	221,051	221,053	221,056	221,056
Treasury stock, at cost	(58,430)	(40,881)	(25,701)	(7,654)	(505)
Retained earnings restricted for Preferred Stock dividend requirements	341,008	265,288	188,051	—	—
Common Stock and premium	1,557,293	1,556,928	1,556,483	1,556,026	1,551,057
Capital stock expense	(56,151)	(56,144)	(56,138)	(56,116)	(56,103)
Retained earnings	679,579	1,801,919	1,609,268	1,480,644	956,356
Total Capitalization*	6,623,083	7,966,904	7,797,996	6,430,346	6,194,661
Current Liabilities	583,017	339,573	277,173	975,214	506,054
Deferred Credits:					
Accumulated deferred income tax reductions	963,975	921,397	692,758	486,333	338,607
Other	144,015	83,217	75,195	62,039	54,649
Total Deferred Credits	1,107,990	1,004,614	767,953	548,372	393,256
Reserves for Claims, Damages, Pensions, and Benefits	12,247	12,596	15,033	9,334	6,890
Total Capitalization and Liabilities	$8,326,337	$9,323,687	$8,858,155	$7,963,266	$7,100,861

**Includes $685,621,000 of Trust Obligations for 1984.*

Common and Preferred Stock Prices

The Common Stock of the Company is traded on the New York Stock Exchange and the Pacific Stock Exchange. The Preferred Stock $100 par value,Series B,E,I,J,K, and S and the Preferred Stock $25 par value, Series O,P,T,U,V,W, and X of the Company, are traded on the New York Stock Exchange. The table below indicates the high and low prices on the New York Stock Exchange listing of composite transactions for the years 1987 and 1988.

	Common Stock		Preferred Stock											
			Series B 5%		Series E 4.35%		Series I 5¾%		Series J 8.12%		Series K 8.30%		Series O $2.47	
Quarter	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low
1987														
First	11⅞	10	45	40	41¼	35¼	80½	74¾	72½	63¼	74	65	23¾	21
Second	10¾	8¾	47	42	44	38	80	74½	75½	68	78	69	23	19
Third	12⅜	9	52	45	43	41½	88	75¼	81½	74¾	82	75	26½	22½
Fourth	11¾	6½	52	43½	46½	36¼	88	81¼	81	67	80½	65½	26	18¾
1988														
First	10¼	7⅛	50	44	49½	40½	80½	78½	81	67½	83	67½	27	21
Second	14	8	66½	49	63½	49	100	79½	98	82	101¼	82	30⅝	24½
Third	15⅜	12⅜	61⅛	53½	52½	49½	106	97	98	89½	99½	90	31⅛	28½
Fourth	17⅛	11½	64	51½	56	41¼	114	99	102	78¼	105	80⅛	32¼	23¾

	Preferred Stock													
	Series P $2.43		Series S 9.80%		Series T $3.31		Series U $4.25		Series V $3.50		Series W $3.52		Series X $3.50	
Quarter	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low	High	Low
1987														
First	23	20⅝	89	84	29¼	25	32⅜	28⅜	31⅛	26¼	31½	27⅜	30¾	26
Second	23	19½	89½	84⅛	28⅛	24⅝	31¾	28½	30⅛	27	29⅝	26⅞	29½	27
Third	26¼	22⅛	93½	88	32⅞	27½	37¾	30½	33½	27⅞	34¼	28⅛	32⅞	27⅜
Fourth	24	16¼	95	80	31¼	19⅞	35¼	23¾	32	22½	32⅞	21	30⅞	21⅛
1988														
First	27	18¾	102	81	30	23¾	34	27½	31½	25	33	25½	32	24½
Second	30½	24¾	122½	99⅝	37½	29¼	42⅛	32½	38	30¼	40⅝	31	38	30
Third	30	26¾	122½	116	37⅜	34⅞	42¾	40	39	35⅝	41¼	37⅜	38⅝	35½
Fourth	31¼	21¼	125	106½	38⅝	27½	44½	34	40¼	30⅜	43¼	32	40¼	30¼

The Series D-4.25% Stock is traded in the over-the-counter market. No price data is available for 1988. The Series F, H, L, M, and R Preferred Stock are held privately.

Corporate Information

Executive Offices
175 East Old Country Road
Hicksville, N.Y. 11801

Common Stock Listed
New York Stock Exchange
Pacific Stock Exchange

Ticker Symbol: LIL

Transfer Agents
Common Stock
Manufacturers Hanover
Trust Company
450 West 33rd Street
New York, N.Y. 10001
212-613-7147

Preferred Stock
The First National Bank
of Boston
50 Morrissey Boulevard
Dorchester, MA. 02102
800-442-2001

Registrar
Common and Preferred Stock
Mellon Securities Trust
Company
120 Broadway
New York, N.Y. 10271

Shareowners' Agent for Automatic Dividend Reinvestment Plan
Manufacturers Hanover
Trust Company
Dividend Reinvestment
Department
P.O. Box 24850
Church Street Station
New York, N.Y. 10242
212-613-7147

Annual Meeting
For the last several years, the Annual Meeting of Shareowners has been held in May. For 1989, a specific date cannot yet be determined due to recent important events on which shareowners might have to vote. A notice of the meeting, a proxy statement and a proxy will be mailed to shareowners at a later date.

Form 10-K Annual Report
The Company will furnish, without charge, a copy of the Company's Annual Report, Form 10-K, as filed with the Securities and Exchange Commission, upon written request to: Investor Relations, Long Island Lighting Company, 175 East Old Country Road, Hicksville, N.Y. 11801

Directors

William J. Catacosinos
Chairman of the Board and
Chief Executive Officer
Long Island Lighting Company

Leon J. Campo
Assistant Superintendent for
Finance, East Meadow School
District; Chairman, Suffolk
County Water Authority

Winfield E. Fromm
Retired Vice President
Eaton Corporation
Electronics

Lionel M. Goldberg
Senior Vice President
Alexander & Alexander
of New York, Inc.
Insurance

Basil A. Paterson
Partner
Meyer, Suozzi, English
& Klein, PC
Law

Eben W. Pyne
Corporate Director
and Consultant
Retired Senior Vice President
Citibank, N.A.

John H. Talmage
Farm Manager
H.R. Talmage & Son

Phyllis S. Vineyard
Director
Long Island Community
Foundation

Russell C. Youngdahl
President and
Chief Operating Officer
Long Island Lighting Company

Officers

William J. Catacosinos
Chairman of the Board and
Chief Executive Officer

Russell C. Youngdahl
President and
Chief Operating Officer

Anthony F. Earley, Jr.
Executive Vice President

George J. Sideris
Senior Vice President
Finance

James T. Flynn
Group Vice President
Engineering and Operations

P. Alan Gambill
Group Vice President
Commercial Operations

Ralph T. Brandifino
Vice President
Finance

Ira L. Freilicher
Vice President
Law and Corporate Affairs and
Associate Secretary

Robert X. Kelleher
Vice President
Human Resources

Jay R. Kessler
Vice President
Gas Operations

John D. Leonard, Jr.
Vice President
Nuclear Operations

Adam M. Madsen
Vice President
Corporate Planning

Brian R. McCaffrey
Vice President
Administration

Joseph W. McDonnell
Vice President
Communications

William J. Museler
Vice President
Electric Operations

John J. Russell
Vice President
Community Affairs

William G. Schiffmacher
Vice President
Engineering and Construction

John A. Weismantle
Vice President
Corporate Projects
Research and Development

Walter F. Wilm, Jr.
Vice President
Customer Relations

Edward J. Youngling
Vice President
Conservation and
Load Management

Victor A. Staffieri
General Counsel

Michael Czumak
Controller and
Chief Accounting Officer

Andrew R. Ragogna
Treasurer

John J. Kearney, Jr.
Secretary

Herbert M. Leiman
Assistant Secretary and
Assistant General Counsel

Long Island Lighting Company
175 East Old Country Road
Hicksville, NY 11801

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