

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended **March 31, 2004**

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Transition period from \_\_\_\_\_ to

Commission file number 1-14161

**KEYSPAN CORPORATION**

(Exact name of Registrant as specified in its Charter)

New York 11-3431358  
(State or other jurisdiction of (IRS Employer Identification No.)  
incorporation or organization)

One MetroTech Center, Brooklyn, New York 11201  
175 East Old Country Road, Hicksville, New York 11801  
(Address of principal executive offices) (Zip Code)

(718) 403-1000 (Brooklyn)  
(631) 755-6650 (Hicksville)  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

<u>Class of Common Stock</u>	<u>Outstanding at April 16, 2004</u>
\$.01 par value	160,164,056

KEYSPAN CORPORATION AND SUBSIDIARIES

INDEX

	<u>Page No.</u>
Part I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
<u>Consolidated Balance Sheet -     March 31, 2004 and December 31, 2003</u>	3
<u>Consolidated Statement of Income -     Three Months Ended March 31, 2004 and 2003</u>	5
<u>Consolidated Statement of Cash Flows -     Three Months Ended March 31, 2004 and 2003</u>	6
<u>Notes to Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial     Condition and Results of Operations</u>	31
<u>Item 3. Quantitative and Qualitative Disclosures     About Market Risk</u>	59
Part II. OTHER INFORMATION	
<u>Item 1. Legal Proceedings</u>	64
<u>Item 6. Exhibits and Reports on Form 8-K</u>	64
<u>Signatures</u>	65

**CONSOLIDATED BALANCE SHEET**  
(Unaudited)

<i>(In Thousands of Dollars)</i>	<b>March 31, 2004</b>	December 31, 2003
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and temporary cash investments	\$ 256,940	\$ 205,751
Accounts receivable	1,384,598	1,029,459
Unbilled revenue	460,460	505,633
Allowance for uncollectible accounts	(91,016)	(79,184)
Gas in storage, at average cost	154,072	488,521
Material and supplies, at average cost	118,772	121,415
Other	69,519	115,304
	<u>2,353,345</u>	<u>2,386,899</u>
<b>Investments and Other</b>	<b>256,372</b>	<b>248,565</b>
<b>Property</b>		
Gas	6,590,421	6,522,251
Electric	2,671,594	2,636,537
Other	429,716	425,576
Accumulated depreciation	(2,655,711)	(2,610,876)
Gas exploration and production, at cost	3,157,026	3,088,242
Accumulated depletion	(1,229,368)	(1,167,427)
	<u>8,963,678</u>	<u>8,894,303</u>
<b>Deferred Charges</b>		
Regulatory assets	554,563	578,383
Goodwill and other intangible assets	1,810,161	1,809,712
Other	741,613	722,320
	<u>3,106,337</u>	<u>3,110,415</u>
<b>Total Assets</b>	<b>\$ 14,679,732</b>	<b>\$ 14,640,182</b>

See accompanying Notes to the Consolidated Financial Statements.

**CONSOLIDATED BALANCE SHEET**  
(Unaudited)

<i>(In Thousands of Dollars)</i>	<b>March 31, 2004</b>	December 31, 2003
<b>LIABILITIES AND CAPITALIZATION</b>		
<b>Current Liabilities</b>		
Current redemption of long-term debt	\$ 1,471	\$ 1,471
Accounts payable and other liabilities	950,861	1,141,597
Commercial paper	294,150	481,900
Dividends payable	72,070	72,289
Taxes accrued	197,686	46,580
Customer deposits	41,028	40,370
Interest accrued	102,967	64,609
	<u>1,660,233</u>	<u>1,848,816</u>
<b>Deferred Credits and Other Liabilities</b>		
Regulatory liabilities:		
Miscellaneous liabilities	93,110	104,034
Removal cost recovered	462,585	450,034
Deferred income tax	1,250,672	1,278,341
Postretirement benefits and other reserves	1,060,525	961,962
Other	162,713	121,790
	<u>3,029,605</u>	<u>2,916,161</u>
<b>Commitments and Contingencies (See Note 6)</b>	-	-
<b>Capitalization</b>		
Common stock	3,492,116	3,487,645
Retained earnings	796,410	621,430
Other comprehensive income	(89,309)	(59,932)
Treasury stock	(366,691)	(378,487)
Total common shareholders' equity	<u>3,832,526</u>	<u>3,670,656</u>
Preferred stock	83,433	83,568
Long-term debt	5,537,456	5,611,432
<b>Total Capitalization</b>	<u>9,453,415</u>	<u>9,365,656</u>
<b>Minority Interest in Subsidiary Companies</b>	<u>536,479</u>	<u>509,549</u>
<b>Total Liabilities and Capitalization</b>	<u>\$ 14,679,732</u>	<u>\$ 14,640,182</u>

See accompanying Notes to the Consolidated Financial Statements.

**CONSOLIDATED STATEMENT OF INCOME**  
(Unaudited)

<i>(In Thousands of Dollars, Except Per Share Amounts)</i>	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>Revenues</b>		
Gas Distribution	\$ 1,927,779	\$ 1,832,701
Electric Services	359,136	397,700
Energy Services	129,059	129,065
Gas Exploration and Production	152,419	127,847
Energy Investments	27,180	25,212
Total Revenues	<u>2,595,573</u>	<u>2,512,525</u>
<b>Operating Expenses</b>		
Purchased gas for resale	1,226,573	1,196,165
Fuel and purchased power	101,612	97,522
Operations and maintenance	492,466	498,189
Depreciation, depletion and amortization	171,684	144,971
Operating taxes	122,279	124,713
Total Operating Expenses	<u>2,114,614</u>	<u>2,061,560</u>
Income from equity investments	5,717	5,729
Operating Income	<u>486,676</u>	<u>456,694</u>
<b>Other Income and (Deductions)</b>		
Interest charges	(84,066)	(68,939)
Gain on sale of subsidiary stock	-	19,020
Cost of debt redemption	-	(18,194)
Minority interest	(20,293)	(18,054)
Other	2,761	15,397
Total Other Income and (Deductions)	<u>(101,598)</u>	<u>(70,770)</u>
<b>Income Taxes</b>		
Current	147,702	129,575
Deferred	(10,320)	13,258
Total Income Taxes	<u>137,382</u>	<u>142,833</u>
Earnings Before Effect of Change in Accounting Principle	247,696	243,091
Cummulative Effect of Change in Accounting Principle	-	174
<b>Net Income</b>	<u>247,696</u>	<u>243,265</u>
Preferred stock dividend requirements	1,461	1,461
<b>Earnings for Common Stock</b>	<u>\$ 246,235</u>	<u>\$ 241,804</u>
<b>Basic Earnings Per Share:</b>		
Before Change in Accounting Principle,		
less preferred stock dividends	\$ 1.54	\$ 1.54
Change in Accounting Principle	-	-
Basic Earnings Per Share	<u>\$ 1.54</u>	<u>\$ 1.54</u>
<b>Diluted Earnings Per Share</b>		
Before Change in Accounting Principle,		
less preferred stock dividends	\$ 1.53	\$ 1.53
Change in Accounting Principle	-	-
Diluted Earnings Per Share	<u>\$ 1.53</u>	<u>\$ 1.53</u>
<b>Average Common Shares Outstanding (000)</b>	<u>159,892</u>	<u>156,886</u>
<b>Average Common Shares Outstanding - Diluted (000)</b>	<u>161,164</u>	<u>158,045</u>

See accompanying Notes to the Consolidated Financial Statements.

**CONSOLIDATED STATEMENT OF CASH FLOWS**  
(Unaudited)

<i>(In Thousands of Dollars)</i>	<b>Three Months Ended March 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>Operating Activities</b>		
Net income	\$ 247,696	\$ 243,265
<b>Adjustments to reconcile net income to net cash provided by (used in) operating activities</b>		
Depreciation, depletion and amortization	171,684	144,971
Deferred income tax	(10,320)	13,258
Income from equity investments	(5,717)	(5,729)
Dividends from equity investments	104	-
Amortization of interest rate swap	(2,448)	(2,500)
(Gain) on disposal of subsidiary stock	-	(19,020)
Minority interest	20,293	18,054
<b>Changes in assets and liabilities</b>		
Accounts receivable	(298,134)	(520,062)
Materials and supplies, fuel oil and gas in storage	337,092	201,789
Accounts payable and other liabilities	(190,736)	146,311
Taxes accrued	151,106	203,411
Interest accrued	38,357	8,324
Captive insurance	43,214	-
Other	76,895	64,755
<b>Net Cash Provided by Operating Activities</b>	<b>579,086</b>	<b>496,827</b>
<b>Investing Activities</b>		
Construction expenditures	(220,224)	(220,779)
Cost of removal	(6,204)	(6,938)
Proceeds from monetization of Houston Exploration	-	79,200
Proceeds from sale of property	13,138	-
<b>Net Cash Used in Investing Activities</b>	<b>(213,290)</b>	<b>(148,517)</b>
<b>Financing Activities</b>		
Treasury stock issued	11,796	26,307
Equity issuance	-	473,573
Issuance of long-term debt	20,000	39,161
Payment of long-term debt	(94,853)	(72,565)
Payment of commercial paper	(187,750)	(238,365)
Redemption of promissory notes	-	(447,005)
Preferred stock dividends paid	(1,461)	(1,461)
Common stock dividends paid	(71,474)	(63,557)
Other	9,135	9,047
<b>Net Cash Used in Financing Activities</b>	<b>(314,607)</b>	<b>(274,865)</b>
Net Increase in Cash and Cash Equivalents	\$ 51,189	\$ 73,445
Cash and Cash Equivalents at Beginning of Period	205,751	170,617
Cash and Cash Equivalents at End of Period	\$ 256,940	\$ 244,062

Cash equivalents are short-term marketable securities purchased with maturities of three months or less that were carried at cost which approximates fair value.

See accompanying Notes to the Consolidated Financial Statements.

## **NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

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

### **1. BASIS OF PRESENTATION**

In our opinion, the accompanying unaudited Consolidated Financial Statements contain all adjustments necessary to present fairly KeySpan’s financial position as of March 31, 2004, and the results of operations for the three months ended March 31, 2004 and March 31, 2003, as well as cash flows for the three months ended March 31, 2004 and March 31, 2003. The accompanying financial statements should be read in conjunction with the consolidated financial statements and notes included in KeySpan’s Annual Report on Form 10K for the year ended December 31, 2003. The December 31, 2003 financial statement information has been derived from the 2003 audited financial statements. Income from interim periods may not be indicative of future results. Certain reclassifications were made to conform prior period financial statements to the current period financial statement presentation.

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

We have approximately 3.6 million common stock options outstanding at March 31, 2004, that were not included in the calculation of diluted EPS since the exercise price associated with these options was greater than the average market price of our common stock.

Under the requirements of Statement of Financial Accounting Standards (“SFAS”) No. 128, “Earnings Per Share” our basic and diluted EPS are as follows:

<i>(In Thousands of Dollars, Except Per Share Amounts)</i>	Three Months Ended March 31,	
	2004	2003
Earnings for common stock	\$ 246,235	\$ 241,804
Interest savings on convertible preferred stock	129	133
Houston Exploration dilution	(81)	(87)
<b>Earnings for common stock - adjusted</b>	<b>\$ 246,283</b>	<b>\$ 241,850</b>
Weighted average shares outstanding (000)	159,892	156,886
Add dilutive securities:		
Options	1,050	931
Convertible preferred stock	222	228
<b>Total weighted average shares outstanding - assuming dilution</b>	<b>161,164</b>	<b>158,045</b>
<b>Basic earnings per share</b>	<b>\$ 1.54</b>	<b>\$ 1.54</b>
<b>Diluted earnings per share</b>	<b>\$ 1.53</b>	<b>\$ 1.53</b>

## 2. BUSINESS SEGMENTS

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

The Gas Distribution segment consists of six gas distribution subsidiaries. KeySpan Energy Delivery New York (“KEDNY”) provides gas distribution services to customers in the New York City Boroughs of Brooklyn, Queens and Staten Island. KeySpan Energy Delivery Long Island (“KEDLI”) provides gas distribution services to customers in the Long Island Counties of Nassau and Suffolk and the Rockaway Peninsula of Queens County. The remaining gas distribution subsidiaries, Boston Gas Company, Colonial Gas Company, Essex Gas Company and EnergyNorth Natural Gas, Inc., collectively referred to as KeySpan Energy Delivery New England (“KEDNE”), provide gas distribution service to customers in Massachusetts and New Hampshire.

The Electric Services segment consists of subsidiaries that: operate the electric transmission and distribution system owned by LIPA; own and provide capacity to and produce energy for LIPA from our generating facilities located on Long Island; and manage fuel supplies for LIPA to fuel our Long Island generating facilities. These services are provided in accordance with long-term service contracts having remaining terms that range from three to eleven years and power purchase agreements for 23 years. The Electric Services segment also includes subsidiaries that own, lease and operate the 2,450 megawatt (“MW”) Ravenswood electric generation facility (“Ravenswood facility”), located in Queens, New York, which includes the recently completed 250 MW combined cycle electric generating facility located at the Ravenswood site (see below). All of the energy, capacity and ancillary services related to the Ravenswood facility is sold to the New York Independent System Operator (“NYISO”) energy markets. The Electric Services segment also provides retail marketing of electricity to commercial customers.

We are currently in the process of structuring a leveraged lease financing for the new 250 megawatt electric generating facility located at the existing Ravenswood site, and are seeking to close this transaction in May to coincide with the commencement of full commercial operation of the new facility. At the closing, the new facility will be acquired by the lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to it. All obligations of our subsidiary under the lease will be unconditionally guaranteed by KeySpan. We anticipate that this lease transaction will generate cash proceeds equivalent to the fair market value of the facility, as determined by a third-party appraiser. It is expected that the cash proceeds from this transaction will be used to redeem outstanding commercial paper. This lease transaction is intended to qualify as an operating lease under SFAS 98 “Accounting for Leases: Sale/Leaseback Transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; an Initial Direct Costs of Direct Financing Leases, an amendment of FASB Statements No.13, 66, 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11.” The lease will have an initial term of 36 years and operating lease expense is anticipated to be between \$15 million to \$17 million per year. Lease payments will fluctuate from year to year, but are substantially paid over the first 16 years.

The Energy Services segment includes companies that provide energy-related and a minimal amount of fiber optic services to customers primarily located within the Northeastern United States, with concentrations in the New York City metropolitan area, including New Jersey and Connecticut, as well as Rhode Island, Pennsylvania, Massachusetts and New Hampshire, through the following lines of business: (i) Home Energy Services, which provides residential and small commercial customers with service and maintenance of energy systems and appliances; and (ii) Business Solutions, which provides plumbing, heating, ventilation, air conditioning and mechanical services, as well as operation and maintenance, design, engineering and consulting services to commercial and industrial customers.

The Energy Investments segment consists of our gas exploration and production investments, as well as certain other domestic and international energy-related investments. Our gas exploration and

production subsidiaries are engaged in gas and oil exploration and production, and the development and acquisition of domestic natural gas and oil properties. These investments consist of our 55% equity interest in The Houston Exploration Company (“Houston Exploration”), an independent natural gas and oil exploration company, as well as KeySpan Exploration and Production, LLC, our wholly owned subsidiary engaged in a joint venture with Houston Exploration.

Subsidiaries in this segment also hold a 20% equity interest in the Iroquois Gas Transmission System LP, a pipeline that transports Canadian gas supply to markets in the Northeastern United States and a 50% interest in the Premier Transmission Pipeline in Northern Ireland. At March 31, 2004, we had an approximate 61% investment in certain midstream natural gas assets in Western Canada through KeySpan Energy Canada Partnership (“KeySpan Canada”). With the exception of KeySpan Canada, which is consolidated in our financial statements, these subsidiaries are accounted for under the equity method.

On April 1, 2004, The KeySpan Facilities Income Fund (the “Fund”) issued 15.617 million units at a price of \$12.60 per unit for gross total proceeds of approximately CDN\$196.8 million. The proceeds of the offering were used to acquire an additional 35.91% interest in the business of KeySpan Canada from KeySpan. KeySpan received net proceeds of approximately CDN\$186.3 million (or approximately US\$140 million), after commissions and expenses. The Fund’s ownership in KeySpan Canada has now increased from 39.1% to approximately 75%. KeySpan’s ownership of KeySpan Canada is now approximately 25%. KeySpan expects to record a pre-tax gain of approximately \$20 million on this transaction, which will be reflected in its earnings in the second quarter of 2004. The proceeds from the transaction will be used to redeem outstanding debt.

The accounting policies of the segments are the same as those used for the preparation of the Consolidated Financial Statements. The segments are strategic business units that are managed separately because of their different operating and regulatory environments. Operating results of our segments are evaluated by management on an operating income basis. At March 31, 2004, the total assets of each reportable segment have not changed materially from those levels reported at December 31, 2003. However, in the first quarter of 2004 we reclassified the operating results of our electric marketing subsidiary from the Energy Services segment to the Electric Services segment. As a result we restated the financial results for the first quarter of 2003. The reportable segment information is as follows:

<i>(In Thousands of Dollars)</i>	Energy Investments					Eliminations	Consolidated
	Gas Distribution	Electric Services	Energy Services	Gas Exploration and Production	Other Investments		
<b>Three Months Ended March 31, 2004</b>							
Unaffiliated revenue	1,927,779	359,136	129,059	152,419	27,180	-	2,595,573
Intersegment revenue	-	-	3,436	-	1,265	(4,701)	-
Operating Income	379,653	47,200	(18,474)	62,108	12,922	3,267	486,676
<b>Three Months Ended March 31, 2003</b>							
Unaffiliated revenue	1,832,701	397,700	129,065	127,847	25,212	-	2,512,525
Intersegment revenue	-	25	1,426	-	1,252	(2,703)	-
Operating Income	364,937	39,644	(9,122)	55,590	10,124	(4,479)	456,694

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

Because of the nature of our Electric Services business, electric revenues are derived from two large customers - the NYISO and LIPA. Electric Services revenues from these customers of \$345.6 million and \$334.4 million for the three months ended March 31, 2004 and 2003 represent approximately 13% of our consolidated revenues in both periods.

### 3. COMPREHENSIVE INCOME

The table below indicates the components of comprehensive income:

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Net Income	\$ 247,696	\$ 243,265
Other comprehensive income (loss), net of tax		
Net losses (gains) on derivative instruments	11,029	2,354
Foreign currency translation adjustments	(1,896)	9,753
Unrealized gains (losses) on marketable securities	513	(3,156)
Settlement of derivative premiums	3,437	-
Unrealized losses on derivative financial instruments	(42,458)	(14,749)
Other comprehensive loss, net of tax	(29,375)	(5,798)
Comprehensive Income	\$ 218,321	\$ 237,467
Related tax (benefit) expense		
Net losses (gains) on derivative instruments	5,939	1,267
Foreign currency translation adjustments	(1,021)	5,252
Unrealized gains (losses) on marketable securities	274	(1,699)
Settlement of derivative premiums	1,851	-
Unrealized losses on derivative financial instruments	(22,862)	(7,942)
Total Tax (Benefit) Expense	\$ (15,819)	\$ (3,122)

#### 4. HEDGING AND DERIVATIVE FINANCIAL INSTRUMENTS

*Financially-Settled Commodity Derivative Instruments – Hedging Activities:* From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas exploration and production activities and its electric generating facilities. Derivative financial instruments are employed by Houston Exploration to hedge cash flow variability associated with forecasted sales of natural gas. The Ravenswood facility uses derivative financial instruments to hedge the cash flow variability associated with the purchase of natural gas and oil that will be consumed during the generation of electricity. The Ravenswood facility also hedges the cash flow variability associated with a portion of on-peak electric energy sales.

The majority of these derivative financial instruments are cash flow hedges that qualify for hedge accounting under SFAS 133 “Accounting for Derivative Instruments and Hedging Activities,” as amended by SFAS 149 “Amendment of Statement 133 on Derivative Instruments and Hedging Activities,” collectively SFAS 133, and are not considered held for trading purposes as defined by current accounting literature. Accordingly, we carry the fair market value of our derivative instruments on the Consolidated Balance Sheet as either a current or deferred asset or liability, as appropriate, and defer the effective portion of unrealized gains or losses in accumulated other comprehensive income. Gains and losses are reclassified from accumulated other comprehensive income to the Consolidated Statement of Income in the period the hedged transaction affects earnings. Gains and losses are reflected as a component of either revenue or fuel and purchased power depending on the hedged transaction. Hedge ineffectiveness results from changes during the period in the price differentials between the index price of the derivative contract and the index price at the point of sale for the cash flow that is being hedged, and is recorded directly to earnings.

Houston Exploration has utilized collars and purchased put options, as well as over-the-counter (“OTC”) swaps, to hedge the cash flow variability associated with forecasted sales of a portion of its natural gas production. At March 31, 2004, Houston Exploration has hedge positions in place for approximately 70% of its estimated 2004 gas production, with an effective floor price of \$4.26 and an effective ceiling price of \$5.85. Further, Houston Exploration has hedge positions in place for approximately 60% of its estimated 2005 gas production, with an effective floor price of \$4.57 and an effective ceiling price of \$5.46. Houston Exploration uses standard New York Mercantile Exchange (“NYMEX”) futures prices to value its swap positions and, in addition, uses published volatility in its Black-Scholes calculation for outstanding options. The maximum length of time over which Houston Exploration has hedged such cash flow variability is through December 2005. The fair market value of these derivative instruments at March 31, 2004 was a liability of \$83.8 million. The estimated amount of losses associated with such derivative instruments that are reported in other comprehensive income and that are expected to be reclassified into earnings over the next twelve months is \$63.5 million, or approximately \$41 million after-tax. For the first three months of 2004, Houston Exploration recorded an unrealized loss of \$1.0 million (\$0.7 million net of tax) representing the ineffective portion of its derivative instruments.

With respect to price exposure associated with fuel purchases for the Ravenswood facility, KeySpan employs standard NYMEX natural gas futures contracts to hedge the cash flow variability for a portion of forecasted purchases of natural gas. KeySpan also employs the use of financially-settled oil swap contracts to hedge the cash flow variability for a portion of forecasted purchases of fuel oil that will be consumed at the Ravenswood facility. The maximum length of time over which we have hedged cash flow variability associated with forecasted purchases of natural gas and fuel oil is through September 2005. We use standard NYMEX futures prices to value the gas futures contracts and market quoted forward prices to value oil swap contracts. The fair market value of these derivative instruments at March 31, 2004 was an asset of \$0.3 million. A substantial portion of these derivative instruments, which are reported in other comprehensive income, are expected to be reclassified into earnings over the next twelve months.

We have also engaged in the use of cash-settled swap instruments to hedge the cash flow variability associated with a portion of forecasted peak electric energy sales from the Ravenswood facility. Our hedging strategy is to hedge approximately 50% of forecasted on-peak summer season electric energy sales and a portion of forecasted peak electric energy sales for the remainder of the year. The maximum length of time over which we have hedged cash flow variability is through December 2005. We use market quoted forward prices to value these outstanding derivatives. The fair market value of these derivative instruments at March 31, 2004 was a liability of \$1.1 million. The estimated amount of losses associated with such derivative instruments that are reported in other

comprehensive income and that are expected to be reclassified into earnings over the next twelve months is \$0.6 million, or approximately \$0.4 million after-tax.

The table below summarizes the fair value of each category of derivative instrument outstanding at March 31, 2004 and its related line item on the Consolidated Balance Sheet. Fair value is the amount at which derivative instruments could be exchanged in a current transaction between willing parties, other than in a forced liquidation sale.

<i>(In Thousands of Dollars)</i>	March 31, 2004	December 31, 2003
<b>Gas Contracts:</b>		
Other current assets	\$ 47	\$ 3,458
Accounts payable and other liabilities	(63,535)	(35,592)
Other deferred liabilities	(20,302)	(4,734)
<b>Oil Contracts:</b>		
Other current assets	257	-
Other deferred charges	6	385
<b>Electric Contracts:</b>		
Accounts payable and other liabilities	(572)	-
Other deferred liabilities	(477)	259
	<b>\$ (84,576)</b>	<b>\$ (36,224)</b>

*Financially-Settled Commodity Derivative Instruments that Do Not Qualify for Hedge Accounting:* KeySpan subsidiaries also employ a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133. In 2003, we sold a “swaption” to hedge the cash flow variability associated with 50 MW of forecasted 2004 summer electric energy sales from the Ravenswood facility. The swaption is an option that gives the counterparty the right, but not the obligation, to enter into a swap transaction with KeySpan in the future at a given strike price. This swaption can be converted into a swap, at the election of the counterparty and has an expiration date of June 1, 2004. The premium payment KeySpan received was recorded as a current liability on the Consolidated Balance Sheet. The premium generally will be recorded into income at the time the swaption is either exercised or expires. An internally developed option-pricing model is used to value the swaption and at March 31, 2004, the fair value of the swaption was immaterial.

*Firm Gas Sales Derivative Instruments - Regulated Utilities:* We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. Our strategy is to minimize fluctuations in firm gas sales prices to our regulated firm gas sales customers in our New York and New England service territories. The accounting for these derivative instruments is subject to SFAS 71 “Accounting for the Effects of Certain Types of Regulation.” Therefore, changes in the fair value of these derivatives have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers consistent with

regulatory requirements. At March 31, 2004, these derivatives had a net fair market value of \$18.4 million and are reflected as a regulatory liability on the Consolidated Balance Sheet.

*Physically-Settled Commodity Derivative Instruments:* SFAS 133 establishes criteria that must be satisfied in order for option contracts, forward contracts with optionality features, or contracts that combine a forward contract and a purchase option contract to be exempted as normal purchases and sales. Based upon a continuing review of our physical gas contracts, we determined that certain contracts for the physical purchase of natural gas associated with our regulated gas utilities are not exempt as normal purchases from the requirements of SFAS 133. Since these contracts are for the purchase of natural gas sold to regulated firm gas sales customers, the accounting for these contracts is subject to SFAS 71. Therefore, changes in the market value of these contracts have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. At March 31, 2004 these contracts had a net negative fair market value of \$5.3 million, and are reflected as a \$6.0 million regulatory asset and \$0.7 million regulatory liability on the Consolidated Balance Sheet.

*Interest Rate Derivative Instruments:* In May 2003, we entered into interest rate swap agreements in which we swapped \$250 million of 7.25% fixed rate debt to floating rate debt. Under the terms of the agreements, we received the fixed coupon rate associated with these bonds and paid our swap counterparties a variable interest rate based on LIBOR, that was reset on a semi-annual basis. These swaps were designated as fair-value hedges and qualified for “short-cut” hedge accounting treatment under SFAS 133. During the three months ended March 31, 2004, we paid our counterparty an

average interest rate of 6.44%, and as a result, we realized interest savings of \$0.5 million. The fair market value of this derivative was \$2 million at March 31, 2004.

On April 7, 2004 we terminated these swap agreements and received \$1.2 million from our swap counterparties, of which \$0.7 million represented accrued swap interest. The difference between the termination settlement amount and the amount of accrued interest, \$0.5 million, will be recorded as a reduction to interest expense over the remaining life of the bond.

*Weather Derivatives:* The utility tariffs associated with KEDNE's operations do not contain weather normalization adjustments. As a result, fluctuations from normal weather may have a significant positive or negative effect on the results of these operations. In October 2003, we entered into heating-degree day call and put options to mitigate the effect of fluctuations from normal weather on KEDNE's financial position and cash flows for the 2003/2004 winter heating season – November 2003 through March 2004. With respect to sold call options, KeySpan was required to make a payment of \$27,500 per heating degree day to its counterparties when actual weather experienced during this time frame was above 4,440 heating degree days, which equates to approximately 2% colder than normal weather, based on the most recent 20-year average for normal weather. The maximum amount KeySpan was required to pay on its sold call options was \$5.5 million. With respect to purchased put options, KeySpan would have received a \$27,500 per heating degree day payment from its counterparties when actual weather was below 4,266 heating degree days, or approximately 2% warmer than normal. The maximum amount KeySpan would have received on its purchased put options was \$11 million. The net premium cost for these options was \$0.4 million. We account for these derivatives pursuant to the requirements of EITF 99-2, "Accounting for Weather Derivatives." In this regard, such instruments are accounted for using the "intrinsic value method" as set forth in such guidance. During the first quarter of 2004, weather, as measured in heating degree-days, was 9.4% colder than normal and, as a result, \$4.1 million was recorded as a reduction to revenues .

Derivative contracts are primarily used to manage exposure to market risk arising from changes in commodity prices and interest rates. In the event of non-performance by a counterparty to a derivative contract, the desired impact may not be achieved. The risk of counterparty non-performance is generally considered a credit risk and is actively managed by assessing each counterparty credit profile and negotiating appropriate levels of collateral and credit support. We believe that our credit risk related to the above mentioned derivative financial instruments is no greater than the risk associated with the primary contracts which they hedge and that the elimination of a portion of the price risk reduces volatility in our reported results of operations, financial position and cash flows and lowers overall business risk.

## 5. RECENT ACCOUNTING PRONOUNCEMENTS

In March 2004, the Financial Accounting Standards Board ("FASB") issued, as a proposal, FASB Staff Position ("FSP") 106-b "Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003." When issued in final, this

guidance will supersede FSP 106-1 issued in 2003 and will clarify the accounting and disclosure requirements for employers with postretirement benefit plans that have been or will be affected by the passage of the Medicare Prescription Drug Improvement and Modernization Act of 2003 (“the Act”). The Act introduces two new features to Medicare that an employer needs to consider in measuring its obligation and net periodic postretirement benefit costs. The effective date for the new requirements is the first interim or annual period beginning after June 15, 2004 or for KeySpan’s purposes the third quarter of 2004.

KeySpan's retiree health benefit plan currently includes a prescription drug benefit that is provided to retired employees. It is anticipated that implementation of the new requirements will have a positive impact on KeySpan’s results of operations and cash flows, although the magnitude of the impact can not be determined with any degree of certainty at this time.

## 6. FINANCIAL GUARANTEES AND CONTINGENCIES

*Variable Interest Entity:* KeySpan has an arrangement with a variable interest entity through which we lease a portion of the Ravenswood facility. We acquired the Ravenswood facility, then a 2,200-megawatt electric generating facility located in Queens, New York, in part, through a variable interest entity from The Consolidated Edison Company of New York, Inc. (“Consolidated Edison”) on June 18, 1999 for approximately \$597 million. In order to reduce the initial cash requirements, we entered into a lease arrangement (“Master Lease”) with a variable interest, unaffiliated financing entity that acquired a portion of the facility, or three steam generating units, directly from Consolidated Edison and leased it to our subsidiary. The variable interest unaffiliated financing entity acquired the property for \$425 million, financed with debt of \$412.3 million (97% of capitalization) and equity of \$12.7 million (3% of capitalization). KeySpan has no ownership interests in the units or the variable interest entity. KeySpan has guaranteed all payment and performance obligations of our subsidiary under the Master Lease. Monthly lease payments substantially equal the monthly interest expense on such debt securities.

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

We have classified the Master Lease as \$412.3 million long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary. Further, we have an asset on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date, or approximately \$385 million.

Under the terms of our credit facility, the Master Lease has been considered debt in the ratio of debt-to-total capitalization since the inception of the lease. If our subsidiary that leases the Ravenswood facility were not able to fulfill its payment obligations with respect to the Master Lease payments, then the maximum amount KeySpan would be exposed to under its current guarantees would be \$425 million, plus the present value of the remaining lease payments through June 20, 2009.

*Asset Retirement Obligations:* In 2003, KeySpan adopted SFAS 143, "Accounting for Asset Retirement Obligations." SFAS 143 required us to record a liability and corresponding asset representing the present value of legal obligations associated with the retirement of tangible, long-lived assets. At March 31, 2004, the present value of our future asset retirement obligation ("ARO") was approximately \$88.6 million, primarily related to our investment in Houston Exploration.

KeySpan's largest asset base is its gas transmission and distribution system. A legal obligation exists due to certain safety requirements at final abandonment. In addition, a legal obligation may be construed to exist with respect to KeySpan's liquefied natural gas ("LNG") storage tanks due to clean up responsibilities upon cessation of use. However, mass assets such as storage, transmission and distribution assets are believed to operate in perpetuity and, therefore, have indeterminate cash flow estimates. Since that exposure is in perpetuity and cannot be measured, no liability will be recorded pursuant to SFAS 143. KeySpan's ARO will be re-evaluated in future periods until sufficient information exists to determine a reasonable estimate of fair value.

## Environmental Matters

*New York Sites:* Within the State of New York we have identified 43 historical manufactured gas plant (“MGP”) sites and related facilities, which were owned or operated by KeySpan subsidiaries or such companies’ predecessors.

We have identified 28 of these sites as being associated with the historical operations of KEDNY. One site has been fully remediated. The remaining sites will be investigated and, if necessary, remediated under the terms and conditions of Administrative Orders on Consent (“ACO”) or Voluntary Cleanup Agreements (“VCA”). Expenditures incurred to date by us with respect to KEDNY MGP-related activities total \$42.6 million.

The remaining 15 sites have been identified as being associated with the historical operations of KEDLI. Expenditures incurred to date by us with respect to KEDLI MGP-related activities total \$33.9 million. One site has been fully investigated and requires no further action. The remaining sites will be investigated and, if necessary, remediated under the conditions of ACOs or VCAs.

We presently estimate the remaining cost of our KEDNY and KEDLI MGP-related environmental remediation activities will be \$220.6 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred to date by us with respect to these MGP-related activities total \$76.5 million.

With respect to remediation costs, the KEDNY and KEDLI rate plans generally provide for the recovery of investigation and remediation costs in rates charged to gas distribution customers. At March 31, 2004, we have reflected a regulatory asset of \$240.8 million for our KEDNY/KEDLI MGP sites. In accordance with New York State Public Service Commission (“NYPSC”) policy, KeySpan records a reduction to regulatory liabilities as costs are incurred for environmental clean-up activities. At March 31, 2004, these previously deferred regulatory liabilities totaled \$53 million. In October 2003, KEDNY and KEDLI filed a joint petition with the NYPSC seeking rate treatment for additional environmental costs that may be incurred in the future.

We are also responsible for environmental obligations associated with the Ravenswood facility, purchased from Consolidated Edison in 1999, including remediation activities associated with its historical operations and those of the MGP facilities that formerly operated at the site. We are not responsible for liabilities arising from disposal of waste at off-site locations prior to the acquisition closing and any monetary fines arising from Consolidated Edison’s pre-closing conduct. We presently estimate the remaining environmental clean up activities for this site will be \$3.3 million, which amount has been accrued by us. Expenditures incurred to date total \$1.7 million.

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

Boston Gas Company, Colonial Gas Company and Essex Gas Company may have or share responsibility under applicable environmental laws for the remediation of 66 of these sites. A subsidiary of National Grid USA (“National Grid”), formerly New England Electric System, has assumed responsibility for remediating 11 of these sites, subject to a limited contribution from Boston Gas Company, and has provided full indemnification to Boston Gas Company with respect to 8 other sites. In addition, Boston Gas Company, Colonial Gas Company, and Essex Gas Company have each assumed responsibility for remediating 3 sites. At this time, it is uncertain as to whether Boston Gas Company, Colonial Gas Company or Essex Gas Company have or share responsibility for remediating any of the other sites. No notice of responsibility has been issued to us for any of these sites from any governmental environmental authority.

We presently estimate the remaining cost of these Massachusetts KEDNE MGP-related environmental cleanup activities will be \$25.4 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred since November 8, 2000 with respect to these MGP-related activities total \$13.9 million.

We may have or share responsibility under applicable environmental laws for the remediation of 10 MGP sites and related facilities associated with the historical operations of EnergyNorth. At four of these sites we have entered into cost sharing agreements with other parties who share responsibility for remediation of these sites. EnergyNorth also has entered into an agreement with the United States Environmental Protection Agency (“EPA”) for the contamination from the Nashua site that was allegedly commingled with asbestos at the Nashua River Asbestos Site, adjacent to the Nashua MGP site.

We presently estimate the remaining cost of EnergyNorth MGP-related environmental cleanup activities will be \$13.8 million, which amount has been accrued by us as a reasonable estimate of probable cost for known sites. Expenditures incurred since November 8, 2000, with respect to these MGP-related activities total \$8 million.

By rate orders, the Massachusetts Department of Telecommunications and Energy (“DTE”) and the New Hampshire Public Utility Commission (“NHPUC”) provide for the recovery of site investigation and remediation costs and, accordingly, at March 31, 2004, we have reflected a regulatory asset of \$51.2 million for the KEDNE MGP sites. Colonial Gas Company and Essex Gas Company are not subject to the provisions of Statement of Financial Accounting Standard (“SFAS”) 71, “Accounting for the Effects of Certain Types of Regulation” and therefore have recorded no regulatory asset. However, rate plans currently in effect for these subsidiaries provide for the recovery of investigation and remediation costs.

*KeySpan New England, LLC Sites:* We are aware of three non-utility sites associated with KeySpan New England, LLC, a successor company to Eastern Enterprises, for which we may have or share environmental remediation or ongoing maintenance responsibility. These three sites, located in

Philadelphia, Pennsylvania, New Haven, Connecticut and Everett, Massachusetts, were associated with historical operations involving the production of coke and related industrial processes. Honeywell International, Inc. and Beazer East, Inc. (both former owners and/or operators of certain facilities at Everett (“the Everett Facility”) together with KeySpan, have entered into an ACO with the Massachusetts Department of Environmental Protection for the investigation and development of a remedial response plan for a portion of that site. KeySpan, Honeywell and Beazer East have entered into a cost-sharing agreement under which each company has agreed to pay one-third of the costs of compliance with the consent order, while preserving any claims it may have against the other companies for, among other things, reallocation of proportionate liability.

We presently estimate the remaining cost of our environmental cleanup activities for the three non-utility sites will be approximately \$24.3 million, which amount has been accrued by us as a reasonable estimate of probable costs for known sites. Expenditures incurred since November 8, 2000, with respect to these sites total \$8.5 million.

We believe that in the aggregate, the accrued liability for these MGP sites and related facilities identified above are reasonable estimates of the probable cost for the investigation and remediation of these sites and facilities. As circumstances warrant, we periodically re-evaluate the accrued liabilities associated with MGP sites and related facilities. We may be required to investigate and, if necessary, remediate each site previously noted, or other currently unknown former sites and related facility sites, the cost of which is not presently determinable but may be material to our financial position, results of operations or cash flows. Remediation costs for each site may be materially higher than noted, depending upon remediation experience, selected end use for each site, and actual environmental conditions encountered.

See KeySpan’s Annual Report on Form 10K for the year ended December 31, 2003 Note 7 to those Consolidated Financial Statements “Contractual Obligations, Financial Guarantees and Contingencies” for further information on environmental matters.

## Legal Matters

From time to time we are subject to various legal proceedings arising out of the ordinary course of our business. Except as described below, or in KeySpan’s Annual Report on Form 10K for the year ended December 31, 2003, we do not consider any of such proceedings to be material to our business or likely to result in a material adverse effect on our results of operations, financial condition or cash flows.

KeySpan and certain of its current and former officers and directors are defendants in a consolidated class action lawsuit filed in the United States District Court for the Eastern District of New York. This lawsuit alleges, among other things, violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (“Exchange Act”), in connection with disclosures relating to or following the acquisition of the Roy Kay companies. In October 2001, a shareholder’s derivative action was commenced in the same court against certain current and former officers and directors of

KeySpan, alleging, among other things, breaches of fiduciary duty, violations of the New York Business Corporation Law and violations of Section 20(a) of the Exchange Act. On June 12, 2002, a second derivative action was commenced which asserted similar allegations. Each of these proceedings seeks monetary damages in an unspecified amount. On March 18, 2003, the court granted our motion to dismiss the class action complaint. The court's order dismissed certain class allegations with prejudice, but provided the plaintiffs a final opportunity to file an amended complaint concerning the remaining allegations. In April 2003, plaintiffs filed an amended complaint and in July 2003 the court denied our motion to dismiss the amended complaint but did strike certain allegations. On November 20, 2003, the court granted our motion for reconsideration of the July 2003 order and the court struck additional allegations from the amended complaint which effectively limited the potential class period. On December 19, 2003, KeySpan filed a motion to dismiss the derivative actions. The motion is still pending. KeySpan intends to vigorously defend each of these proceedings. However, we are unable to predict the outcome of these proceedings or what effect, if any, such outcome will have on our financial condition, results of operations or cash flows.

KeySpan subsidiaries, along with several other parties, have been named as defendants in numerous proceedings filed by plaintiffs claiming various degrees of injury from asbestos exposure at generating facilities formerly owned by Long Island Lighting Company ("LILCO") and others. In connection with the May 1998 transaction with LIPA, costs incurred by KeySpan for liabilities for asbestos exposure arising from the activities of the generating facilities previously owned by LILCO are recoverable from LIPA through the Power Supply Agreement ("PSA") between LIPA and KeySpan.

KeySpan is unable to determine the outcome of the outstanding asbestos proceedings, but does not believe that such outcome, if adverse, will have a material effect on its financial condition, results of operation or cash flows. KeySpan believes that its cost recovery rights under the PSA, its indemnification rights against third parties and its insurance coverage (above applicable deductible limits) cover its exposure for asbestos liabilities generally.

## Financial Guarantees

KeySpan has issued financial guarantees in the normal course of business, primarily on behalf of its subsidiaries, to various third party creditors. At March 31, 2004, the following amounts would have to be paid by KeySpan in the event of non-payment by the primary obligor at the time payment is due:

<i>Nature of Guarantee (In Thousands of Dollars)</i>		Amount of Exposure	Expiration Dates
Guarantees for Subsidiaries			
Medium-Term Notes - KEDLI	(i)	\$ 525,000	2008-2010
Industrial Development Revenue Bonds	(ii)	128,000	2027
Master Lease - Ravenswood	(iii)	425,000	2004
Surety Bonds	(iv)	169,000	Revolving
Commodity Guarantees and Other	(v)	51,000	2005
Letters of Credit	(vi)	74,000	2004
		\$ 1,372,000	

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

- (i) KeySpan has fully and unconditionally guaranteed \$525 million to holders of Medium-Term Notes issued by KEDLI. These notes are due to be repaid on January 15, 2008 and February 1, 2010. KEDLI is required to comply with certain financial covenants under the debt agreements. Currently, KEDLI is in compliance with all covenants and management does not anticipate that KEDLI will have any difficulty maintaining such compliance. The face value of these notes is included in long-term debt on the Consolidated Balance Sheet.
- (ii) KeySpan has fully and unconditionally guaranteed the payment obligations of its subsidiaries with regard to \$128 million of Industrial Development Revenue Bonds issued through the Nassau County and Suffolk County Industrial Development Authorities for the construction of the Glenwood and Port Jefferson electric-generation peaking plants. The face value of these notes are included in long-term debt on the Consolidated Balance Sheet.
- (iii) KeySpan has guaranteed all payment and performance obligations of KeySpan Ravenswood, LLC, the lessee under the \$425 million Ravenswood master lease (the "Master Lease") associated with the lease of the Ravenswood facility. The initial term of the lease expires on June 20, 2004 and may be extended until June 20, 2009. The Master Lease is classified as \$412.3 million long-term debt on the Consolidated Balance Sheet.

- (iv) KeySpan has agreed to indemnify the issuers of various surety and performance bonds associated with certain construction projects currently being performed by subsidiaries within the Energy Services segment. In the event that the operating companies in the Energy Services segment fail to perform their obligations under contract, the injured party may demand that the surety make payments or provide services under the bond. KeySpan would then be obligated to reimburse the surety for any expenses or cash outlays it incurs.
- (v) KeySpan has guaranteed commodity-related payments for certain of its subsidiaries. These guarantees are provided to third parties to facilitate physical and financial transactions involved in the purchase of natural gas, oil and other petroleum products for electric production and marketing activities. The guarantees cover actual purchases by these subsidiaries that are still outstanding as of March 31, 2004.
- (vi) KeySpan has arranged for stand-by letters of credit to be issued to third parties that have extended credit to certain subsidiaries. Certain vendors require us to post letters of credit to guarantee subsidiary performance under our contracts and to ensure payment to our subsidiary subcontractors and vendors under those contracts. Certain of our vendors also require letters of credit to ensure reimbursement for amounts they are disbursing on behalf of our subsidiaries, such as to beneficiaries under our self-funded insurance programs. Such letters of credit are generally issued by a bank or similar financial institution. The letters of credit commit the issuer to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, KeySpan would be required to reimburse the issuer of the letter of credit.

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

*Other Contingencies:* We derive a substantial portion of our revenues in our Electric Services segment from a series of agreements with LIPA pursuant to which we manage LIPA's transmission and distribution system and supply the majority of LIPA's customers' electricity needs. The agreements terminate at various dates between May 28, 2006 and May 28, 2013, and at this time, we can provide no assurance that any of the agreements will be renewed or extended, or if they were to be renewed or extended, the terms and conditions thereof. In addition, given the complexity of these agreements, disputes arise from time to time between KeySpan and LIPA concerning the rights and obligations of each party to make and receive payments as required pursuant to the terms of these agreements. As a result, KeySpan is unable to determine what effect, if any, the ultimate resolution of these disputes will have on its financial condition, results of operations or cash flows.

## STOCK OPTIONS

Stock options have been issued to KeySpan officers, directors and certain other management employees and consultants as approved by the Board of Directors. These options generally vest over a three-to-five year period and have a ten-year exercise period. Moreover, under a separate plan, Houston Exploration has issued stock options to its directors and key Houston Exploration employees. (Beginning in 2004, KeySpan officers that serve on the Houston Exploration Board of Directors will not receive Houston Exploration stock options.) In 2003, KeySpan and Houston Exploration adopted the prospective method of transition of accounting for stock option expense in accordance with SFAS 148 "Accounting for Stock-Based Compensation – Transition and Disclosure". Accordingly, compensation expense has been recognized by employing the fair value recognition provisions of SFAS 123 "Accounting for Stock-Based Compensation" for grants awarded after January 1, 2003.

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

<i>(In Thousands of Dollars, Except Per Share Amounts)</i>	Three Months Ended March 31,	
	2004	2003
Earnings available for common stock:		
As reported	\$ 246,235	\$ 241,804
Add: recorded stock-based compensation expense, net of tax	1,512	857
Deduct: total stock-based compensation expense, net of tax	(2,967)	(2,913)
Pro-forma earnings	\$ 244,780	\$ 239,748
Earnings per share:		
Basic - as reported	\$ 1.54	\$ 1.54
Basic - pro-forma	\$ 1.53	\$ 1.53
Diluted - as reported	\$ 1.53	\$ 1.53
Diluted - pro-forma	\$ 1.52	\$ 1.52

## 8. POSTRETIREMENT BENEFITS

*Pension Plans:* The following information represents the consolidated net periodic pension cost for the three months ended March 31, 2004 and 2003 for our noncontributory defined benefit pension plans which cover substantially all employees. Benefits are based on years of service and compensation. Funding for pensions is in accordance with requirements of federal law and regulations. KEDLI and Boston Gas Company are subject to certain deferral accounting requirements mandated by the New York Public Service Commission (“NYSPSC”) and the Department of Telecommunications Energy (“DTE”), respectively for pension costs and other postretirement benefit costs. Further, KeySpan’s electric subsidiaries are subject to certain “true-up” provisions in accordance with the LIPA service agreements.

The calculation of net periodic pension cost is as follows:

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Service cost, benefits earned during the period	\$ 13,079	\$ 11,883
Interest cost on projected benefit obligation	36,047	34,568
Expected return on plan assets	(36,521)	(32,639)
Net amortization and deferral	16,917	16,737
Total pension cost	\$ 29,522	\$ 30,549

*Other Postretirement Benefits:* The following information represents the consolidated net periodic other postretirement benefit cost for the three months ended March 31, 2004 and 2003 for our noncontributory defined benefit plans covering certain health care and life insurance benefits for retired employees. We have been funding a portion of future benefits over employees’ active service lives through Voluntary Employee Beneficiary Association (“VEBA”) trusts. Contributions to VEBA trusts are tax deductible, subject to limitations contained in the Internal Revenue Code.

Net periodic other postretirement benefit cost included the following components:

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Service cost, benefits earned during the period	5,392	4,706
Interest cost on accumulated postretirement benefit obligation	18,521	17,451
Expected return on plan assets	(7,708)	(6,883)
Net amortization and deferral	11,280	8,954
Other postretirement cost	27,485	24,228

In 2004, KeySpan is expected to contribute approximately \$89 million to its pension plans and approximately \$58 million to its other postretirement benefit plans, which are the same funding levels as reported in KeySpan's Annual Report on Form 10K for the Year Ended December 31, 2003.

## 9. LONG-TERM DEBT

At March 31, 2004, KeySpan had \$460 million of MEDS Equity Units outstanding at 8.75% consisting of a three-year forward purchase contract for our common stock and a six-year note. The purchase contract commits us, three years from the date of issuance of the MEDS Equity Units, May 2005, to issue and the investors to purchase, a number of shares of our common stock based on a formula tied to the market price of our common stock at that time. The 8.75% coupon is composed of interest payments on the six-year note of 4.9% and premium payments on the three-year equity forward contract of 3.85%. These instruments have been recorded as long-term debt on the Consolidated Balance Sheet. Further, upon issuance of the MEDS Equity Units, we recorded a direct charge to retained earnings of \$49.1 million, which represents the present value of the forward contract's premium payments.

There were 9.2 million MEDS Equity units issued which are subject to conversion upon execution of the three-year forward purchase contract. The number of shares to be issued depends on the average closing price of our common stock over the 20 day trading period ending on the third trading day prior to May 16, 2005. If the average closing price over this time frame is less than or equal to \$35.30 of KeySpan's common stock, 13 million shares will be issued. If the average closing price over this time frame is greater than or equal to \$42.36, 10.9 million shares will be issued. The number of shares issued at a price between \$35.30 and \$42.36 will be between 10.9 million and 13 million based upon a sliding scale.

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

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

## 10. KEYSpan GAS EAST CORPORATION SUMMARY FINANCIAL INFORMATION

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

<b>Statement of Income</b>					
Three Months Ended March 31, 2004					
<i>(In Thousands of Dollars)</i>	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
<b>Revenues</b>	\$ 153	\$ 471,083	\$ 2,124,490	\$ (153)	\$ 2,595,573
<b>Operating Expenses</b>					
Purchased gas	-	291,089	935,484	-	1,226,573
Fuel and purchased power	-	-	101,612	-	101,612
Operations and maintenance	369	33,217	458,880	-	492,466
Intercompany expense	-	1,355	(1,355)	-	-
Depreciation and amortization	-	29,841	141,843	-	171,684
Operating taxes	-	19,543	102,736	-	122,279
Total Operating Expenses	369	375,045	1,739,200	-	2,114,614
Income from equity investments	-	-	5,717	-	5,717
<b>Operating Income (Loss)</b>	(216)	96,038	391,007	(153)	486,676
Interest charges	(53,488)	(15,863)	(71,475)	56,760	(84,066)
Other income and (deductions)	297,529	374	(1,960)	(313,475)	(17,532)
<b>Total Other Income and (Deductions)</b>	244,041	(15,489)	(73,435)	(256,715)	(101,598)
<b>Income Taxes (Benefit)</b>	(5,862)	22,710	120,534	-	137,382
			-	-	
<b>Net Income</b>	\$ 249,687	\$ 57,839	\$ 197,038	\$ (256,868)	\$ 247,696

---

**Statement of Income**

---

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31, 2003				
	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
<b>Revenues</b>	\$ 143	\$ 478,345	\$ 2,034,180	\$ (143)	\$ 2,512,525
<b>Operating Expenses</b>					
Purchased gas	-	287,009	909,156	-	1,196,165
Fuel and purchased power	-	-	97,522	-	97,522
Operations and maintenance	7,259	38,220	452,710	-	498,189
Intercompany expense	34	1,182	(1,182)	(34)	-
Depreciation and amortization	(20)	26,920	118,071	-	144,971
Operating taxes	-	24,005	100,708	-	124,713
Total Operating Expenses	7,273	377,336	1,676,985	(34)	2,061,560
Income from equity investments	-	-	5,729	-	5,729
<b>Operating Income (Loss)</b>	(7,130)	101,009	362,924	(109)	456,694
Interest charges	(46,477)	(15,006)	(52,299)	44,843	(68,939)
Other income and (deductions)	293,453	(7,217)	4,514	(292,581)	(1,831)
<b>Total Other Income and (Deductions)</b>	246,976	(22,223)	(47,785)	(247,738)	(70,770)
<b>Income Taxes</b>	(3,419)	28,312	117,940	-	142,833
<b>Earnings before change in accounting principle</b>	243,265	50,474	197,199	(247,847)	243,091
<b>Cumulative change in accounting principle</b>			174	-	174
<b>Net Income</b>	\$ 243,265	\$ 50,474	\$ 197,373	\$ (247,847)	\$ 243,265

---

**Balance Sheet**

	March 31, 2004				
	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>					
<b>Current Assets</b>					
Cash & temporary cash investments	\$ 81,730	\$ 59	\$ 175,151	\$ -	\$ 256,940
Accounts receivable, net	7,667	274,627	1,471,748	-	1,754,042
Other current assets	2,479	44,457	295,427	-	342,363
	91,876	319,143	1,942,326	-	2,353,345
<b>Equity Investments</b>	4,740,262	1,043	160,609	(4,645,542)	256,372
<b>Property</b>					
Gas	-	1,919,592	4,670,829	-	6,590,421
Other	-	-	6,258,336	-	6,258,336
Accumulated depreciation and depletion	-	(316,831)	(3,568,248)	-	(3,885,079)
	-	1,602,761	7,360,917	-	8,963,678
<b>Intercompany Accounts Receivable</b>	2,977,170		1,212,607	(4,189,777)	-
<b>Deferred Charges</b>	375,495	225,589	2,505,253	-	3,106,337
<b>Total Assets</b>	<b>\$ 8,184,803</b>	<b>\$ 2,148,536</b>	<b>\$ 13,181,712</b>	<b>\$ (8,835,319)</b>	<b>\$ 14,679,732</b>
<b>LIABILITIES AND CAPITALIZATION</b>					
<b>Current Liabilities</b>					
Accounts payable	\$ 49,113	\$ 162,274	\$ 740,946	\$ -	\$ 952,333
Commercial paper	294,150		-	-	294,150
Other current liabilities	283,634	12,275	117,841	-	413,750
	626,897	174,549	858,787	-	1,660,233
<b>Intercompany Accounts Payable</b>	-	48,291	2,556,920	(2,605,211)	-
<b>Deferred Credits and Other Liabilities</b>					
Deferred income tax	(48,188)	259,184	1,039,676	-	1,250,672
Other deferred credits and liabilities	571,504	175,547	1,031,882	-	1,778,933
	523,316	434,731	2,071,558	-	3,029,605
<b>Capitalization</b>					
Common shareholders' equity	3,901,569	840,061	3,736,438	(4,645,542)	3,832,526
Preferred stock	83,433	-	-	-	83,433
Long-term debt	3,049,588	650,904	3,421,530	(1,584,566)	5,537,456
<b>Total Capitalization</b>	<b>7,034,590</b>	<b>1,490,965</b>	<b>7,157,968</b>	<b>(6,230,108)</b>	<b>9,453,415</b>
<b>Minority Interest in Subsidiary Companies</b>	-	-	536,479	-	536,479
<b>Total Liabilities &amp; Capitalization</b>	<b>\$ 8,184,803</b>	<b>\$ 2,148,536</b>	<b>\$ 13,181,712</b>	<b>\$ (8,835,319)</b>	<b>\$ 14,679,732</b>

**Balance Sheet**

	December 31, 2003				
	Guarantor	KEDLI	Other Subsidiaries	Eliminations	Consolidated
<b>ASSETS</b>					
<b>Current Assets</b>					
Cash & temporary cash investments	\$ 97,567	\$ 1,554	\$ 106,630	\$ -	\$ 205,751
Accounts receivable, net	3,298	209,151	1,243,459	-	1,455,908
Other current assets	3,250	130,994	590,996	-	725,240
	104,115	341,699	1,941,085	-	2,386,899
<b>Investments and Other</b>	4,475,949	1,123	153,520	(4,382,027)	248,565
<b>Property</b>					
Gas	-	1,899,375	4,622,876	-	6,522,251
Other	-	-	6,150,355	-	6,150,355
Accumulated depreciation and depletion	-	(312,204)	(3,466,099)	-	(3,778,303)
	-	1,587,171	7,307,132	-	8,894,303
<b>Intercompany Accounts Receivable</b>	3,105,571	-	1,274,293	(4,379,864)	-
<b>Deferred Charges</b>	374,076	237,870	2,498,469	-	3,110,415
<b>Total Assets</b>	<b>\$ 8,059,711</b>	<b>\$ 2,167,863</b>	<b>\$ 13,174,499</b>	<b>\$ (8,761,891)</b>	<b>\$ 14,640,182</b>
<b>LIABILITIES AND CAPITALIZATION</b>					
<b>Current Liabilities</b>					
Accounts payable	\$ 125,892	\$ 165,613	\$ 850,092	\$ -	\$ 1,141,597
Commercial paper	481,900	-	-	-	481,900
Other current liabilities	129,168	16,125	80,026	-	225,319
	736,960	181,738	930,118	-	1,848,816
<b>Intercompany Accounts Payable</b>	-	116,197	2,679,101	(2,795,298)	-
<b>Deferred Credits and Other Liabilities</b>					
Deferred income tax	(48,059)	256,882	1,069,518	-	1,278,341
Other deferred credits and liabilities	532,062	179,919	925,839	-	1,637,820
	484,003	436,801	1,995,357	-	2,916,161
<b>Capitalization</b>					
Common shareholders' equity	3,707,785	782,223	3,562,675	(4,382,027)	3,670,656
Preferred stock	83,568	-	-	-	83,568
Long-term debt	3,047,395	650,904	3,497,699	(1,584,566)	5,611,432
<b>Total Capitalization</b>	<b>6,838,748</b>	<b>1,433,127</b>	<b>7,060,374</b>	<b>(5,966,593)</b>	<b>9,365,656</b>
<b>Minority Interest in Subsidiary Companies</b>	-	-	509,549	-	509,549
<b>Total Liabilities &amp; Capitalization</b>	<b>\$ 8,059,711</b>	<b>\$ 2,167,863</b>	<b>\$ 13,174,499</b>	<b>\$ (8,761,891)</b>	<b>\$ 14,640,182</b>

**Statement of Cash Flows**

	Three Months Ended March 31, 2004			
	Guarantor	KEDLI	Other Subsidiaries	Consolidated
<b>Operating Activities</b>				
Net Cash Provided by Operating Activities	\$ 95,128	\$ 91,155	\$ 392,803	\$ 579,086
<b>Investing Activities</b>				
Capital expenditures	-	(24,388)	(195,836)	(220,224)
Cost of removal	-	(356)	(5,848)	(6,204)
Proceeds from sale of property	-	-	13,138	13,138
Net Cash Provided by (Used in) Investing Activities	-	(24,744)	(188,546)	(213,290)
<b>Financing Activities</b>				
Treasury stock issued	11,796	-	-	11,796
Payment of debt, net	(187,750)	-	(74,853)	(262,603)
Common and preferred stock dividends paid	(72,935)	-	-	(72,935)
Other	9,523	-	(388)	9,135
Net intercompany accounts	128,401	(67,906)	(60,495)	-
Net Cash Provided by (Used in) Financing Activities	(110,965)	(67,906)	(135,736)	(314,607)
Net Increase in Cash and Cash Equivalents	\$ (15,837)	\$ (1,495)	\$ 68,521	\$ 51,189
Cash and Cash Equivalents at Beginning of Period	97,567	1,554	106,630	205,751
Cash and Cash Equivalents at End of Period	\$ 81,730	\$ 59	\$ 175,151	\$ 256,940

**Statement of Cash Flows**

	Three Months Ended March 31, 2003			
	Guarantor	KEDLI	Other Subsidiaries	Consolidated
<b>Operating Activities</b>				
Net Cash Provided by (Used in) Operating Activities	\$ 239,598	\$ 121,439	\$ 135,790	\$ 496,827
<b>Investing Activities</b>				
Capital expenditures	-	(25,941)	(194,838)	(220,779)
Cost of removal	-	(420)	(6,518)	(6,938)
Proceeds from monetization of Houston Exploration	79,200	-	-	79,200
Net Cash Used in Investing Activities	79,200	(26,361)	(201,356)	(148,517)
<b>Financing Activities</b>				
Treasury stock issued	26,307	-	-	26,307
Equity issuance	473,573	-	-	473,573
Redemption of promissory notes	(447,005)	-	-	(447,005)
Payment of debt, net	(238,365)	-	(33,404)	(271,769)
Common and preferred stock dividends paid	(65,018)	-	-	(65,018)
Other	7,153	-	1,894	9,047
Net intercompany accounts	(73,193)	(87,265)	160,458	-
Net Cash Provided by (Used in) Financing Activities	(316,548)	(87,265)	128,948	(274,865)
Net Increase (Decrease) in Cash and Cash Equivalents	\$ 2,250	\$ 7,813	\$ 63,382	\$ 73,445
Cash and Cash Equivalents at Beginning of Period	88,308	6,472	75,837	170,617
Cash and Cash Equivalents at End of Period	\$ 90,558	\$ 14,285	\$ 139,219	\$ 244,062

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Consolidated Review of Results

The following is a summary of transactions affecting comparative earnings and a discussion of material changes in revenues and expenses during the three months ended March 31, 2004, compared to the three months ended March 31, 2003. Capitalized terms used in the following discussion, but not otherwise defined, have the same meaning as when used in the Notes to the Consolidated Financial Statements included under Item 1. References to "KeySpan," "we," "us," and "our" mean KeySpan Corporation, together with its consolidated subsidiaries.

Operating income by segment, as well as consolidated earnings available for common stock is set forth in the following table for the periods indicated.

<i>(In Thousands of Dollars, Except per Share)</i>		
Quarter Ended March 31,	2004	2003
Gas Distribution	\$ 379,653	\$ 364,937
Electric Services	47,200	39,644
Energy Services	(18,474)	(9,122)
Energy Investments	75,030	65,714
Eliminations and other	3,267	(4,479)
<b>Operating Income</b>	<b>486,676</b>	<b>456,694</b>
Interest charges	(84,066)	(68,939)
Other income and (deductions)	(17,532)	(1,831)
Income taxes	137,382	142,833
<b>Income before cumulative effect of a change in accounting principle</b>	<b>247,696</b>	<b>243,091</b>
Cumulative effect of a change in accounting principle	-	174
<b>Net Income</b>	<b>247,696</b>	<b>243,265</b>
Preferred stock dividend requirements	1,461	1,461
<b>Earnings for Common Stock</b>	<b>\$ 246,235</b>	<b>\$ 241,804</b>
Basic Earnings per Share		
Income before cumulative effect of a change in accounting principle	\$ 1.54	\$ 1.54
Change in accounting principle	-	-
	<b>\$ 1.54</b>	<b>\$ 1.54</b>

As indicated in the above table, operating income increased \$30 million, or 7%, for the quarter ended March 31, 2004, compared to the corresponding period last year. The increase in operating income reflects higher earnings from the Gas Distribution, Energy Investments and Electric Services segments, somewhat offset by a decrease in earnings from the Energy Services segment. The Gas Distribution segment benefited from oil-to-gas conversions throughout all our service territories, as well as from a rate increase resulting from the Boston Gas Company rate proceeding concluded last fall. In the Energy Investment segment, higher gas production volumes and realized gas prices

resulted in an increase in operating income associated with gas exploration and production activities, while the Electric Services segment benefited from generally lower operating costs. Operating results for the Energy Services segment reflects higher operating costs. (See the discussion under the caption “Review of Operating Segments” for further details on each segment.)

The increase in interest expense of \$15.1 million, or 22%, reflects the benefits realized in 2003 associated with interest rate swaps. In February 2003, we terminated an interest rate swap agreement with a notional amount of \$270 million. This swap was used to hedge a portion of outstanding promissory notes that were issued to the Long Island Power Authority (“LIPA”) in connection with the KeySpan/Long Island Lighting Company (“LILCO”) business combination completed in May 1998. In March 2003, we called approximately \$447 million of the outstanding promissory notes and recorded debt redemption charges of \$18.2 million in other income and (deductions). The cash proceeds from the termination of the interest rate hedge were \$18.4 million, of which \$8.1 million represented accrued swap interest. The difference between the termination settlement amount and the amount of accrued swap interest, \$10.3 million, was recorded to earnings (as an adjustment to interest expense) in the first quarter of 2003 and effectively offset a portion of the redemption charges. Further, in December 2003, KeySpan implemented FASB Interpretation No. 46 (“FIN 46”), “Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51.” This Interpretation required us to, among other things, consolidate the Ravenswood Master Lease and classify the lease obligation as long-term debt on the Consolidated Balance Sheet based on our current status as primary beneficiary. As a result of implementing FIN 46, beginning January 1, 2004 lease payments have been reflected as interest expense on the Consolidated Statement of Income resulting in an increase to interest expense of \$7.5 million for the first quarter of 2004.

Other income and (deductions) includes minority interest adjustments of \$20.3 million and \$18.1 million for the first quarter of 2004 and 2003, respectively, related to our ownership interest in The Houston Exploration Company (“Houston Exploration”) our gas exploration and production subsidiary, as well as our ownership interest in KeySpan Canada, which owns natural gas processing facilities in western Canada. On April 1, 2004 KeySpan completed the sale of an additional 36% interest in KeySpan Canada. KeySpan’s ownership interest in KeySpan Canada is now 25%. (See Note 2 to the Consolidated Financial Statements “Business Segments” for additional details.)

In addition to the debt redemption charges noted above, other income and (deductions) for the first quarter of 2003 also includes a gain of \$19.0 million reflecting the monetization of a portion of our ownership interest in Houston Exploration. In February 2003, we reduced our ownership interest in Houston Exploration from 66% to approximately 55% following the repurchase, by Houston Exploration, of three million shares of common stock owned by KeySpan. Income taxes were not provided on this transaction, since the transaction was structured as a return of capital. Further, during the first quarter of 2003 Houston Exploration recorded a \$10.6 million severance tax refund for severance taxes paid in 2002 and earlier periods, which has also been reflected in other income and (deductions).

Income tax expense for the first quarter of 2004 generally reflects the level of pre-tax income and a \$6.0 million benefit to income taxes resulting from a revised appraisal associated with property that was disposed of in 2003.

Earnings available for common stock for the three months ended March 31, 2004, increased by \$4.4 million, or 2%, compared to the same period last year. Earnings per share, however, remained the same as last year since average common shares outstanding for the quarter ended March 31, 2004 increased by 2%, reflecting the re-issuance of shares held in treasury pursuant to dividend reinvestment and employee benefit plans. This increase in average common shares outstanding reduced first quarter 2004 earnings per share by \$0.03 compared to the corresponding period in 2003.

Consistent with our prior earnings guidance, KeySpan's consolidated earnings for 2004 are forecasted to be in the range of \$2.55 to \$2.75 per share, excluding special items. Earnings from continuing core operations (defined for this purpose as all continuing operations other than exploration and production, less preferred stock dividends) are forecasted to be in the range of \$2.20 to \$2.30 per share, while earnings from exploration and production operations are forecasted to be in the range of \$0.35 to \$0.45 per share.

Consolidated earnings are seasonal in nature due to the significant contribution to earnings of the gas distribution operations. As a result, we expect to earn most of our annual earnings in the first and fourth quarters of the fiscal year.

### **Review of Operating Segments**

In response to new disclosure regulations adopted by the Securities and Exchange Commission as part of its implementation of the Sarbanes-Oxley Act of 2002 – specifically Regulation G which became effective March 2003 – we report all of KeySpan's segment results on an Operating Income basis. Management believes that this Generally Accepted Accounting Principle (GAAP) based measure provides a reasonable indication of KeySpan's underlying performance associated with its operations. The following is a discussion of financial results achieved by KeySpan's operating segments presented on an operating income basis.

### **Gas Distribution**

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

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

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Revenues	\$ 1,927,779	\$ 1,832,701
Cost of gas	1,226,573	1,154,132
Revenue taxes	34,755	38,616
Net Revenues	666,451	639,953
Operating Expenses		
Operations and maintenance	172,399	166,090
Depreciation and amortization	76,940	70,817
Operating taxes	37,459	38,109
Total Operating Expenses	286,798	275,016
Operating Income	\$ 379,653	\$ 364,937
Firm gas sales and transportation (MDTH)	154,316	154,627
Transportation - Electric Generation (MDTH)	4,139	5,003
Other Sales (MDTH)	52,956	54,709
Warmer (Colder) than Normal - New York	(6.0)%	(8.5)%
Warmer (Colder) than Normal - New England	(9.4)%	(10.0)%

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

### *Net Revenues*

Net gas revenues (revenues less the cost of gas and associated revenue taxes) from our gas distribution operations increased by \$26.5 million, or 4%, in the first quarter of 2004 compared to same quarter last year. Net gas revenues benefited from customer additions and oil-to-gas conversions, as well as from a rate increase resulting from the Boston Gas Company's rate proceeding that was concluded in the fourth quarter of 2003. As measured in heating degree days, weather for the first quarter of 2004 in our New York and New England service territories was approximately 6% and 9% colder than normal, respectively, compared to approximately 9% and 10% colder than normal last year, respectively. Weather was approximately 2% warmer than last year across KeySpan's service territories.

Net revenues from firm gas customers (residential, commercial and industrial customers) in our New York service territory increased by \$13.1 million for the first quarter of 2004 compared to the same period last year. Customer additions and oil-to-gas conversions, net of attrition and conservation, added \$9.4 million to net gas revenues. Further, we realized a \$3.5 million benefit to net gas revenues as a result of an additional billing day in the leap year. Weather, which was slightly warmer than last year, resulted in an adverse impact to comparative net gas revenues of \$1.9 million. KEDNY and KEDLI each operate under a utility tariff that contains a weather normalization adjustment that significantly offsets variations in firm net revenues due to fluctuations in normal weather. Since weather was colder than normal we refunded to firm customers \$13 million through the weather normalization adjustment. Also included in net gas revenues is the recovery of property

taxes that added \$2.1 million to net revenues during the first quarter of 2004. These revenues, however, do not impact net income since the taxes they are designed to recover are expensed as amortization charges on the Consolidated Statement of Income. Firm gas distribution rates for KEDNY and KEDLI in the first quarter of 2004, other than for the recovery of gas costs, have remained substantially unchanged from rates charged last year.

Net revenues from firm gas customers in our New England service territory increased by \$21.1 million for the first quarter of 2004 compared to the same period last year. Customer additions and oil-to-gas conversions, net of attrition and conservation, added \$3.5 million to net gas revenues. Further, we realized a \$2.2 million benefit in net gas revenues as a result of an additional billing day for leap year. As mentioned, the Massachusetts Department of Telecommunications and Energy (“DTE”) approved a \$27 million base rate increase for the Boston Gas Company, which became effective November 1, 2003. This rate increase resulted in a benefit to net gas revenues of \$10.6 million during the first quarter of 2004. (See the caption under “Regulation and Rate Matters” for further information regarding the rate filing.) The gas distribution operations of our New England based subsidiaries do not have a weather normalization adjustment. Weather, which was slightly warmer than last year, resulted in an adverse impact to comparative net gas revenues of \$3.0 million. To mitigate the effect of fluctuations in normal weather patterns on KEDNE’s results of operations and cash flows, weather derivatives were in place for the 2003/2004 winter heating season. Since weather during the first quarter of 2004 was approximately 9% colder than normal in the New England service territories, we recorded a \$4.1 million reduction to revenues to reflect the loss on these derivative transactions. Similarly, in 2003 we recorded an \$11.9 million reduction to revenues. As a result of these transactions, comparative net revenues were favorably impacted by \$7.8 million (See Note 4 to the Consolidated Financial Statements “Hedging and Derivative Financial Instruments” for further information).

In our large-volume heating and other interruptible (non-firm) markets, which include large apartment houses, government buildings and schools, gas service is provided under rates that are designed to compete with prices of alternative fuel, including No. 2 and No. 6 grade heating oil. These “dual-fuel” customers can consume either natural gas or fuel oil for heating purposes. Net revenues in these markets decreased \$7.7 million during the first quarter of 2004 compared to same period last year. This decrease reflects a lower quantity of gas sales to customers within this market due, in part, to customers heating with an alternative fuel. Further, since weather during January 2004 was significantly colder than normal and last year, KeySpan discontinued sales service to a segment of its dual-fuel customers for a number of days during the month, as permitted under its tariff and directed by the New York State Public Service Commission to ensure reliable service to firm customers. The majority of interruptible profits earned by KEDNE and KEDLI are returned to firm customers as an offset to gas costs.

We are committed to our expansion strategies initiated during the past few years. We believe that significant growth opportunities exist on Long Island and in our New England service territories. We estimate that on Long Island approximately 36% of the residential and multi-family markets, and approximately 58% of the commercial market, currently use natural gas for space heating. Further, we estimate that in our New England service territories approximately 53% of the residential and multi-family markets, and approximately 63% of the commercial market, currently use natural gas

for space heating purposes. We will continue to seek growth, in all our market segments, through the expansion of our gas distribution system, as well as through the conversion of residential homes from oil-to-gas for space heating purposes and the pursuit of opportunities to grow multi-family, industrial and commercial markets.

#### *Firm Sales, Transportation and Other Quantities*

Firm gas sales and transportation quantities for the quarter ended March 31, 2004 were consistent with such quantities for same period in 2003. Net revenues are not affected by customers opting to purchase their gas supply from other sources, since delivery rates charged to transportation customers generally are the same as delivery rates charged to full sales service customers. Transportation quantities related to electric generation reflect the transportation of gas to our electric generating facilities located on Long Island. Net revenues from these services are not material.

Other sales quantities include on-system interruptible quantities, off-system sales quantities (sales made to customers outside of our service territories) and related transportation. We have an agreement with Coral Resources, L.P. (“Coral”), a subsidiary of Shell Oil Company, under which Coral assists in the origination, structuring, valuation and execution of energy-related transactions on behalf of KEDNY and KEDLI. We also have a portfolio management contract with Entergy Koch Trading, LP (“EKT”), under which EKT provides all of the city gate supply requirements at market prices and manages certain upstream capacity, underground storage and term supply contracts for KEDNE. These agreements expire on March 31, 2006.

#### *Purchased Gas for Resale*

The increase in gas costs for the first quarter of 2004 compared to the first quarter of 2003 of \$72.4 million, or 6%, reflects an increase of 9% in the price per dekatherm of gas purchased, and a 2% decrease in the quantity of gas purchased. The current gas rate structure of each of our gas distribution utilities includes a gas adjustment clause, pursuant to which variations between actual gas costs incurred for resale to firm sales customers and gas costs billed to firm sales customers are deferred and refunded to or collected from customers in a subsequent period.

### *Operating Expenses*

Operating expenses during the first quarter of 2004 compared to the same quarter last year have increased by \$11.8 million, or 4%. The increase in operating expense is attributable, in part, to higher pension and other postretirement benefits which increased by \$4.1 million, net of amounts subject to regulatory deferral accounting treatment, over the level incurred in 2003. The cost of these benefits has risen primarily as a result of increased health care costs. In addition, the bad debt reserve has increased primarily as a result of higher account receivables due to higher cost of gas purchased. Higher depreciation and amortization expense reflects the continued expansion of the gas distribution system.

### *Other Matters*

In order to serve the anticipated market requirements in our New York service territories, KeySpan and Duke Energy Corporation formed Islander East Pipeline Company, LLC ("Islander East") in 2000. Islander East is owned 50% by KeySpan and 50% by Duke Energy, and was created to pursue the authorization and construction of an interstate pipeline from Connecticut, across Long Island Sound, to a terminus near Northport, Long Island. Applications for all necessary regulatory authorizations were filed in 2000 and 2001. To date, Islander East has received a final certificate from the Federal Energy Regulatory Commission ("FERC") and all necessary permits from the State of New York. However, the State of Connecticut has denied Islander East's application for a coastal zone management permit and a permit under Section 401 of the Clean Water Act. Islander East has reinstated its appeal of the State of Connecticut's determination on the coastal zone management issue to the United States Department of Commerce. On April 16, 2004, Islander East filed a petition for a declaratory order challenging the denial of the Section 401 permit with the State of Connecticut's Department of Environmental Protection. Once in service, the pipeline is expected to transport up to 260,000 DTH daily to the Long Island and New York City energy markets, enough natural gas to heat 600,000 homes. The pipeline will also allow KeySpan to diversify the geographic sources of its gas supply. However, we are unable to predict when or if all regulatory approvals required to construct this pipeline will be obtained. Various options for the financing of pipeline construction are currently being evaluated. At March 31, 2004, total expenditures associated with the siting and permitting of the Islander East pipeline were \$17.7 million.

### **Electric Services**

The Electric Services segment primarily consists of subsidiaries that own and operate oil and gas fired electric generating plants in the Borough of Queens (including the "Ravenswood facility") and the counties of Nassau and Suffolk on Long Island. In addition, through long-term contracts of varying lengths, we manage the electric transmission and distribution ("T&D") system, the fuel and electric purchases, and the off-system electric sales for LIPA. The Electric Services segment also provides retail marketing of electricity to commercial customers, the earnings of which were previously reported in the Energy Services segment. Financial results for 2003 have been restated to reflect these activities in the Electric Services segment.

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

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Revenues	\$ 359,136	\$ 397,725
Purchased fuel	101,489	139,421
Net Revenues	257,647	258,304
Operating Expenses		
Operations and maintenance	147,185	164,401
Depreciation	21,605	16,620
Operating taxes	41,657	37,639
Total Operating Expenses	210,447	218,660
Operating Income	\$ 47,200	\$ 39,644
Electric sales (MWH)*	983,106	767,349
Capacity(MW)*	2,450	2,200
Cooling degree days	N/A	N/A

\*Reflects the operations of the Ravenswood facility only.

### *Net Revenues*

Total electric net revenues realized during the first quarter of 2004 were comparable to such revenues realized during the first quarter of 2003.

Net revenues from the Ravenswood facility for the first quarter of 2004 were consistent with net revenues realized in the first quarter of 2003. Comparative net revenues reflect higher energy margins of \$3.4 million, offset by a decrease in capacity revenues of \$3.3 million. The increase in energy margins reflects a higher level of megawatt hours (“MWh”) sold into the New York Independent System Operator (“NYISO”) energy market. Energy sales quantities during the first quarter of 2003 were adversely impacted by the scheduled major overhaul of our largest electric generating unit.

We employ derivative financial hedging instruments to hedge the cash flow variability for a portion of forecasted purchases of natural gas and fuel oil consumed at the Ravenswood facility. Further, we have engaged in the use of derivative financial hedging instruments to hedge the cash flow variability associated with a portion of forecasted peak electric energy sales from the Ravenswood facility. These derivative instruments resulted in hedging losses, which are reflected in net electric margins, of \$4.4 million for the quarter ended March 31, 2004, compared to hedging gains of \$1.6 million for the for the quarter ended March 31, 2003. (See Note 4 to the Consolidated Financial Statements “Hedging and Derivative Financial Instruments” as well as Item 3. Quantitative and Qualitative Disclosures about Market Risk for further information).

The decrease in capacity revenues reflects a revision to the NYISO's capacity market procurement design. In 2003, the FERC approved a revised capacity market procurement design with an effective date of May 21, 2003. This revised capacity market procurement design is based on a demand curve rather than relying on deficiency auctions to procure necessary capacity. The deficiency auction with its associated fixed minimum capacity requirements was replaced with a spot market auction that pays gradually declining prices as additional capacity is offered and gradually increasing prices as

capacity offers decrease. This new market design recognizes the value of capacity in excess of the minimum requirement and reduces price spikes during periods of shortage. Essentially, the demand curve design eliminates the high and low cycles inherent in the deficiency auction market design. This new market design also established seasonal electric generator specific price caps. Price caps establish the maximum price per MW that capacity can be sold into the NYISO by divested electric generators like Ravenswood. Prior to this design change, one price cap was established for the entire year and was effective for all electric generators. As a result of this re-design, Ravenswood's 2003/2004 structured winter price cap was lower than the yearly price cap effective during the 2002/2003 winter, which was prior to the implementation of the new demand curve methodology, resulting in lower capacity revenues.

The rules and regulations for capacity, energy sales and the sale of certain ancillary services to the NYISO energy markets continue to evolve and the FERC has adopted several price mitigation measures that have adversely impacted earnings from the Ravenswood facility over time. Certain of these mitigation measures are still subject to rehearing and possible judicial review. The final resolution of these issues and their effect on our financial position, results of operations and cash flows cannot be fully determined at this time. (See KeySpan's 2003 Annual Report on Form 10K for the Year Ended December 31, 2003 Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "Market and Credit Risk Management Activities" for a further discussion of these matters.)

Net revenues for the first quarter of 2004 from the service agreements with LIPA, including the power purchase agreements associated with two electric peaking facilities, were comparable to such revenues earned during the first quarter of 2003. (For a description of the LIPA Agreements and power purchase agreements, see KeySpan's 2003 Annual Report on Form 10K for the Year Ended December 31, 2003 Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "Electric Services – Revenue Mechanisms.")

### *Operating Expenses*

Operating expenses decreased by \$8.2 million, or 4%, in the first quarter of 2004 compared to the same quarter of 2003. This decrease reflects in part, the implementation of FIN 46. As previously mentioned, this Interpretation, which KeySpan implemented in December 2003, required KeySpan to, among other things, consolidate the Ravenswood Master Lease and classify the lease obligation as long-term debt on the Consolidated Balance Sheet. Further, an asset was recorded on the Consolidated Balance Sheet for an amount substantially equal to the fair market value of the leased assets at the inception of the lease, less depreciation since that date. As a result of implementing FIN 46, beginning January 1, 2004 lease payments have been reflected as interest expense on the Consolidated Statement of Income and the leased assets are being depreciated. The reclassification of lease payments to interest expense, partially offset by the higher depreciation expense, resulted in a comparative decrease to operating expense of approximately \$3 million. (See Note 6 to the Consolidated Financial Statements "Financial Guarantees and Contingencies" for additional information regarding the Ravenswood leasing arrangement.) The remaining decrease in comparative operating expenses reflects lower repair and maintenance costs on our electric generating units, as well as the timing of certain costs related to the LIPA service agreements.

### *Other Matters*

During 2002, construction began on a new 250 MW combined cycle generating facility at the Ravenswood facility site. The new facility was synchronized to the electric grid in December 2003 and commenced operational testing in January 2004. In March, the facility completed full load Dependable Maximum Net Capacity testing. The capacity and energy produced from this plant are anticipated to be sold into the NYISO energy markets during the second quarter of 2004.

KeySpan is currently in the process of structuring a leveraged lease financing for this new generating facility. KeySpan is seeking to close this transaction to coincide with the commencement of full commercial operation of the new facility. At the closing, the new facility will be acquired by the lessor from our subsidiary, KeySpan Ravenswood, LLC, and simultaneously leased back to it. All obligations of our subsidiary under the lease will be unconditionally guaranteed by KeySpan. We anticipate that this lease transaction will generate cash proceeds generally equivalent to the fair market value of the facility, as determined by a third-party appraiser. It is expected that the cash proceeds from this transaction will be used to redeem outstanding commercial paper. This lease transaction is intended to qualify as an operating lease under SFAS 98 "Accounting for Leases: Sale/Leaseback Transactions Involving Real Estate; Sales-Type Leases of Real Estate; Definition of the Lease Term; an Initial Direct Costs of Direct Financing Leases, an amendment of FASB Statements No.13, 66, 91 and a rescission of FASB Statement No. 26 and Technical Bulletin No. 79-11." The lease will have an initial term of 36 years and operating lease expense is anticipated to be between \$15 million to \$17 million per year. Lease payments will fluctuate from year to year, but are substantially paid over the first 16 years.

In 2003, the New York State Board on Electric Generation Siting and the Environment issued an opinion and order which granted a certificate of environmental capability and public need for a 250 MW combined cycle electric generating facility in Melville, Long Island, which is now final and non-appealable. Also in 2003, LIPA issued a Request for Proposal ("RFP") seeking bids from developers to either build and operate a Long Island generating facility, and/or a new cable that will link Long Island to dedicated off-Long Island power of between 250 to 600 MW of electricity by no later than the summer of 2007. KeySpan and American National Power Inc. ("ANP") filed a joint proposal in response to LIPA's RFP. Under the proposal, KeySpan and ANP will jointly own and operate two 250 MW electric generating facilities to be located on Long Island, one of which is the Melville site and the other in the town of Brookhaven which also has received all permits and approvals. It is anticipated that LIPA will respond to the joint proposal in the second quarter of 2004. At March 31, 2004, total expenditures associated with the siting, permitting and construction of the

Ravenswood expansion project, and the siting, permitting and procurement of equipment for the Long Island 250 MW combined cycle electric generating facility were approximately \$400 million.

As part of our growth strategy, we continually evaluate the possible acquisition and development of additional generating facilities in the Northeast. However, we are unable to predict when or if any such facilities will be acquired and the effect any such acquired facilities will have on our financial condition, results of operations or cash flows.

## Energy Services

The Energy Services segment includes subsidiaries that provide energy-related and a minimal amount of fiber optic services to customers primarily located within the Northeastern United States, with concentrations in the New York City metropolitan area including New Jersey and Connecticut, as well as Rhode Island, Pennsylvania, Massachusetts and New Hampshire, through the following lines of business: (i) Home Energy Services, which provides residential and small commercial customers with service and maintenance of energy systems and appliances; (ii) Business Solutions, which provides plumbing, heating, ventilation, air conditioning and mechanical services, as well as operation and maintenance, design, engineering and consulting services to commercial and industrial customers.

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

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Revenues	\$ 132,495	\$ 130,491
Less: cost of sales	105,870	105,145
Gross profit	26,625	25,346
Operating expenses	45,099	34,468
Operating (Loss)	\$ (18,474)	\$ (9,122)

The Energy Services segment realized additional operating losses of \$9.4 million for the three months ended March 31, 2004 compared to the same period last year. The increase in operating expenses principally reflects the write-off of accounts receivable and contract revenues on certain projects that were determined to be uncollectible, as well as the write-down of inventory balances. The increase in gross profit margin is primarily a result of the operations of Bard, Rao + Athanas Consulting Engineers LLC (“BR+A”) which was acquired in the third quarter of 2003. Total backlog for the KeySpan Services group of companies increased to \$508 million compared to \$479 million at March 31, 2003, primarily due to the BR+A acquisition.

The operating results of this segment continue to be below expectations. Management will continue to monitor the operating performance of this segment and will conduct a review of the carrying value of goodwill during the year. The recorded goodwill for this segment, as a result of prior acquisitions, is approximately \$171 million. At this point in time, we are unable to predict what effect, if any, the outcome of this review will have on the carrying value of our goodwill or on financial position or results of operations.

## Energy Investments

The Energy Investment segment consists of our gas exploration and production operations, certain other domestic and international energy-related investments, as well as certain technology related investments. Our gas exploration and production subsidiaries include our 55% ownership interest in The Houston Exploration Company (“Houston Exploration”) and our wholly-owned subsidiary

KeySpan Exploration and Production LLC (“KES E&P”). These companies are engaged in gas and oil exploration and production, and the development and acquisition of domestic natural gas and oil properties.

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

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Revenues	\$ 152,419	\$ 127,847
Depletion and amortization expense	61,921	47,443
Other operating expenses	28,390	24,814
<b>Operating Income</b>	<b>\$ 62,108</b>	<b>\$ 55,590</b>
Natural gas and oil production (Mmcf)	30,373	26,086
Natural gas (per Mcf) realized	\$ 4.99	\$ 4.93
Natural gas (per Mcf) unhedged	\$ 5.43	\$ 6.35

\*Operating income above represents 100% of our gas exploration and production subsidiaries' results for the periods indicated. Gas reserves and production are stated in BCFe and Mmcf, which includes equivalent oil reserves.

The increase in operating income of \$6.5 million or 12% for the three months ended March 31, 2004 compared to the same period of 2003, primarily reflects an increase in revenues offset, to some extent, by an increase in operating expenses associated with a higher depletion rate. Revenues for the first quarter of 2004 benefited from a 16% increase in production volumes, a slight increase in average realized gas prices (average wellhead price received for production including hedging gains and losses), as well as from the comparative impact of derivative hedging instruments.

Derivative financial hedging instruments are employed by Houston Exploration to provide more predictable cash flow, as well as to reduce its exposure to fluctuations in natural gas prices. The average realized gas price for the three months ended March 31, 2004 was 92% of the average unhedged natural gas price, resulting in revenues that were \$12.5 million lower than revenues that would have been achieved if derivative financial instruments had not been in place. Houston Exploration has hedge positions in place for slightly less than 70% of its estimated 2004 production, principally through the use of costless collars. Further, at March 31, 2004, Houston Exploration has derivative financial instruments in place for approximately 60% of its estimated 2005 production. The average realized gas price for the first quarter of 2003 was 77% of the average unhedged natural gas price, resulting in revenues that were approximately \$35 million lower than revenues that would have been achieved if derivative financial instruments had not been in place. Houston Exploration hedged almost 70% of its 2003 first quarter production, principally through the use of costless collars. (See Note 4 to the Consolidated Financial Statements, “Hedging and Derivative Financial Instruments” as well as Item 3. Quantitative and Qualitative Disclosures about Market Risk for further information.)

The depletion rate experienced during the first quarter of 2004 was \$2.04 per Mcf, compared to \$1.76 per Mcf experienced during the corresponding quarter last year. The increase in the depletion rate is the result of additional costs to Houston Exploration’s depreciation base with fewer additions for reserves.

The table below indicates the net proved reserves of the gas exploration and production subsidiaries at December 31, 2003.

	BCFe	%
Houston Exploration	755	99.1%
KSE E&P	7	0.9%
Total	762	100.0%

This segment also consists of KeySpan Canada; our 20% interest in Iroquois Gas Transmission System LP (“Iroquois”); our wholly owned 600,000 barrel liquefied natural gas (“LNG”) storage and receiving facility located in Rhode Island (“KeySpan LNG”); and our 50% interest in Premier Transmission Limited located in Northern Ireland.

Selected financial data and operating statistics for these energy-related investments are set forth in the following table for the periods indicated.

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Revenues	\$ 28,445	\$ 26,464
Less: Operation and maintenance expense	15,388	16,644
Other operating expenses	5,852	5,353
Add: Equity earnings	5,717	5,657
Operating Income	\$ 12,922	\$ 10,124

\*Operating income above reflects 100% of KeySpan’s Canada’s results.

The increase in operating income in the first quarter of 2004, compared to the same period last year, primarily reflects higher operating income associated with our Canadian investments. KeySpan Canada experienced higher unit sales, as well as higher quantities of sales of natural gas liquids, as a result of increasing oil prices. The pricing of natural gas liquids is directly related to oil prices. We do not consider certain businesses contained in the Energy Investments segment to be part of our core asset group.

On April 1, 2004, The KeySpan Facilities Income Fund (the “Fund”) issued 15.617 million units at a price of \$12.60 per unit for gross total proceeds of approximately CDN\$196.8 million. The proceeds of the offering were used to acquire a 35.91% interest in the business of KeySpan Canada from KeySpan. KeySpan received net proceeds of approximately CDN\$186.3 million (or approximately US\$140 million), after commissions and expenses. The Fund’s ownership in KeySpan Canada has now increased from 39.1% to approximately 75%. KeySpan’s ownership of KeySpan Canada is now approximately 25%. KeySpan expects to record a pre-tax gain of approximately \$20 million on this transaction, which will be reflected in earnings in the second quarter of 2004. The proceeds from the transaction will be used to redeem outstanding debt.

We have stated in the past that we may sell or otherwise dispose of all or a portion of our non-core assets. Based on current market conditions, however, we cannot predict when, or if, any additional

sales or dispositions of our non-core assets may take place, or the effect that any such additional sale or disposition may have on our financial position, results of operations or cash flows.

### **Allocated Costs**

We are subject to the jurisdiction of the Securities and Exchange Commission (“SEC”) under the Public Utility Holding Company Act (“PUHCA”) as amended. As part of the regulatory provisions of PUHCA, the SEC regulates various transactions among affiliates within a holding company system. In accordance with the SEC’s regulations under PUHCA and the New York State Public Service Commission, we have service companies that provide: (i) traditional corporate and administrative services; (ii) gas and electric transmission and distribution systems planning, marketing, and gas supply planning and procurement; and (iii) engineering and surveying services to subsidiaries. During the first quarter of 2003, these non-operating subsidiaries incurred expenses related to consulting, auditing and legal costs associated with the implementation of the Sarbanes-Oxley Act that were not allocated to the various operating subsidiaries. Further, the operating income variation as reflected in “elimination and other” is due, in part, to the timing of certain corporate expenses.

### **Liquidity**

Cash flow from operations increased \$82.3 million, or 17%, in the first quarter of 2004 compared to the same time last year, reflecting generally higher cash earnings and higher cash flow from gas exploration and production activities. In addition, during the first quarter of 2004, we consolidated our newly created “captive” insurance company, which included \$43.2 million of cash and short-term marketable securities.

At March 31, 2004, we had cash and temporary cash investments of \$256.9 million. During the three months ended March 31, 2004, we repaid \$187.8 million of commercial paper and, at March 31, 2004, \$294.2 million of commercial paper was outstanding at a weighted average annualized interest rate of 1.1%. We had the ability to borrow up to an additional \$1 billion at March 31, 2004, under the terms of our credit facility.

KeySpan has a \$1.3 billion revolving credit facility, syndicated among sixteen banks. The facility is used to support KeySpan’s commercial paper program, and consists of two separate credit facilities with different maturities but substantially similar terms and conditions: a \$450 million facility that extends for 364 days (or until June 25, 2004), and a \$850 million facility that is committed for three years. The fees for the facilities are subject to a ratings-based grid, with an annual fee that ranges from eight to twenty five basis points on the 364-day facility and ten to twenty basis points on the three-year facility. Both credit agreements allow for KeySpan to borrow using several different types of loans; specifically, Eurodollar loans, ABR loans, or competitively bid loans. Eurodollar loans are based on the Eurodollar rate plus a margin. ABR loans are based on the highest of the Prime Rate, the base CD rate plus 1%, or the Federal Funds Effective Rate plus 0.5%, plus a margin. Competitive bid loans are based on bid results requested by KeySpan from the lenders. The margins on both facilities are ratings based and range from zero basis points to 112.5 basis points. The margins are increased if outstanding loans are in excess of 33% of the total facility. In addition, the

364-day facility has a one-year term out option, which would cost an additional 0.25% if utilized. We do not anticipate borrowing against this facility; however, if the credit rating on our commercial paper program were to be downgraded, it may be necessary to do so.

The credit facility contains certain affirmative and negative operating covenants, including restrictions on KeySpan's ability to mortgage, pledge, encumber or otherwise subject its property to any lien, as well as certain financial covenants that require us to, among other things, maintain a consolidated indebtedness to consolidated capitalization ratio of no more than 64%. Violation of this covenant could result in the termination of the credit facility and the required repayment of amounts borrowed thereunder, as well as possible cross defaults under other debt agreements.

Under the terms of the credit facility, KeySpan's debt-to-total capitalization ratio reflects 80% equity treatment for the MEDS Equity Units issued in 2002. At March 31, 2004, consolidated indebtedness, as calculated under the terms of the credit facility was 56.1% of consolidated capitalization.

The credit facility also requires that net cash proceeds from the sale of significant subsidiaries be applied to reduce consolidated indebtedness. Further, an acceleration of indebtedness of KeySpan or one of its subsidiaries for borrowed money in excess of \$25 million in the aggregate, if not annulled within 30 days after written notice, would create an event of default under the Indenture dated November 1, 2000, between KeySpan Corporation and the JPMorganChase Bank as Trustee. At March 31, 2004, KeySpan was in compliance with all covenants.

Houston Exploration had a revolving credit facility with a commercial banking syndicate that provided Houston Exploration with a commitment of \$300 million. The credit facility was amended on April 1, 2004 and, as amended, provides Houston Exploration with a commitment of \$400 million which may be increased with prior approval from the banking syndicate to a maximum of \$450 million. The credit facility is subject to borrowing base limitations. Pursuant to the April 1, 2004 amendment, the borrowing base was increased from \$300 million to \$375 million. The \$375 million borrowing base is expected to remain in effect until the next scheduled redetermination on October 1, 2004. Up to \$40 million of the borrowing base is now available for the issuance of letters of credit. Outstanding borrowings continue to be unsecured and with the exception of trade payables, the facility ranks senior to Houston Exploration's \$175 million 7% subordinated notes. The amended facility matures on April 1, 2008

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

Financial covenants under the new facility require Houston Exploration to, among other things, (i) maintain an interest coverage ratio of at least 3.00 to 1.00 of earnings before interest, taxes and depreciation ("EBITDA") to cash interest; (ii) maintain a total debt to EBITDA ratio of not more

than 3.50 to 1.00; and (iii) generally prohibits the hedging of more than 85% of natural gas and oil production during any 12-month period. At March 31, 2004, Houston Exploration was in compliance with all financial covenants.

During the first quarter of 2004, Houston Exploration borrowed \$20 million under its credit facility and repaid \$77 million. At March 31, 2004, \$70 million of borrowings remained outstanding at a weighted average annualized interest rate of 3.27%. Also, \$0.4 million was committed under outstanding letters of credit obligations. Currently, Houston Exploration has \$304.6 million of borrowing capacity available to it.

KeySpan Canada has a credit facility that has two tranches with the following maturities: (i) \$37.5 million matures in 364 days; and (ii) \$37.5 million matures in two years. During the first quarter of 2004, KeySpan Canada repaid \$17.7 million under the facility and at March 31, 2004, \$57.3 million was available for future borrowing.

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

We satisfy our seasonal working capital requirements primarily through internally generated funds and the issuance of commercial paper. We believe that these sources of funds are sufficient to meet our seasonal working capital needs.

## Capital Expenditures and Financing

### *Construction Expenditures*

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

<i>(In Thousands of Dollars)</i>	Three Months Ended March 31,	
	2004	2003
Gas Distribution	\$ 82,235	\$ 78,013
Electric Services	36,617	56,731
Energy Investments	97,215	84,309
Energy Services and other	4,157	1,726
	\$ 220,224	\$ 220,779

Construction expenditures related to the Gas Distribution segment are primarily for the renewal, replacement and expansion of the distribution system. Construction expenditures for the Electric Services segment reflect costs to: (i) maintain our generating facilities; and (ii) expand the Ravenswood facility. Construction expenditures related to the Energy Investments segment primarily reflect costs associated with gas exploration and production activities. Expenditures also include development costs associated with the joint venture with Houston Exploration, as well as costs related to KeySpan Canada's gas processing facilities.

## Financing

KeySpan did not engage in any financing transactions during the first quarter of 2004. However, we anticipate replacing outstanding commercial paper used to finance the construction of a new 250 MW combined cycle generating facility at the Ravenswood facility site with the proceeds from a proposed sale/leaseback transaction anticipated to be completed in the second quarter of 2004. (See the earlier discussion under the caption “Electric Services” for further details on this proposed transaction). We will continue to evaluate our capital structure and financing strategy for the remainder of 2004 and beyond. We believe that our current sources of funding (i.e., internally generated funds, the proposed sale/leaseback transaction, and the availability of commercial paper) are sufficient to meet our anticipated capital needs for the foreseeable future.

The following table represents the ratings of our long-term debt at March 31, 2004. Currently, Standard & Poor’s and Moody’s Investor Services ratings on KeySpan’s and its subsidiaries’ long-term debt are on negative outlook.

	Moody's Investor Services	Standard & Poor's	FitchRatings
KeySpan Corporation	A3	A	A-
KEDNY	N/A	A+	A+
KEDLI	A2	A+	A-
Boston Gas	A2	A	N/A
Colonial Gas	A2	A+	N/A
Electric Generation	A3	A	N/A

## Off-Balance Sheet Arrangements

### *Guarantees*

KeySpan has a number of financial guarantees with its subsidiaries that have remained substantially unchanged since December 31, 2003. At March 31, 2004, KeySpan has fully and unconditionally guaranteed: (i) \$525 million of medium-term notes issued by KEDLI; (ii) the obligations of KeySpan Ravenswood LLC, the lessee under the \$425 million Master Lease Agreement associated with the Ravenswood facility; and (iii) the payment obligations of our subsidiaries related to \$128 million of tax-exempt bonds issued through the Nassau County and Suffolk County Industrial Development Authority for the construction of the Glenwood and Port Jefferson electric-generation peaking facilities. The medium-term notes, the Master Lease Agreement and the tax-exempt bonds are reflected on the Consolidated Balance Sheet. Further, KeySpan has guaranteed: (i) up to \$169 million of surety bonds associated with certain construction projects currently being performed by subsidiaries within the Energy Services segment; (ii) certain supply contracts, margin accounts and purchase orders for certain subsidiaries in an aggregate amount of \$51 million; and (iii) \$74 million of subsidiary letters of credit. These guarantees are not recorded on the Consolidated Balance Sheet. At this time, we have no reason to believe that our subsidiaries will default on their current obligations. However, we cannot predict when or if any defaults may take place or the impact such defaults may have on our consolidated results of operations, financial condition or cash flows. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies" for additional information regarding KeySpan's guarantees.)

In addition, KeySpan intends to guarantee the payment obligations of its subsidiaries in connection with the proposed sale/leaseback transaction for the financing of the new 250 MW electric generating facility located on the Ravenswood site.

### *Variable Interest Entity*

We have an arrangement with a variable interest entity through which we lease a portion of the Ravenswood facility. We acquired the Ravenswood facility, in part, through the variable interest entity from The Consolidated Edison Company of New York, Inc. ("Consolidated Edison") on June 18, 1999 for approximately \$597 million. In order to reduce the initial cash requirements, we entered into a lease agreement (the "Master Lease") with a variable interest, unaffiliated financing entity that acquired a portion of the facility, three steam generating units, directly from Consolidated Edison and leased it to a KeySpan subsidiary. The variable interest unaffiliated financing entity acquired the property for \$425 million, financed with debt of \$412.3 million (97% of capitalization) and equity of \$12.7 million (3% of capitalization). Monthly lease payments equal the monthly interest expense on the debt securities. This variable interest entity is fully consolidated in KeySpan's financial statements. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies" for additional information regarding the Master Lease.)

## **Contractual Obligations**

KeySpan has certain contractual obligations related to its outstanding long-term debt, outstanding credit facility borrowings, outstanding commercial paper borrowings, operating and capital leases, and demand charges associated with certain commodity purchases. These obligations have remained substantially unchanged since December 31, 2003. (For additional details regarding these obligations see KeySpan's Annual Report on Form 10K for the Year Ended December 31, 2003, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations, Note 6 "Long-Term Debt", as well as Note 7 to those Consolidated Financial Statements "Contractual Obligations, Financial Guarantees and Contingencies.")

## Discussions of Critical Accounting Policies and Assumptions

In preparing our financial statements, the application of certain accounting policies requires difficult, subjective and/or complex judgments. The circumstances that make these judgments difficult, subjective and/or complex have to do with the need to make estimates about the impact of matters that are inherently uncertain. Actual effects on our financial position and results of operations may vary significantly from expected results if the judgments and assumptions underlying the estimates prove to be inaccurate. At March 31, 2004, KeySpan's critical accounting policies and assumptions have remained substantially unchanged since December 31, 2003. Below is a brief discussion of those critical accounting policies requiring such subjectivity. For a more detailed discussion of these policies and assumptions see KeySpan's Annual Report on Form 10K for the Year Ended December 31, 2003, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations "Discussion of Critical Accounting Policies and Assumptions."

### *Percentage of Completion Accounting*

Percentage-of-completion accounting is a method of accounting for long-term construction type contracts in accordance with Generally Accepted Accounting Principles and, accordingly, the method used for engineering and mechanical contracting revenue recognition by the Energy Services segment. Due to uncertainties inherent within estimates employed to apply percentage-of-completion accounting, it is possible that estimates will be revised as project work progresses. Changes in estimates resulting in additional future costs to complete projects can result in reduced margins or loss contracts.

### *Valuation of Goodwill*

KeySpan records goodwill on purchase transactions, representing the excess of acquisition cost over the fair value of net assets acquired. In testing for goodwill impairment under Statement of Financial Accounting Standards ("SFAS") 142 "Goodwill and Other Intangible Assets", significant reliance is placed upon a number of estimates regarding future performance that require broad assumptions and significant judgment by management. A change in the fair value of our investments could cause a significant change in the carrying value of goodwill. The assumptions used to measure the fair value of our investments are the same as those used by us to prepare annual operating segment and consolidated earnings and cash flow forecasts. In addition, these assumptions are used to set annual budgetary guidelines.

Although management determined that the fair value of KeySpan's assets adequately exceeded their carrying value for the year ended December 31, 2003, the operating performance of the Energy Services segment continues to be below expectations. Management will continue to monitor the operating performance of this segment and will conduct a review of the carrying value of goodwill during the year. The recorded goodwill for this segment, as a result of prior acquisitions, is approximately \$171 million. At this point in time, we are unable to predict what effect, if any, the outcome of this review will have on the carrying value of our goodwill or on financial position or results of operations.

Management will continue to review and focus on its overall strategy for each of KeySpan's business units and accordingly will continue to evaluate the carrying value of goodwill. While we

believe that our assumptions are reasonable, actual results, however, may differ from our projections.

#### *Accounting for the Effects of Rate Regulation on Gas Distribution Operations*

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

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

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

As is further discussed under the caption “Regulation and Rate Matters,” the rate plans previously in effect for KEDNY and KEDLI have expired. The continued application of SFAS 71 to record the activities of these subsidiaries is contingent upon the actions of regulators with regard to future rate plans. We are currently evaluating various options that may be available to us including, but not limited to, proposing new plans for KEDNY and KEDLI. The ultimate resolution of any future rate plans could have a significant impact on the application of SFAS 71 to these entities and, accordingly, on our financial position, results of operations and cash flows. However, management believes that currently available facts support the continued application of SFAS 71 and that all regulatory assets and liabilities are recoverable or refundable through the regulatory environment. It should be noted that the DTE approved a base revenue increase for the Boston Gas Company in the fourth quarter of 2003. (See the discussion under the caption “Regulation and Rate Matters” for additional information regarding the Boston Gas Company’s filing.)

Rate regulation is undergoing significant change as regulators and customers seek lower prices for utility service and greater competition among energy service providers. In the event that regulation significantly changes the opportunity for us to recover costs in the future, all or a portion of our regulated operations may no longer meet the criteria for the application of SFAS 71. In that event, a write-down of our existing regulatory assets and liabilities could result. In management’s opinion, our regulated subsidiaries that currently are subject to the provisions of SFAS 71 will continue to be subject to SFAS 71 for the foreseeable future.

#### *Pension and Other Postretirement Benefits*

KeySpan participates in both non-contributory defined benefit pension plans, as well as other post-retirement benefit (“OPEB”) plans (collectively “postretirement plans”). KeySpan’s reported costs of providing pension and OPEB benefits are dependent upon numerous factors resulting from actual

plan experience and assumptions of future experience. Pension and OPEB costs (collectively "postretirement costs") are impacted by actual employee demographics, the level of contributions made to the plans, earnings on plan assets, and health care cost trends. Changes made to the provisions of these plans may also impact current and future postretirement costs. Postretirement costs may also be significantly affected by changes in key actuarial assumptions, including anticipated rates of return on plan assets and the discount rates used in determining the postretirement costs and benefit obligations. Actual results that differ from our assumptions are accumulated and amortized over ten years.

Historically, we have funded our qualified pension plans in excess of the amount required to satisfy minimum ERISA funding requirements. At March 31, 2004, we had a funding credit balance in excess of the ERISA minimum funding requirements. Although we have presently exceeded ERISA funding requirements, our pension plans, on an actuarial basis, are currently underfunded. Therefore,

for 2004, KeySpan expects to contribute a total of \$147 million to its funded and unfunded post-retirement plans. Future funding requirements are heavily dependent on actual return on plan assets and prevailing interest rates. (In addition to Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations in KeySpan's Annual Report on Form 10K for the Year Ended December 31, 2003, see also Note 4 of those Consolidated Financial Statements, "Postretirement Benefits.")

### *Full Cost Accounting*

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

Under full cost accounting rules, total capitalized costs are limited to a ceiling equal to the present value of future net revenues, discounted at 10%, plus the lower of cost or fair value of unproved properties less income tax effects (the "ceiling limitation"). A quarterly ceiling test is performed to evaluate whether the net book value of the full cost pool exceeds the ceiling limitation. If capitalized costs (net of accumulated depreciation, depletion and amortization) less deferred taxes are greater than the discounted future net revenues or ceiling limitation, a write-down or impairment of the full cost pool is required.

Natural gas and oil reserve quantities represent estimates only. Under full cost accounting, reserve estimates are used to determine the full cost ceiling limitation as well as the depletion rate. Houston Exploration estimates its proved reserves and future net revenues using sales prices estimated to be in effect as of the date it makes the reserve estimates. Further, Houston Exploration employs independent petroleum engineers in the preparation of estimated reserve quantities. Natural gas prices, which have fluctuated widely in recent years, affect estimated quantities of proved reserves and future net revenues. Any estimates of natural gas and oil reserves and their values are inherently

uncertain, including many factors beyond our control.

### *Valuation of Derivative Instruments*

We employ derivative instruments to manage commodity and financial market risk. All of our derivative instruments, except for certain weather derivatives, are reported on the Consolidated Balance Sheet at fair value in accordance with SFAS 133; weather derivatives are accounted for in accordance with Emerging Issues Task Force (“EITF”) 99-2. None of KeySpan’s derivative instruments qualify as “energy trading contracts” as defined by current accounting literature.

For those derivative instruments designated as cash flow hedges under SFAS 133, which are the majority of KeySpan’s derivative instruments, changes in the derivative’s fair market value are recorded in other comprehensive income on the Consolidated Balance Sheet, (in line with effectiveness measurements) and are recorded through earnings at the time of settlement. To the extent hedge contracts are deemed ineffective, that portion will impact earnings.

Additionally, we use derivative financial instruments to reduce cash flow variability associated with the purchase price for a portion of future natural gas purchases for our regulated gas distribution activities; the accounting for such derivative instruments is subject to SFAS 71. KeySpan’s non-regulated subsidiaries may employ a limited number of financial derivatives that do not qualify for hedge accounting treatment under SFAS 133, and, therefore, changes in the market value of these derivative instruments are recorded through earnings.

When available, quoted market prices are used to record a derivative contract’s fair value. Fair value is the amount at which derivative instruments could be exchanged in a current transaction between willing parties, other than in a liquidation sale. However market values for certain derivative contracts may not be readily available or determinable. If no active market exists for a commodity, a specific contract type, or for the entire term of a contract’s duration, fair values are based on pricing models. Such models employ matrix pricing based on contracts with similar terms and risks, including pricing based on broker quotes and industry publications. A substantial percentage of the fair value of KeySpan’s derivative contracts is based on observable market prices or is derived from such prices. Changes in market conditions or the occurrence of unforeseen events could affect the timing of recognition of changes in fair value of certain hedging derivatives.

See Note 4 to the Consolidated Financial Statements “Hedging and Derivative Financial Instruments and Item 3, “Quantitative and Qualitative Disclosures About Market Risk” for a further description of our derivative instruments.

## **Regulation and Rate Matters**

### *Gas Matters*

As of March 31, 2004, the rate agreements for KEDNY and KEDLI have expired. Under the terms of the KEDNY and KEDLI rate agreements, gas distribution rates and all other provisions will remain in effect until changed by the NYPSC. At this time, we are currently evaluating various options that may be available to us regarding the KEDNY and KEDLI rate plans, including but not limited to, proposing new rate plans.

Regarding the Boston Gas Company, in 2003 the DTE approved a \$25.9 million increase in base revenues with an allowed return on equity of 10.2% assuming an equal balance of debt and equity. On January 27, 2004 the DTE issued orders on Boston Gas Company's Motion for Recalculation, Reconsideration and Clarification that granted an additional \$1.1 million in base revenues, for a total of \$27 million. The DTE also approved a Performance Based Rate Plan (the "Plan") for up to ten years.

For an additional discussion of our current gas distribution rate agreements, see KeySpan's Annual Report on Form 10K for the Year Ended December 31, 2003, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Regulation and Rate Matters."

### *Electric Matters*

KeySpan sells to LIPA all of the capacity and, to the extent requested, energy conversion services from our existing Long Island based oil and gas-fired generating plants. Sales of capacity and energy conversion services are made under rates approved by the FERC in accordance with the Power Supply Agreement ("PSA") entered into between KeySpan and LIPA in 1998. The current FERC approved rates, which have been in effect since May 1998, expired on December 31, 2003. KeySpan filed with the FERC an updated cost of service for the Long Island based generating plants in October 2003. The rate filing included, among other things, an annual revenue increase of 2.1% or approximately \$6.4 million, a return on equity of 11%, updated operating and maintenance expense levels and recovery of certain other costs. FERC approved implementation of new rates starting January 1, 2004, subject to refund. Settlement negotiations with LIPA are currently ongoing.

### *Securities and Exchange Commission Regulation*

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

KeySpan has the authorization, under PUHCA to do the following through December 31, 2006 (the "Authorization Period"): (a) to issue and sell up to an additional amount of \$3.0 billion of common stock, preferred stock, preferred and equity-linked securities, and long-term debt securities (the "Long-Term Financing Limit") in accordance with certain defined parameters; (b) in addition to the Long-Term Financing Limit, to issue and sell up to an aggregate amount of \$1.3 billion of short-term debt (the "Short-Term Financing Limit"); (c) to issue up to 13 million shares of common stock under dividend reinvestment and stock-based management incentive and employee benefit plans; (d) to maintain existing and enter into additional hedging transactions with respect to outstanding indebtedness in order to manage and minimize interest rate costs; (e) to issue guarantees and other forms of credit support in an aggregate principal amount not to exceed \$4.0 billion outstanding at any one time; (f) to refund, repurchase (through open market purchases, tender offers or private transactions), replace or refinance debt or equity securities outstanding during the Authorization Period through the issuance of similar or any other type of authorized securities; (g) to pay dividends out of capital and unearned surplus as well as paid-in-capital with respect to certain subsidiaries, subject to certain limitations; (h) to engage in preliminary development activities and administrative and management activities in connection with anticipated investments in exempt wholesale generators, foreign utility companies and other energy-related companies; (i) to organize and/or acquire the equity securities of entities that will serve the purpose of facilitating authorized financings; (j) to invest up to \$3.0 billion in exempt wholesale generators and foreign utility companies; (k) to create and/or acquire the securities of entities organized for the purpose of facilitating investments in other non-utility subsidiaries; and (l) to enter into certain types of affiliate transactions between certain non-utility subsidiaries involving cost structures above the typical "at-cost" limit.

In addition, we have committed that during the Authorization Period, our common equity will be at least 30% of our consolidated capitalization and each of our utility subsidiaries' common equity will be at least 30% of such entity's capitalization. At March 31, 2004 KeySpan's consolidated common equity was 39% of its consolidated capitalization, including commercial paper, and each of its utility subsidiaries common equity was at least 35% of its respective capitalization.

## **Environmental Matters**

KeySpan is subject to various federal, state and local laws and regulatory programs related to the environment. Ongoing environmental compliance activities, which have not been material, are charged to operation and maintenance activities. We estimate that the remaining cost of our manufactured gas plant ("MGP") related environmental cleanup activities, including costs associated with the Ravenswood facility, will be approximately \$263.1 million and we have recorded a related liability for such amount. We have also recorded an additional \$24.3 million liability representing the estimated environmental cleanup costs related to a former coal tar processing facility. Further, as of March 31, 2004, we have expended a total of \$108.6 million on environmental remediation. (See Note 6 to the Consolidated Financial Statements, "Financial Guarantees and Contingencies".)

## Market and Credit Risk Management Activities

*Market Risk:* KeySpan is exposed to market risk arising from potential changes in one or more market variables, such as energy commodity price risk, interest rate risk, foreign currency exchange rate risk, volumetric risk due to weather or other variables. Such risk includes any or all changes in value whether caused by commodity positions, asset ownership, business or contractual obligations, debt covenants, exposure concentration, currency, weather, and other factors regardless of accounting method. We manage our exposure to changes in market prices using various risk management techniques for non-trading purposes, including hedging through the use of derivative instruments, both exchange-traded and over-the-counter contracts, purchase of insurance and execution of other contractual arrangements.

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

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

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

*Equity and Debt Securities Risk:* KeySpan is exposed to price risk due to investments in equity and debt securities held to fund benefit payments for various employee pension and other postretirement benefit plans. To the extent that the values of investments held decline, the effect will be reflected in KeySpan's recognition of periodic cost of such employee benefit plans and the determination of the amount of cash to be contributed to the employee benefit plans.

*Regulatory Issues and Competitive Environment:* We are subject to various other risk exposures and uncertainties associated with our gas and electric operations. The most significant contingency involves the evolution of the gas distribution and electric industries towards more competitive and deregulated environments. These risks have not changed substantially since December 31, 2003. For additional information regarding these risks see KeySpan's Annual Report on Form 10K for the Year Ended December 31, 2003, Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations "Market and Credit Risk Management Activities."

### **Cautionary Statement Regarding Forward-Looking Statements**

Certain statements contained in this Quarterly Report on Form 10-Q concerning expectations, beliefs, plans, objectives, goals, strategies, future events or performance and underlying assumptions and other statements that are other than statements of historical facts, are "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Without limiting the foregoing, all statements under the captions "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Item 3. Quantitative and Qualitative Disclosures About Market Risk" relating to our future outlook, anticipated capital expenditures, future cash flows and borrowings, pursuit of potential future acquisition opportunities and sources of funding, are forward-looking statements. Such forward-looking statements reflect numerous assumptions and involve a number of risks and uncertainties and actual results may differ materially from those discussed in such statements.

Among the factors that could cause actual results to differ materially are:

- Svolatility of energy prices used to generate electricity;
- Sfluctuations in weather and in gas and electric prices;
- Sgeneral economic conditions, especially in the Northeast United States;
- Sour ability to successfully reduce our cost structure and operate efficiently;
- Sour ability to successfully contract for natural gas supplies required to meet the needs of our firm customers;
- Simplementation of new accounting standards;
- Sinflationary trends and interest rates;
- Sthe ability of KeySpan to identify and make complementary acquisitions, as well as the successful integration of recent and future acquisitions;
- Savailable sources and cost of fuel;
- Screditworthiness of counterparties to derivative instruments and commodity contracts;
- Sthe resolution of certain disputes with LIPA concerning each party's rights and obligations under various agreements;

Retention of key personnel;

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

The impact of federal and state utility regulatory policies and orders on our regulated and unregulated businesses;

Potential write-down of our investment in natural gas properties when natural gas prices are depressed or if we have significant downward revisions in our estimated proved gas reserves;

Competition facing our unregulated Energy Services businesses, including but not limited to competition from other mechanical, plumbing, heating, ventilation and air conditioning, and engineering companies, as well as, other utilities and utility holding companies that are permitted to engage in such activities;

The degree to which we develop unregulated business ventures, as well as federal and state regulatory policies affecting our ability to retain and operate such business ventures profitably;

Changes in political conditions, acts of war or terrorism;

Changes in rates of return on overall debt and equity markets could have an adverse impact on the value of pension assets;

Changes in accounting standards or GAAP which may require adjustment to financial statements;

A change in the fair value of our investments that could cause a significant change in the carrying value of goodwill;

Timely receipts of payments from our two largest customers LIPA and the NYISO; and

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

For any of these statements, KeySpan claims the protection of the safe harbor for forward-looking information contained in the Private Securities Litigation Reform Act of 1995, as amended. For additional discussion on these risks, uncertainties and assumptions, see “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

*Financially-Settled Commodity Derivative Instruments – Non-Regulated Hedging Activities:* From time to time, KeySpan subsidiaries have utilized derivative financial instruments, such as futures, options and swaps, for the purpose of hedging the cash flow variability associated with changes in commodity prices. KeySpan is exposed to commodity price risk primarily with regard to its gas exploration and production activities and its electric generating facilities. Derivative financial instruments are employed by Houston Exploration to hedge cash flow variability associated with

forecasted sales of natural gas. The Ravenswood facility uses derivative financial instruments to hedge the cash flow variability associated with the purchase of natural gas and oil that will be consumed during the generation of electricity. The Ravenswood facility also hedges the cash flow variability associated with a portion of peak electric energy sales.

For derivative instruments associated with gas exploration and production activities, KeySpan uses standard New York Mercantile Exchange (“NYMEX”) future price quotes to value swap positions and published volatility in its Black-Scholes calculation for outstanding options. Further, KeySpan uses standard NYMEX futures prices to value gas futures contracts and market quoted forward prices to value oil swap and natural gas basis swap contracts associated with its Ravenswood facility. We also use market quoted forward prices to value electric derivatives associated with the Ravenswood facility.

The following tables set forth selected financial data associated with these derivative financial instruments noted above that were outstanding at March 31, 2004.

Type of Contract	Year of Maturity	Volumes mmcf	Floor \$	Ceiling \$	Fixed Price \$	Current Price \$	Fair Value (\$000)
<b>Gas</b>							
Collars	2004	55,000	3.75	5.05	-	5.11 - 6.19	(32,688)
	2005	54,750	4.50	5.69	-	5.30 - 6.44	(24,526)
Swaps/Futures - Short Natural Gas	2004	11,000	-	-	4.96	5.11 - 6.19	(11,267)
	2005	18,250	-	-	4.77	5.30 - 6.44	(15,355)
Swaps/Futures - Long Natural Gas	2004	50	-	-	5.11 - 5.14	5.93 - 6.04	43
	2005	10	-	-	4.95	5.28	3
139,060							(83,790)

Type of Contract	Year of Maturity	Volumes Barrels	Fixed Price \$	Current Price \$	Fair Value (\$000)
<b>Oil</b>					
Swaps - Long Fuel Oil	2004	69,104	22.40 - 30.80	28.58 - 30.90	194
	2005	42,000	24.85 - 30.80	28.88 - 31.16	69
111,104					263

Type of Contract	Year of Maturity	MWh	Fixed Margin/ Price \$	Current Price \$	Fair Value (\$000)
<b>Electricity</b>					
Swaps - Energy	2004	536,800	15.09 - 45.25	16.10 - 45.00	(134)
	2005	335,200	13.74 - 48.64	15.57 - 48.57	(915)
872,000					(1,049)

	<b>2004</b>
<i>Change in Fair Value of Derivative Instruments</i>	<b>(\$000)</b>
Fair value of contracts at January 1,	\$ (36,224)
Losses on contracts realized	16,968
(Decrease) in fair value of all open contracts	(65,320)
Fair value of contracts outstanding at March 31,	\$ (84,576)

*(In Thousands of Dollars)*

<i>Sources of Fair Value</i>	<b>Fair Value of Contracts</b>			<b>Fair Value</b>
	<b>Mature Within</b>		<b>Total</b>	
	<b>12 Months</b>	<b>Thereafter</b>		
Prices actively quoted	\$ (52,529)	(8,388)	\$ (60,917)	
Prices based on models and other valuation methods	(10,958)	(11,915)	\$ (22,873)	
Local published indicies	(315)	(471)	\$ (786)	
	\$ (63,802)	\$ (20,774)	\$ (84,576)	

We measure the commodity risk of our derivative hedging instruments using a sensitivity analysis. The sensitivity analysis performed on these derivative positions measures the potential change in the fair market value based on a hypothetical 10% movement in energy prices. Based on a 10% increase in the forward commodity curve for natural gas from the March 31, 2004 level, it was estimated that the fair market value of outstanding derivative instruments expected to be settled in 2004 associated with our gas exploration and production activities would decrease by approximately \$27 million. A 10% decrease in the forward commodity curve for natural gas would increase the fair market value of these outstanding derivative instruments by approximately \$24 million. We also perform sensitivity analysis on the estimated physical sale of natural gas by our gas exploration and production subsidiaries. Based on a 10% increase in the forward commodity curve for natural gas from the March 31, 2004 level, it was estimated that pre-tax income from our gas exploration and production activities would increase by approximately \$58 million for the remainder of 2004. A 10% decrease in the forward commodity curve for natural gas would decrease pre-tax income by approximately \$57 million. Based upon the preceding sensitivity analysis, the net impact of a 10% increase in the forward commodity curve for natural gas would benefit pre-tax income by approximately \$31 million. A 10% decrease in the forward commodity curve for natural gas would result in a net decrease to pre-tax income of approximately \$34 million. The fact that a 10% change in the forward commodity curve for natural gas has a significant impact on pre-tax income is indicative of the fact that our gas exploration and production subsidiaries do not hedge 100% of their estimated production.

Based on sensitivity analysis performed on derivative instruments associated with the operations of the Ravenswood facility, it is estimated that a 10% increase in the forward commodity curves for electricity and fuel from the March 31, 2004 level would decrease the fair market value of outstanding derivative instruments that hedge the cash flow variability associated with a portion of peak electric energy sales by \$1 million. A 10% decrease in the forward commodity curves for electricity and fuel would increase the fair market value of these derivative instruments by a similar amount. We also perform sensitivity analysis on the estimated physical sale of electricity by the

Ravenswood facility. Based on a 10% increase in the forward commodity curves for electricity and fuel from the March 31, 2004 level, it was estimated that pre-tax income from the Ravenswood facility would increase by approximately \$11 million for the remainder of 2004. A 10% decrease in the forward commodity curves for electricity and fuel would decrease pre-tax income by approximately \$9 million. Based upon the preceding sensitivity analysis, the net impact of a 10% increase in the forward commodity curves for electricity and fuel would benefit pre-tax income by approximately \$9 million. A 10% decrease in the forward commodity curves for electricity and fuel would result in a net decrease to pre-tax income of approximately \$8 million.

*Firm Gas Sales Derivative Instruments - Regulated Utilities:* We use derivative financial instruments to reduce the cash flow variability associated with the purchase price for a portion of future natural gas purchases associated with our Gas Distribution operations. The accounting for these derivative instruments is subject to SFAS 71 “Accounting for the Effects of Certain Types of Regulation.” Therefore, changes in the fair value of these derivatives have been recorded as a regulatory asset or regulatory liability on the Consolidated Balance Sheet. Gains or losses on the settlement of these contracts are initially deferred and then refunded to or collected from our firm gas sales customers consistent with regulatory requirements.

The following table sets forth selected financial data associated with these derivative financial instruments that were outstanding at March 31, 2004.

Type of Contract	Year of Maturity	Volumes mmcf	Floor (\$)	Ceiling (\$)	Fixed Price (\$)	Current Price (\$)	Fair Value (\$000)
Options	2004	2,310	4.50 - 5.25	4.76 - 6.00	-	5.11-6.19	309
	2005	1,520	4.50 - 5.25	5.00 - 6.00	-	5.30-6.44	285
Swaps	2004	13,900	-	-	5.44 -5.59	5.11-6.19	8,976
	2005	15,440	-	-	5.60 - 5.64	5.30-6.44	8,873
		33,170					18,443

See Note 4 to the Consolidated Financial Statements “Hedging and Derivative Financial Instruments” for a further description of all our derivative instruments.

#### **Item 4. Controls and Procedures**

KeySpan maintains “disclosure controls and procedures”, as such term is defined under Exchange Act Rule 13a-15(e), that are designed to ensure that information required to be disclosed by KeySpan in the reports it files or submits under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and that such information is accumulated and communicated to KeySpan’s management, including its Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

An evaluation of the effectiveness of KeySpan’s disclosure controls and procedures as of March 31, 2004 was conducted under the supervision and with the participation of KeySpan’s Chief Executive Officer and Chief Financial Officer. Based on that evaluation, KeySpan’s Chief Executive Officer and Chief Financial Officer have concluded that KeySpan’s disclosure controls and procedures were adequate and designed to ensure that material information relating to KeySpan and its consolidated subsidiaries would be made known to the Chief Executive Officer and Chief Financial Officer by others within those entities, particularly during the periods when periodic reports under the Exchange Act are being prepared. Furthermore, there has been no change in KeySpan’s internal control over financial reporting, identified in connection with the evaluation of such control, that occurred during KeySpan’s last fiscal quarter that has materially affected, or is reasonably likely to materially affect, KeySpan’s internal control over financial reporting. Refer to the Certifications by KeySpan’s Chief Executive Officer and Chief Financial Officer filed as exhibits 31.1 and 31.2 to this report.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

See Note 6 to the Consolidated Financial Statements “Financial Guarantees and Contingencies”.

### **Item 6. Exhibits and Reports on Form 8-K**

#### **(a) Exhibits**

31.1\* Certification of the Chairman and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2\* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1\* Certification of the Chairman and Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2\* Certification of the Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

#### **(b) Reports on Form 8-K**

In our report on Form 8-K dated February 5, 2004, we reported that KeySpan had issued a press release concerning, among other things, consolidated earnings for the year ended December 31, 2003.

---

\*Filed Herewith

**KEYSPAN CORPORATION AND SUBSIDIARIES  
SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on behalf of the undersigned there unto duly authorized.

**KEYSPAN CORPORATION**  
(Registrant)

Date: April 30, 2004

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

