PHASE II REPORT

Options Analysis for the Management of LIPA Assets

LIPA
Long Island Power Authority

For the Long Island Power Authority Board of Trustees
April 28, 2021

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CEO LETTER

Dear Customers and Stakeholders,

The LIPA Board of Trustees has a vision for a Clean, Lean, and Customer-First utility for Long Island and the Rockaways. The Board expects outstanding results, including **excellent customer satisfaction; high reliability and storm resiliency; a clean, carbon-free electric grid; and the lowest possible cost to customers.**

Achieving these results requires two key ingredients – our "secret sauce." First, we must achieve a purity of mission from the Board, to the management, down to the lineworkers and customer-facing employees that **everything we do is for our customers and community**. **We are here to serve**.

Second, **we must have capable, experienced, and empowered management** who can turn the Board's vision into actionable plans and programs. And the Board must insist on **management being accountable for promised results**. We can learn from our setbacks, but there can be no excuses for failing to learn.

To transform into the industry-leading utility the Board wants and our customers deserve, we need to be clear-eyed in our pursuit of the "secret sauce." All great businesses have these two ingredients.

Tropical Storm Isaias

Tropical Storm Isaias put in stark relief that our "secret sauce" is missing its key ingredients. LIPA has paid PSEG Long Island $469 million for management services over the past seven years. **For nearly a half billion dollars, excellence was expected.** Instead, as described in its 90-Day Report, LIPA's Isaias Task Force identified that **systemic management shortcomings were the root cause of PSEG Long Island's failures during the storm**.

The LIPA Board of Trustees has directed PSEG Long Island to implement over **140 recommendations** to improve management, emergency management, and information technology, among other areas. These recommendations encompass storm response as well as other operational concerns. **But fixing the proximate causes of these failures is not sufficient. We need to fundamentally address the management culture that led to these problems.** PSEG Long Island management is provided a high level of autonomy. A high-trust contract could have worked with the right partner. PSEG Long Island's actions and performance have jeopardized that trust.

In November 2020, the Board along with the New York Department of Public Service (DPS), asked LIPA staff to evaluate either (i) terminating LIPA's contract with PSEG Long Island; or (ii) renegotiating that contract to more closely align PSEG Long Island's management orientation and incentives to what LIPA expects from its utility operations.

The Options

On December 16, 2020, LIPA staff issued Phase I of its Options Analysis to the Board and public. This report is the second phase of that effort to present the Board and our stakeholders with options to improve the future management of LIPA's assets.

The good news – LIPA has attractive options. This report lays out the benefits and considerations of four alternatives:

- Option 1: Sell LIPA's Assets to Private Investors
- Option 2: Reset the PSEG Long Island Relationship and Reform the Contract
- Option 3: Contract with a New Service Provider to Improve Operations
- Option 4: Bring Utility Operations Under LIPA Management

The first option, **privatization, significantly raises customer costs by an estimated $32 per month for a typical residential customer**. Based on this result, the LIPA Board, at its December 2020 meeting, asked staff to focus on the three remaining alternatives.

The second option—resetting the PSEG Long Island relationship—requires the agreement of PSEG Long Island. The report outlines the objectives LIPA and DPS have sought to better align PSEG Long Island management incentives and accountabilities and facilitate greater transparency and oversight. **To date, LIPA and PSEG Long Island have been unable to achieve these objectives in negotiations. We continue to engage with PSEG Long Island management and remain open to offers that credibly address the Board's concerns. We will keep the Board and public apprised of any developments.**

The third option—outsourcing to one or more new contractors—provides an opportunity to **reset the expectations of our vendors to match the Board's vision for our customers, while implementing the necessary cultural and contractual changes**. There is a market of potential vendors; however, the actual bidders and terms will not be known until LIPA undertakes a procurement process. **The potential long-term benefits of this transition to a stronger management framework could far outweigh the costs and risks**.

Finally, the fourth option, a LIPA management model of "full municipalization" could achieve the alignment between the Board, management, and customers that is currently lacking. **The case for LIPA management is bolstered by the financial benefits, with projected savings that could exceed $860 million through the full term of the PSEG Long Island contract**. Those funds could be directly invested in customer-facing initiatives or returned to customers rather than paid in management fees. However, **this change in business model would be counter to the intent of the LIPA Reform Act of 2013, which sought to address the mismanagement described in the 2013 Moreland Commission Report on Utility Storm Preparation and Response. It would require the full support of our state's elected officials, regulators, stakeholders, and most importantly customers, as well as a transition plan that adequately mitigates the risks** involved in hiring a new management team, shifting 2,500 employees to a new organization, and migrating certain information technology (IT) systems.

Next Steps

The direction from LIPA's Board was to lay out the facts. This report is the result of a months-long, transparent, and comprehensive assessment of all the options available. **There is no perfect option, and there is no option without risk. For each option, the pros and cons have been carefully detailed to provide the Board of Trustees, elected officials, and stakeholders the facts to make an informed decision**.

LIPA customers deserve better, and we can do better. We CAN achieve the "secret sauce" and deliver a truly exceptional utility for our customers. The options presented in this report demonstrate multiple pathways to improvements in management alignment and accountability, customer focus, local governance, and cost-savings. In terms of next steps, we will continue discussions with PSEG Long Island on contract reforms and update the Board and the public if a proposal warranting consideration becomes available.

Further development of Option 3 will require issuance of a Request for Information to potential bidders. This will be accompanied by an aggressive outreach effort to potential contractors. LIPA staff will report back to the Board on the results at the conclusion of the first phase of the evaluation process.

Finally, we will also continue our diligence efforts and evaluation of the LIPA management model.

The Board has made it clear that it wants to hear from our customers and stakeholders. We look forward to continued discussions with our community as we work to deliver clean, reliable, and affordable electric service for Long Island and the Rockaways.

Thomas Falcone
April 28, 2021

INTRODUCTION

The Current Management Model is Not Meeting Customer Needs

Customers on Long Island and the Rockaways have four primary asks of their electric power company: 1) operate efficiently to limit the cost of service; 2) take actions to ensure reliable power supply, especially during major storms; 3) transition to a clean, carbon-free electric grid; and 4) be trustworthy, empathetic, and accountable to the community and its needs.

In 2013, LIPA customers agreed to pay a high premium to switch day-to-day utility management from National Grid to PSEG Long Island. Under LIPA's management contract with National Grid, the utility was ranked #126 out of 126 major national utility brands in customer satisfaction. **PSEG Long Island committed to be among the top 25 percent of regional utilities by 2018**. Furthermore, the Moreland Commission, established to examine the response of utility companies after Superstorm Sandy, concluded in 2013 that "LIPA's bifurcated management structure failed to work not only during weather emergencies, but also during "blue sky" conditions." PSEG Long Island committed to prioritize storm preparation and response by addressing technology gaps, poor processes for estimated restoration times, and flaws in drafting, drilling, and the actual effectiveness of utility emergency response plans identified under LIPA-National Grid contract.

During the first seven years of its contract—even before Tropical Storm Isaias—PSEG Long Island was unable to deliver the goal of a top performing utility. And while there have been improvements in the emergency restoration process, the Isaias Task Force identified failings in many of the same areas that were problematic under National Grid: IT, processes for estimated restoration times, and flaws in emergency response plans. Following Isaias, customer satisfaction has eroded sharply. The utility's most recent J.D. Power customer satisfaction score has dropped from 717 to 652. PSEG Long Island is now ranked #143 out of 144 electric utilities nationwide and #17 out of 17 for large utilities in the eastern United States.

FIGURE 1:
PSEG Long Island Has Not Delivered on its Promise of a Top 25% Utility for Customer Satisfaction by 2018

	2013	2020	2021 YTD
U.S. Rank	**#126 of 126**	**#124 of 143**	**#143 of 144**
East Large Utilities	#17 of 17	#13 of 17	#17 of 17

PSEG Long Island was provided with significant resources to achieve improvements in customer service and reliability ($4.2+ billion)

The Response to Tropical Storm Isaias Failed Customers

In August 2020, Tropical Storm Isaias left 650,000 customers without power, some for more than a week. During this time customers could not get accurate information from their electric company and found PSEG Long Island either unavailable or their communications misleading. Customer frustration, understandably, has been profound and visceral. Figure 2 includes direct quotes from customers who suffered extended outages.

FIGURE 2:
Customer Experiences and Frustrations with PSEG Long Island During Tropical Storm Isaias

- "It could not have been worse. The preparation leading up to it, the stuff that came up after the fact that explains why all the information wasn't matched up, the reason the call centers didn't have enough people to answer phones and you had to wait on the phone for hours, they were not ready for it in so many different ways. You couldn't get a straight answer, and everything lasted way too long. I really think they were making up stuff and just pushing stuff out on the website and app. There was no way I was getting fixed in the next 6 hours, every 6 hours, for 7 days straight. There's no way. That's fake information."
- "It would have been better because they had all this time to plan for a storm, and that's what they stepped in to begin with…. I think they could have done a lot better than what they did."
- "The field guys who are out there are working hard but it's out of their hands with how many people are actually out there. That's why I said they're unprepared. You know a storm is coming. You have to bring up the trucks. You might lose money but you're the power company. It's your responsibility. Be prepared and get everyone up here to fix what's going to happen."
- "Moments of just breaking down and crying…out of the sheer helplessness of the situation, like who can help me and my family? Will nobody listen to what I'm saying?

On November 18, 2020, LIPA's Isaias Task Force issued a 90-Day Interim Report which concluded, based on extensive analysis, that **PSEG Long Island's poor storm response was fundamentally caused by deep and systemic management failures, neglect, and disconnects. The failures during Isaias were preventable. They were management failures**. When customer needs were most acute, the customers were left underserved.

Decisions should be evaluated based on the expected outcomes at the time they were made, and it is appropriate to conclude that LIPA has not realized its original goal for the PSEG Long Island contract of an industry-leading utility and needs to course correct. Our customers' desire for change—as evidenced by their feedback and waning satisfaction scores—is pronounced and unmistakable. While our customer-facing employees have been driven by service to the community, our service provider's management has been inadequate.

Improving the Management of LIPA's Assets

In response to the Isaias Task Force's report, LIPA's Board of Trustees directed PSEG Long Island to implement over 140 recommendations to improve operations and storm response, among other areas. **The Task Force's main recommendation, however, was to change the way LIPA's assets are managed to improve Long Island operations**.

LIPA released Phase I of its Options Analysis in December 2020. The purpose of the Phase I report was to present the LIPA Board and stakeholders with an initial framing of the range of possible restructuring options for the management of LIPA's assets. The Board of Trustees asked LIPA staff to further refine and develop the alternatives presented in the December report and to present this Phase II report to the public.

Potential Pathways Forward

This report outlines four distinct options, summarized below, for improving the management of LIPA's assets. Each offers a different approach to address current management challenges and has distinctive properties that are worth exploring. Reflecting on insights from the Tropical Storm Isaias investigation and LIPA's broader experience with management contracts, we believe there are clear principles, summarized in Figure 3, against which LIPA's options should be considered. **The most effective management arrangement will be the one that best delivers on these five priorities**.

FIGURE 3:
Guiding Principles for Reformed Management Arrangements

- **Customer Focus** – The core promise of the current management contract—a utility in the top 25% for customer satisfaction—has not been realized. Customer satisfaction needs to be the North Star for any new management arrangement. This means prioritizing the investments and improvements that customers demand and deserve, including emergency preparation and response.
- **Financial Viability** – In a market where electricity costs are high, it is particularly important that management reforms do not adversely impact customer bills. Further, any changes to the management structure should reinforce for customers that their power company is doing everything to control costs.
- **Alignment of Interests** – Clear incentives and controls are necessary to align management interests with those of customers on Long Island and the Rockaways. Management performance should be measured across the full span of its commitments, and management compensation should be clearly tied to how well utility management delivers on its promises.
- **Transparency and Accountability** – The utility must be transparent about performance and cost, and should communicate and disclose this information clearly, honestly, and accurately. The utility should also be accessible to its customers and stakeholders and responsive to their voices.
- **Flexibility** – Contract arrangements that lump many diverse services under one management umbrella weaken accountability for individual services. Future management arrangements should offer greater flexibility, including periodic assessment of individual services to ensure that the intended benefits are being realized and that the provider is focused on evolving customer priorities.

The options considered in this report are summarized below in Figure 4.

- **Option 1: Sell LIPA's Assets to Private Investors**. This would require the sale of LIPA's assets to an investor-owned utility (IOU) or a spin-off of an independent, self-managed LIPA as an IOU.
- **Option 2: Reset the PSEG Long Island Relationship and Reform the Management Contract**. This would involve changing the contract terms of the Operations Services Agreement (OSA) with PSEG Long Island to incentivize empowered, engaged, and accountable management. That local management alignment would also need to be reinforced by stronger contract controls that ensure LIPA's ability to conduct diligent oversight

and meaningfully intervene to make course corrections. LIPA would "trust but verify" the efforts of PSEG Long Island management.

- **Option 3: Outsource to a New Service Provider to Improve Operations.** Continuing with a Service Provider model does not require retaining PSEG Long Island as LIPA's contractor. All the improvements and obligations desired under Option 2 could be arranged with one or more new providers.
- **Option 4: Bring Utility Operations Under LIPA Management.** This "full municipalization" model would require that LIPA end the current contract with PSEG Long Island for utility management services and that PSEG Long Island's ServCo subsidiary (which employs the 2,500 customer-serving employees) becomes a direct subsidiary of LIPA, as is permitted under the LIPA-PSEG Long Island contract. LIPA would then be fully responsible for utility operations, but would also engage private sector partners to perform selected activities (e.g., IT, business services, etc.) to leverage economies of scale, best-in-class knowledge, and operational excellence.

FIGURE 4:
Overview of Structural Options

Private Ownership

1. Sell LIPA's Assets to Private Investors

Higher financing costs, greater tax burden, and ineligibility for federal disaster relief under private ownership require an unrealistic $450 to $600 million of offsetting savings from operations, higher costs to customers, or cutting service.

Public Private Arrangement

2. Reset the PSEG Long Island Relationship and Reform the Contract

- Strengthen PSEG Long Island management incentives and accountability mechanisms
- Strengthen LIPA oversight rights and ability to intervene to make course corrections—"trust but verify" the efforts of PSEG Long Island management

3. Seek a New Service Provider to Improve Operations

- Reset the relationship with a different partner that is better equipped to deliver
- Integrate lessons learned from the PSEG Long Island experience

LIPA Management

4. Bring Utility Operations Under LIPA Management

- LIPA is responsible for service delivery and directly accountable to the LIPA Board and Long Island community
- ServCo subsidiary that employs the 2,500 customer-facing Long Island operations employees becomes a direct subsidiary of LIPA

The choice of capital structure—private or public ownership—is a financing decision. However, Options 2, 3, and 4 are best understood as a management choice. Options 2 and 3 would continue the current model of relying on partners, be it PSEG Long Island or one or more new service providers, to provide day-to-day management of LIPA's assets and 2,500 dedicated staff, but under a new contractual framework to align incentives and improve accountability. Option 4, by bringing day-to-day operations under LIPA, would establish direct control and local accountability.

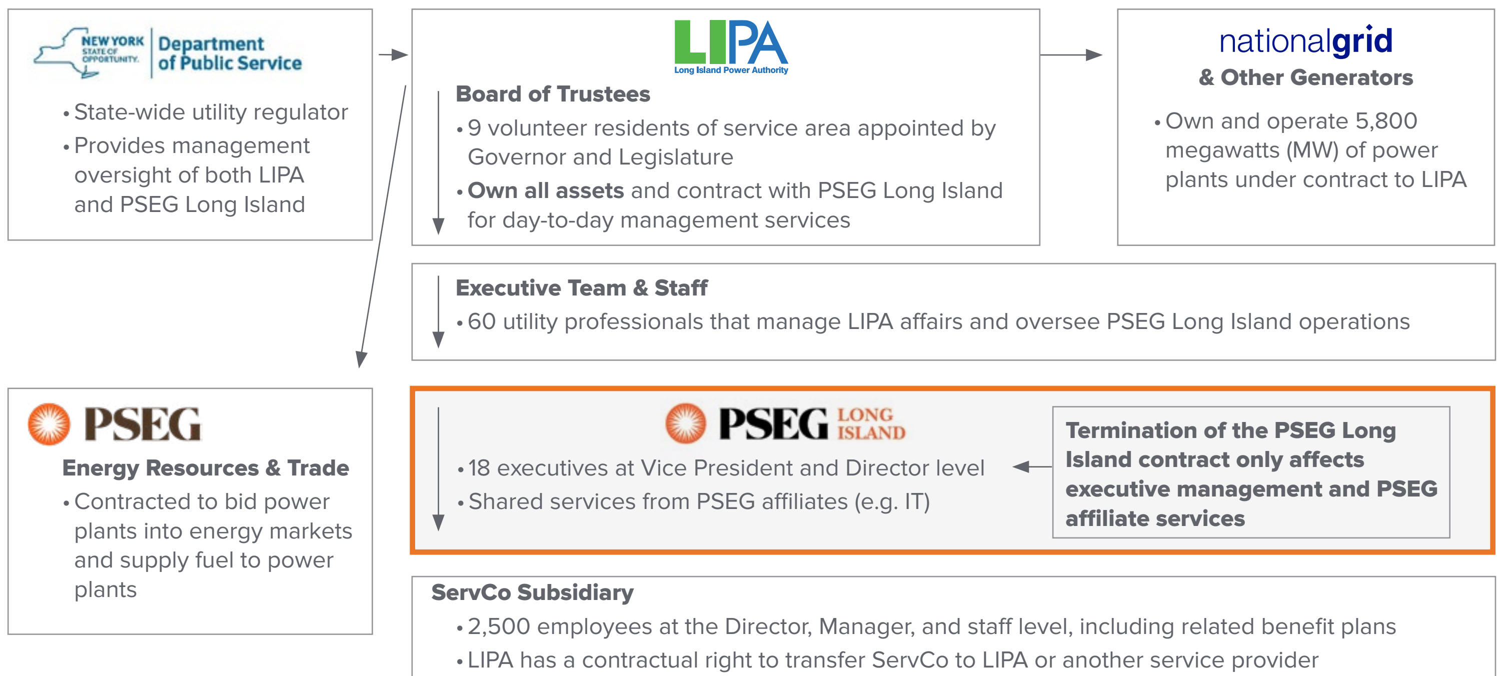
Each of these three options also offers flexibility in sourcing arrangements. For example, in Option 3, LIPA could selectively rebid the services currently provided by PSEG Long Island to other providers in packages, while in Option 4, LIPA would take responsibility for core utility operations while selectively sourcing certain activities to third parties.

These options give LIPA a unique opportunity to blend local control and private-sector participation in an organization that is focused on serving the interests of Long Island electric customers.

The Options under Consideration Would Only Affect Executive Management

The LIPA Reform Act of 2013 allowed a contract with PSEG Long Island to replace the contract with National Grid. Those that negotiated the agreement had the foresight to include provisions that could transfer the management of the dedicated Long Island operating staff and assets to another private contractor or to LIPA management. Figure 5 illustrates LIPA's operating structure. As shown in the Figure, **termination of the PSEG Long Island contract only affects executive management (18 positions) and certain shared services provided by PSEG's New Jersey-based affiliates**. Importantly, the LIPA Reform Act requires that the terms of employment, union agreements, and employment and retirement benefits of LIPA's 2,500 dedicated employees be unaffected by management transitions.

FIGURE 5:
Termination of the PSEG Long Island Contract Only Affects Executive Management



OPTION 1

Sell LIPA Assets to Private Investors

Long Island's electric service was originally provided by an investor-owned utility (IOU). LIPA purchased the investor-owned Long Island Lighting Company (LILCO) in 1998. The purpose of that transaction was to access the lower financing costs available to a public power utility. The transaction resulted in a 20 percent reduction in customer bills; that financial advantage continues today.

Since then, **LIPA has analyzed and reconsidered privatization three times: in 2005, 2011, and 2013. In each instance, LIPA rejected the privatization option due to the impact on cost for electric customers**. As part of our due diligence, LIPA staff revisited the privatization option a fourth time and again found no evidence that would change the conclusion that privatization would significantly raise customer bills. The rationale to continue as a public authority is familiar, straightforward, and echoed in other large public power utilities that have explored privatization alternatives in recent years but decided to remain public.

Public ownership reduces Long Island customer bills by an estimated $32 per month for a typical residential customer. Conversion into a private IOU would significantly raise financing costs, which would ultimately be passed on to customers in the form of higher bills or reduced investments in customer satisfaction, reliability, and clean energy.

LIPA's Lower Cost of Capital

Utilities are asset-intensive businesses, and the cost of capital is a significant component of the cost to customers. LIPA's invested capital, projected to be $10.3 billion in 2022, is 89 percent financed by tax-exempt debt capital of $9.1 billion. The remainder is deferred grants and retained customer funds (i.e. equity). LIPA's interest cost is expected to be 3.87 percent in 2022, as shown in Figure 6. As a public power utility, all LIPA funds are retained and reinvested in the electric grid. By its nonprofit nature, there are no dividend payments to equity investors and no corporate taxes, which are significant cost savings compared to private utilities.

FIGURE 6:
LIPA's Cost of Capital

LONG ISLAND POWER AUTHORITY 2022 PROJECTED BUDGET CAPITAL STRUCTURE & INTEREST COST (in millions)

Description	2022 Projected
Total Projected Debt	$ 9,146
Net Equity Position	$ 1,207
Total Capital	$ 10,353
LIPA's Interest Expense	$ 354
LIPA's Debt Cost	**3.87%**

By comparison, Con Edison, a privately owned New York electric utility, has a cost of capital that is twice LIPA's interest expense (see Figure 7). This simple comparison suggests that if LIPA were privatized, its cost of capital would more than double.

FIGURE 7:
Cost of Capital for a New York IOU (Con Edison)

	Capital Share	Approved Rate
Deposits	1.1%	2.45%
Debt	50.9%	4.63%
Common Equity	48.0%	8.80%
Total Capital	100.0%	6.61%
Income Tax Adder	26.1%	1.48%
Cost of Capital		**8.10%**

Applying the higher cost of capital of private utilities to LIPA, we estimate that public ownership saves customers roughly $447 million per year in financing costs (see Figure 8). **Putting it another way, if LIPA were to privatize, electricity costs to consumers would go up by nearly half-a-billion dollars just for the increased financing costs.** This is the same reason LIPA bought LILCO in 1998—to secure these savings for customers.

FIGURE 8:
LIPA's Financing Savings as a Public Power Utility

COMPARISON OF PUBLIC UTILITY INTEREST EXPENSE VERSUS PRIVATE UTILITY COST OF CAPITAL
(2022 projection)

All Dollars in Millions	
LIPA Pro-Forma Rate Base	$9,886
IOU Cost of Money	8.10%
LIPA Cost at IOU Cost of Money	$801
LIPA Actual Interest Expense	$354
Financing Savings from Public Ownership	**$447**

LIPA's Access to Federal Disaster Recovery Grants

In addition to benefiting from lower financing costs, **LIPA is also eligible for federal disaster recovery and storm hardening grants that are not available to privately owned utilities**.[1] These grants result in significant savings to customers.

Over the past 10 years, LIPA has received over $1.7 billion in disaster recovery grants from the Federal Emergency Management Agency (FEMA) and other sources, averaging $160 million per year (see Figure 9). This level of subsidy would not be available to a privately owned LIPA and would instead have to be recouped from customers through higher electric bills.

FIGURE 9:
LIPA Federal Disaster Recovery and Storm Hardening Grant Proceeds

Year	Significant Storm(s)	Grant Proceeds (in millions)
2010	March Nor'easter	$51
2010	Winter Storm	$46
2011	Hurricane Irene	$155
2012	Superstorm Sandy	$1,314
2013	Winter Storm Nemo	$11
2017	March Blizzard – Stella	$4
2020	Tropical Storm Isaias	$220
	Average of $160 million per year	**$1,760**

Higher Estimated Cost for an Average Residential Customer

Another way to look at the impact of the higher cost of capital and loss of federal grants of a private utility is to analyze the effect on customer bills. **For an average residential customer, the additional cost of privatization is an estimated $32 per month in 2022 and would grow over time**.

Privatization's Potential Synergies are Insufficient to Offset the Higher Costs

There are benefits to accessing scale economies and best practices available from other firms, which are often referred to as "synergies." These synergies are sometimes posited to be more valuable than the lower financing costs of public ownership.

Figure 10 shows the pool of expenses where synergies might be possible. Certain categories of expense do not lend themselves to synergies. Power supply costs, taxes other than income taxes, and payment-in-lieu-of-taxes (PILOTs) will generally be similar regardless of public or private ownership. Meanwhile, other categories of cost, such as financing costs and storm recovery costs, will be higher under private ownership, as discussed previously.

[1] FEMA grants to pay for restoration after a natural disaster, and to mitigate recurring damage to infrastructure, are available only to states, their political subdivisions such as LIPA, and other tribal, governmental, or not-for-profit entities. See Robert T. Stafford Disaster Relief and Emergency Assistance Act, as amended. 42 U.S.C. §§ 5121 et seq.

Excluding these categories of cost, $641 million in expenses remain available for potential synergy benefits—principally what is referred to as Operations and Maintenance expenses of PSEG Long Island and LIPA. **Clearly, it is unrealistic to postulate $450 to $600 million of expense reductions to offset the higher cost of capital and loss of federal disaster recovery grants from an expense pool of only $641 million.**

FIGURE 10:
Synergies Will Not Offset Higher Financing Costs and Loss of Federal Grants

LIPA Budget (in millions) **less costs not subject to synergies**	**$3,754**
Power Supply (electricity and commodity)	$1,776
Financing	$858
Taxes and PILOTS	$340
Pensions and Other Managed Expenses	$69
Storm Recovery	$70
Pool of Expenses Available for Synergies	**$641**

Public Sector Utilities Can Access Private Sector Efficiencies

There are multiple ways for a public utility to access the benefits of scale and the best practices of the private sector that are unrelated to ownership structure. After all, both private and public sector firms hire experts and third parties for this very purpose. **The choice of capital structure—private or public ownership—is a financing decision that can be divorced from the ability to access scale and private sector efficiencies.**

Privatization Has Significant Transaction Costs

Privatization would require appropriate legislative authority, and the transaction costs would be significant. These costs are not captured in this analysis and would only worsen the unfavorable economics of this alternative. For example, it would cost an estimated $1.45 billion premium to early retire tax-exempt bonds issued through both LIPA and the Utility Debt Securitization Authority, which would be required under a change in ownership, as well as additional costs to issue equity or sell LIPA to investors after a change of ownership. These transaction costs contribute no value to customers.

Even exploring privatization is costly in terms of the advisers and legal experts that would need to be retained and the significant investment of time and management attention. Transaction costs for a recently failed evaluation of privatization by another public power utility was estimated to cost in excess of $13 million.[2]

In addition, LIPA would be unable to make the necessary representations about governmental ownership to issue new tax-exempt bonds or refinance already outstanding tax-exempt bonds on a long-term basis. This would impose higher costs on customers and preclude LIPA from refinancing bonds in today's low interest rate environment to reduce costs and save customers money.

[2] Monroe, Nate, et al. (2020, August 31). Money & Power: The secret origins – and public collapse – of the campaign to privatize Jacksonville public utility JEA. Florida Times-Union. Retrieved from https://www.jacksonville.com.

Summary

LIPA has analyzed and reconsidered privatization three times: in 2005, 2011, and 2013. In each instance, LIPA rejected the privatization option due to the impact on cost for electric customers. LIPA staff revisited the privatization option a fourth time and again finds that privatization would significantly raise customer bills by an estimated $32 per month for a typical residential customer. Conversion into a private IOU would significantly raise financing costs and eliminate eligibility for federal disaster recovery grants, which would ultimately be passed on to customers in the form of higher bills or reduced investments in customer satisfaction, reliability, and clean energy.

There are multiple ways for a public utility to access the benefits of scale and the best practices of the private sector that are unrelated to ownership structure. The choice of capital structure—private or public ownership—is a financing decision that can be divorced from the ability to access scale and private sector efficiencies.

Due to the high cost and limited identifiable benefits, the Board of Trustees directed LIPA staff in December 2020 to focus on the remaining alternatives presented in this report that show greater promise.

OPTION 2

Reset the PSEG Long Island Relationship and Reform the Management Contract

The promise of LIPA's business partnership with PSEG Long Island was scale—that operating LIPA's assets jointly with a neighboring utility would deliver best practices and cost savings that more than made up for the PSEG profits built into the agreement. **The thought was that it was worth paying a premium to a neighboring utility for outstanding management.**

However, divorcing control from ownership also creates problems. The agent makes business decisions on behalf of the asset owner but does not ultimately own the outcomes. "Nobody ever washes a rental car," as the saying goes.

Every agreement to outsource management of assets to an agent must assess whether the benefits outweigh the risks, as well as evaluate the controls necessary to minimize the potential for misaligned incentives. Such agreements should also be periodically revisited to ensure that the intended benefits are being realized.[3]

The History of the Single-Partner Municipal Model

In 1998, LIPA purchased the electric transmission and distribution (T&D) assets of the Long Island Lighting Company (LILCO). The power plants and gas utility assets of LILCO were merged with Brooklyn Union Gas, forming KeySpan Corporation, which in 2006 became part of National Grid USA. As part of that 1998 transaction, LIPA contracted with then KeySpan to operate LIPA's T&D system day-to-day. At the time, LIPA had less than a dozen employees and the transaction was primarily a financing arrangement—with lower-cost financing reducing customer bills but few changes in day-to-day operations.

In 2010 and 2011, with the pending expiration of the National Grid management contract, the LIPA Board of Trustees reconsidered the business structure, which was reviewed yet again in 2013 following Superstorm Sandy. Those evaluations recognized various principal-agent problems. For example, the October 2011 study by the Brattle Group found "a third-party provider of ServCo [i.e., the manager of LIPA's assets] inherently faces somewhat limited and under-specified incentives to serve LIPA's interests unequivocally (i.e., a "principal-agent problem")."

The OSA gave wide operational discretion to PSEG Long Island based on three critical expectations:

- That PSEG would dedicate high-quality operational and technical expertise to manage LIPA's system and guide the 2,500 employees who are dedicated to running the Long Island electrical system;
- Management by an established industry player would bring significant operational and efficiency benefits – drawing on PSEG's scale and reserve capacity; and
- That PSEG's "name on the truck" (i.e., reputation on the line) and contract performance incentives would sufficiently align PSEG Long Island with LIPA's interest as the asset owner and minimize principal-agent issues.

[3] IT outsourcing deals for utilities, for example, often include requirements for periodic regulatory demonstration of benefits for customers.

The OSA gave LIPA audit and oversight rights but little flexibility to minimize agency risks, make course corrections, or keep the contractor focused on evolving customer priorities.

PSEG Long Island's Performance Since 2014

Since 2014, the LIPA Board of Trustees has invested over $4.2 billion in Long Island's electric grid—a record amount three times the annual level of investment under the prior National Grid outsourcing contract. In the face of unprecedented investment, system-wide reliability has improved 35 percent, and over 1,000 miles of Long Island's electric grid has been storm-hardened, largely funded by a grant agreement between LIPA and the federal government.

While it is important to recognize that there have been improvements, we also must recognize that we have not delivered on the core promise of the PSEG Long Island contract – a utility in the top 25 percent for customer satisfaction by 2018, with industry-leading emergency preparation and response. As described in the introduction, customer satisfaction improved marginally between 2013 and 2020 – from #126 out of 126 major national utilities in 2013 to #124 out of 144 utilities in 2020 – before declining sharply after Tropical Storm Isaias to #143 out of 144 utilities in the most recent quarterly survey in 2021. It is appropriate to conclude that LIPA has not realized our original goal for the PSEG Long Island contract of an industry-leading utility and needs to course correct.

Furthermore, **the Isaias Task Force's 90-Day Report revealed widespread, systematic, and serious deficiencies in operational and management performance, including emergency preparation and response.** Since Isaias, PSEG Long Island's efforts to rectify the faulty information technology and telephone systems have remained less than robust.

LIPA has also found that the incentive-based compensation intended to reduce agency risks had the unintended effect of encouraging "Balanced Scorecard Blinders"— the excessively narrow focus on a limited set of customer, operational, and financial metrics. The limited set of 27 metrics, which must be mutually agreed upon by LIPA and PSEG Long Island each year, has not proven to be a representative measure of PSEG Long Island's performance as a contractor. PSEG Long Island provides LIPA with several dozen complex, disparate, and specialized services, and experience has demonstrated that the Balanced Scorecard is simply too narrow to adequately measure the job PSEG Long Island has been hired to perform.

The assumption that PSEG Long Island would be aligned with LIPA's interests because their name is on the trucks and pay varies to some degree with Balanced Scorecard results proved to be wrong. **The performance metrics do not accurately reflect the quality of PSEG Long Island's management, and PSEG Long Island management demonstrably has not delivered the excellent management that was the basis of the contract**. For more information, see the Isaias Task Force's 90-Day Report.

Principal-Agent Problems in the PSEG Long Island Outsourcing Contract

Academics and analysts long ago identified the "principal-agent problem," where one entity entrusts another to carry out activities on its behalf. Principal-agent problems are inherent in any outsourcing relationship. These outsourcing arrangements inevitably fail unless the incentives and motivations of the agent are aligned with the best interests of the principal.

As described in Figure 11, the academic literature identifies several broad categories of agency costs inherent to outsourcing agreements. In retrospect, the LIPA-PSEG contract signed in 2013 was a high-trust arrangement with inadequate provisions for verification and course-correction.

There is no perfect contract. A high-trust agreement could have worked with the right business partner. The right partner can make any contract work, and the wrong partner will prove disappointing even under the best of circumstances. Meanwhile, PSEG Long Island management has disappointed as a partner and demonstrated that it should not be trusted with significant discretion without appropriate consequential controls and oversight to ensure performance.

FIGURE 11:
Common Manifestations of Principal-Agent Problems[4]

- **Insufficient effort**. Shirking responsibilities, overly focusing on short-term results, or making decisions without adequate due diligence.
- **Self-dealing**. The agent's incentives may not be entirely aligned with the owners interests. For example, using the owner funds to "gold plate" the system to reduce the risk of the agent failing a contract standard or performance metric.
- **Entrenchment**. Making decisions that increase the cost to the owner to switch to a new provider, such as advertising their own brand, deploying proprietary or integrated information technology systems rather than "plug and play" equipment, or matrixing management responsibilities and functions in ways that are challenging to later untangle.
- **Poor Risk Management**. Taking risks the owner would not knowingly take because the risk is ultimately the owner's and not the agent's.

Management Needs to Be Empowered, Incentivized, and Accountable for Long Island Operations

The principal-agent problems and Balanced Scorecard Blinders are made worse by a matrixed-management structure and corporate shared services that put Newark, New Jersey-based PSEG management in charge of key Long Island operations (including the information technology that failed during the Isaias). Thirty-four PSEG Long Island managers, charged with operating and maintaining LIPA's assets, report to superiors in New Jersey rather than management on Long Island. Indeed, whole categories of mission-critical services, such as IT, are controlled from New Jersey. **These New Jersey-based managers have little accountability for Long Island operations, which are only a small part of their jobs, and none to the LIPA Board of Trustees.**

Additionally, while the nearly $80 million per year of fees paid to PSEG for its executive management services is significant relative to the services PSEG Long Island provides (essentially consisting of 18 management employees plus some shared services), the amount contributes only about four percent of PSEG Enterprise's overall earnings. **It is not surprising that New Jersey corporate management is primarily focused on the other 96 percent of their business.** This has led to a serious misalignment between the management attention and focus that Long Island customers need and are paying for and what is being allowed by the parent corporation. This is precisely why LIPA insists on strengthened regional, dedicated management in any revised contract.

Following instructions from the LIPA Board in November 2020, a team of LIPA staff and outside analysts have conducted due diligence on PSEG operations for Long Island. Based on the information available, **LIPA's investigation has been unable to identify meaningful management or cost synergies arising from matrix management and shared services provided by PSEG from New Jersey, such as IT. From the perspective of**

[4] See Geis, George S., Business Outsourcing and the Agency Cost Problem

LIPA management, the quality of services managed from New Jersey has ranged between medium to low, depending upon the function. For example, budgets, managed from Newark, are "numbers on a page" rather than strategic investment decisions supported by detailed work plans. Asset management, cited as deficient in both 2013 and 2018 management audits as well as in a 2020 LIPA review, remains a maintenance program rather than a strategic program to manage the life-cycle cost of LIPA's large asset base.

The rationale justifying matrix management and shared services was that managers, expertise, and special functions can be shared across organizations or divisions, reducing overall costs and improving quality. These are theoretical benefits that have simply not materialized in the last seven years of operating experience.

Since November 2020, the LIPA Board has documented over 140 serious deficiencies in management, emergency management, IT, strategic planning, asset management, risk management, budgeting and planning, real estate management, inventory management, collections management, and billing of affiliate services, among other areas.

This is not the first time that a service provider has marginalized LIPA operations and customers within a larger enterprise. The Department of Public Service's 2013 Management Audit of LIPA and National Grid stated:

> *"The audit revealed numerous areas where **National Grid's Long Island operations were not treated with the same level of management attention as that shown in National Grid's NYS electric operations.** For LIPA services and operations to improve on a continuous basis, LIPA operations and LIPA customers must remain as important to PSEG executive management at the corporate and Board level as its New Jersey operations and customers."*[5]

Given PSEG Long Island's failure to respond to and recover from Tropical Storm Isaias—including the critical IT functions managed from New Jersey that failed during the storm, as well as the management deficiencies documented by the Board in other areas—we conclude that this sharing arrangement of management and resources with New Jersey simply does not work. **It is abundantly clear that mission-critical functions must be managed from Long Island by experienced, capable, and empowered staff.**

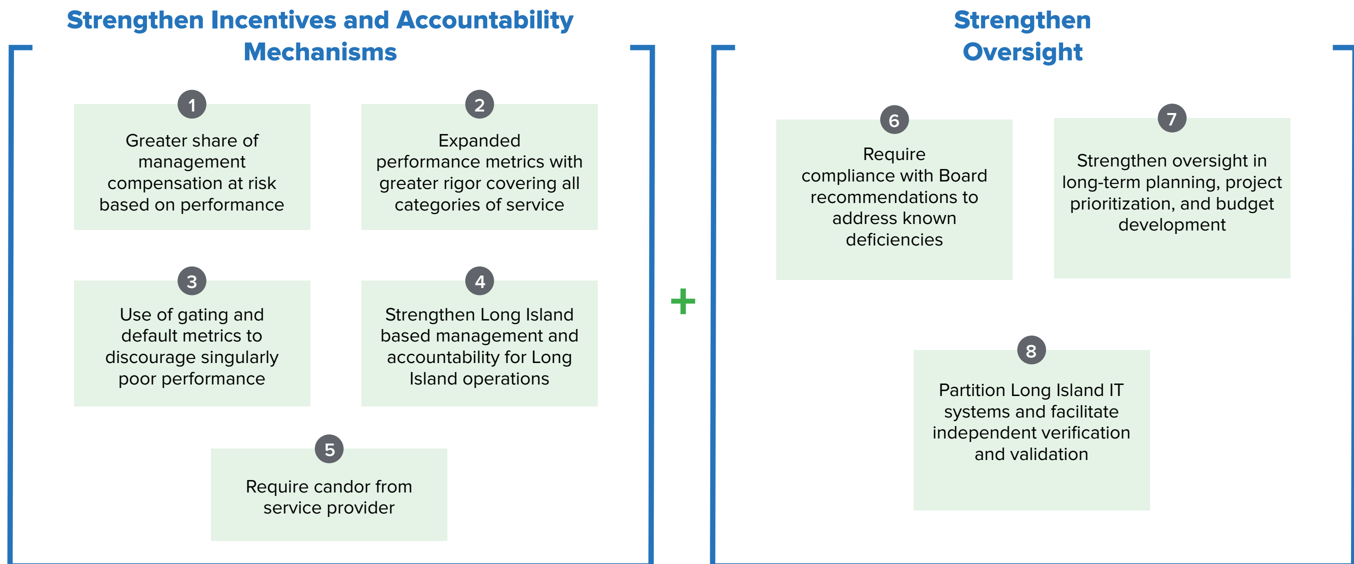
Key Elements of a Reset LIPA – PSEG Long Island Relationship and Reformed Contract

The Isaias Task Force 90-Day Report and this report discuss the types of issues LIPA has experienced with outsourcing management functions to PSEG Long Island since 2014. **The relationship between LIPA and PSEG Long Island needs to be reset to ensure greater alignment, accountability, transparency, and oversight. This reset must start with contractually guaranteed changes that LIPA can rely upon, which then need to be demonstrated through improved PSEG Long Island management performance.**

Figure 12 summarizes the contractual reforms that need to be part of a new service provider agreement, whether with PSEG Long Island or another provider.

[5] Comprehensive Management and Operations Audit of Long Island Power Authority; Matter No. 12-00314; Submitted to The New York Public Service Commission Department of Public Service, September 13, 2013.

FIGURE 12:
The Core Contract Reforms Required for A Better Performing Long Island Utility



Current Status of LIPA and PSEG Long Island Contract Negotiations

LIPA and PSEG Long Island have been engaged in negotiations to reset our relationship and provide the alignment, accountability, transparency, and oversight that the contract reforms, shown in Figure 12, would accomplish. These negotiations have been ongoing since January 2021. The reforms in Figure 12 are designed to provide the LIPA Board of Trustees, elected officials, and customers with the confidence that continuing with PSEG Long Island will achieve the vision set out in 2013 for an industry-leading utility for Long Island customers. These reforms could achieve the critical alignment between the Board, management, and front-line workers necessary for our success. These contract negotiations have been monitored by the DPS, which has a regulatory oversight role of both LIPA and PSEG Long Island and provides independent recommendations to the LIPA Board of Trustees.

To date, LIPA and PSEG Long Island have been unable to achieve the objectives in Figure 12 in negotiations. **PSEG Long Island's latest offer is modestly better than the current contract in some areas. However, it is worse in other areas. Overall, the offer does not fundamentally address the weaknesses of the current contract.**

We will maintain open lines of communication with PSEG Long Island management and remain open to further discussions. We will keep the Board and public apprised if an offer is put forth that addresses the Board's concerns.

Summary

The OSA gave wide operational discretion to PSEG Long Island based on the expectation that PSEG's "name on the truck" and contract performance incentives would align PSEG Long Island management with LIPA's interests and those of its customers. The OSA gave LIPA audit and oversight rights but little flexibility to minimize agency risks, make course corrections, or keep PSEG Long Island management focused on evolving customer priorities.

While it is important to recognize that there have been improvements over the last seven years, Tropical Storm Isaias put in stark relief the problems with the contract. The operational and IT failures experienced by PSEG Long Island during the storm were entirely due to management failures, as detailed in the **Isaias Task Force 90-Day Report**. Additionally, the PSEG Long Island contract has not delivered on its core promise of an industry-leading utility to our customers, and the Board has documented over 140 management deficiencies.

To move ahead with confidence, the relationship between LIPA and PSEG Long Island needs to be reset to ensure greater alignment, accountability, transparency, and oversight. This reset must start with contractually guaranteed changes that LIPA can rely upon, which then need to be demonstrated through improved performance. To date, LIPA and PSEG Long Island have been unable to achieve these objectives in negotiations. LIPA remains open to further discussions. We will keep the Board and public apprised if an offer warranting consideration becomes available.

OPTION 3

Outsource to a New Service Provider to Improve Operations

Incumbency does not imply perpetuity. **The outsourcing model that LIPA has employed since 1998 always contemplated the transition to new service providers depending on the performance of the incumbent and the evolving needs of LIPA and its customers.** LIPA executed such a transition on January 1, 2014, with PSEG Long Island taking over management of day-to-day operations from National Grid.

The rationale for selecting a new service provider would be to identify, through a rigorous and competitive bidding process, a partner that more strongly aligns with the management orientation, capabilities, and partner mentality that LIPA seeks. The lessons of the PSEG Long Island experience remain valid here, and LIPA would seek to employ the strengthened contractual framework and management incentives discussed in Option 2, and specifically Figure 12, above.

The Market for Potential Providers

Whether viewed as a single service provider or a suite of individual and complementary service providers, **there are private firms in the marketplace that may be able to provide the management services required to deliver electricity to LIPA's customers with the level of professionalism that customers expect and deserve.**

The last time the OSA was rebid in 2010, several nearby utilities expressed interest in serving as LIPA's primary partner. Similarly, many firms exist in the United States that can perform selected components of utility operations, including construction, repair, and maintenance of the transmission and distribution system. The current service provider uses several firms to perform these utility functions, with good results for customers in terms of cost and service.

Private firms also exist that routinely perform billing and customer service functions. Again, PSEG Long Island has utilized such firms when it has not been staffed to handle overflow activities or prefers to outsource to specialized firms. IT services, including secure, cloud-based system hosting, software support and maintenance, workflow management, and financial record-keeping, can be outsourced to specialized firms. Customer-facing functions can also be outsourced. For example, most of the energy efficiency programs offered by PSEG Long Island are delivered by third party contractors that interface directly with customers to meet their needs.

The recent procurement by the Puerto Rico Electric Power Authority (PREPA) of essentially the same suite of services LIPA currently obtains from PSEG Long Island demonstrates the potentially robust nature of the market. Despite a challenging circumstance—a utility in bankruptcy and a grid in a poor state of repair after Hurricane Maria—PREPA's procurement saw more than a dozen firms express interest in becoming the service provider and the bid process resulted in four serious final round bidders.

LIPA Need Not Partner with a Single Service Provider

Multi-sourcing, the concept that different firms can be used to separately provide the activities required to run an electric utility, is common in the industry. Utilities routinely source a range of operational activities through third parties. Similar models could be applied in the context of Long Island's utility. For example:

- Transmission and distribution design and construction projects and certain storm restoration activities are routinely outsourced to private firms that have the requisite resources and technical expertise.

- Major transmission lines in New York are being constructed by private developers who then turn over operational control of those lines to the New York Independent System Operator (NYISO).
- Power plant construction and operation are routinely outsourced to qualified firms that generally perform those services competently and at a reasonable cost (only the failures reach public attention, which admittedly happens on occasion). New York State uses similar arrangements to procure renewable resources.
- Energy efficiency and customer-side renewable resources have always been handled on Long Island by third-party vendors, either under contract to LIPA or by qualifying for rebates that LIPA provides. There is no reason to expect this model to change under any of the scenarios that are envisioned for LIPA's future.
- PREPA is transitioning to operate under an outsourcing structure and has awarded a contract to a special purpose joint venture to operate and maintain the electric grid and construct capital projects.

Advantages of Securing a New Service Provider

LIPA's long, direct experience with partnerships and familiarity with the practices of neighboring investor-owned utilities and large public utilities across the country provides insights into the advantages and disadvantages of the public-private partnership model. Key success factors are: (1) choosing the right partner(s); (2) smoothly managing the transition between PSEG Long Island and the new service provider(s); and (3) coordinating and overseeing the activities of the service provider(s).

Securing a new service provider would allow LIPA to focus on the right match of management styles and mutual compatibility on the needs and expectations for our customers. This option offers the possibility of securing a different service provider or providers that will be better aligned with the LIPA Board's vision and more focused on serving the needs of LIPA's customers.

Securing a new service provider, by definition, means the creation of a new operating agreement. Based on LIPA's experience with the existing OSA, the terms of any new operating agreement would have to address the deficiencies that have been observed and documented with the current contract, as summarized in Figure 12. A new agreement could achieve greater oversight authority, increased ability to reward or penalize performance and outcomes, and tighter alignment between the motivations of the service provider(s) and LIPA's customers.

Securing a new service provider also allows LIPA to explore unbundling the service packages and separately awarding the elements to the most qualified providers. This may result in an overall improvement compared to the single partner approach because not every applicant is necessarily best-in-class in each individual element. Such an approach could provide LIPA more flexibility to retain and reward those partners that are doing well while removing and replacing contractors that do not meet expectations. Targeted changes with individual providers can be made much more easily than replacing a single-sourced partner who may be performing well in some areas but not others. The multi-provider approach requires efficient and effective integration of services. This is commonly performed by most companies as targeted outsourcing is a widespread practice.

Disadvantages of Securing a New Service Provider

As with any outsourcing arrangement, hiring a contractor introduces a layer in between the community-owned utility (i.e., LIPA) and its customers. That vendor layer has its own private incentives to maximize contract value to itself rather than the value to the community. A well-crafted contract with the right partner can minimize these agency risks. They can never be entirely eliminated, and a great deal of effort and expense go into the necessary controls to ensure alignment between the vendor and the owner (i.e., trust but verify). There is no way to eliminate these controls, because without independent verification, the owner is left with a "trust only" contract with few methods to align interests and incentivize performance.

Another potential disadvantage of a new service provider, at least when compared to staying with PSEG Long Island, are the costs and continuity risks associated with transition. The existing OSA has several provisions that are intended to smooth this transition, and LIPA believes the continuity risks are manageable. Transitioning between service providers does involve some duplication of effort and the incurrence of costs associated with winding down one provider's activities and ramping up the other. The current OSA includes provisions for backend transition services[6] and contract termination fees.[7] Depending on the circumstances of termination, these costs could be cancelled or partially or fully offset by damages that may be recovered from PSEG Long Island by LIPA. The "Managing a Potential Transition" section of this document covers transition issues in greater depth.

Next Steps

Further development of Option 3 would begin with the issuance of a Request for Information (RFI). This RFI would outline LIPA's requirements and ask potential proposers to detail their capabilities and interest. The RFI would be accompanied by a significant outreach effort by LIPA to potential providers to explain the Board's vision for the utility and the potential framework of a new partnership arrangement consistent with the reforms discussed in Option 2. Staff would report back to the Board and stakeholders on the results of the RFI, which would be a checkpoint before proceeding with a Request for Proposals (RFP). The entire selection process of RFI and RFP may require nine to 12 months. The transition to a new service provider would require an additional six to 12 months beyond the final award of a new contract.

Summary

Transitioning to one or more new service providers provides a unique opportunity to reset the performance of LIPA's contractors to meet the LIPA Board's expectations for its customers and to implement the types of cultural and contractual changes that are being considered to reform the contract with PSEG Long Island.

The LIPA Board's vision for the future of the electric utility on Long Island would be clear and evident from the moment it issues the RFI to final negotiations with the most qualified candidates. The risks of transitioning to new contractors are readily identifiable, and the benefits could easily outweigh the risks. **This selection process would start with an RFI, which would provide an initial indication of interest among potential contractors. The entire selection process will likely require nine to 12 months and the transition process an additional six to 12 months for a total of 15 to 24 months before new vendors are in place.**

[6] Defined in the Amended and Restated Operating Services Agreement at Section 9.2
[7] Defined in the Amended and Restated Operating Services Agreement at Section 8.5(C)

OPTION 4

Bring Utility Operations Under LIPA Management

Option 4 offers a structural solution to the principal-agent problems inherent in outsourcing contracts. Placing the utility under the direct management of LIPA, which has an explicit mandate to protect the interests of customers rather than to maximize profits, removes the divergence between customer interests and commercial interests and ensures that the utility reflects the values and priorities of the Long Island community.

Local management offers several potential benefits:

- **Purity of mission.** Everyone from the Board of Trustees to the CEO, down to the lineworkers and customer-facing employees is accountable to customers and the community.
- **Adaptability and responsiveness.** An independent service provider serves as a layer of separation between strategic vision and execution. A local utility would not have to maneuver around a third-party contract, providing greater flexibility.
- **Transparency.** LIPA performance and contracts could be more transparent to customers and stakeholders than if key operations remain contracted out to a single entity that in turn subcontracts out large chunks of work.
- **Resource efficiency.** A locally rooted utility management could be a strong steward of customer resources.
- **Local governance and accountability.** The Board of Trustees—respected members of the Long Island community—will have the authority, information, and direct oversight necessary to hold management accountable.

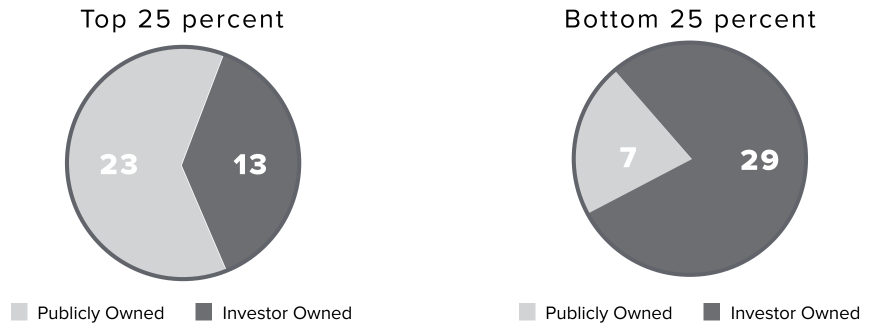
What is the Track Record of Publicly Managed Utilities?

Nationally, non-profit, public utilities have a strong record across key categories of performance, including customer satisfaction and reliability (Figure 13). This provides a strong body of evidence for the legitimacy of the local management model and also means there is an established pool of experience and best practices that LIPA can readily draw upon if this option is pursued.

FIGURE 13:
Nationally Public Utilities Outperform Investor-Owned Utilities on Measures Customers Value

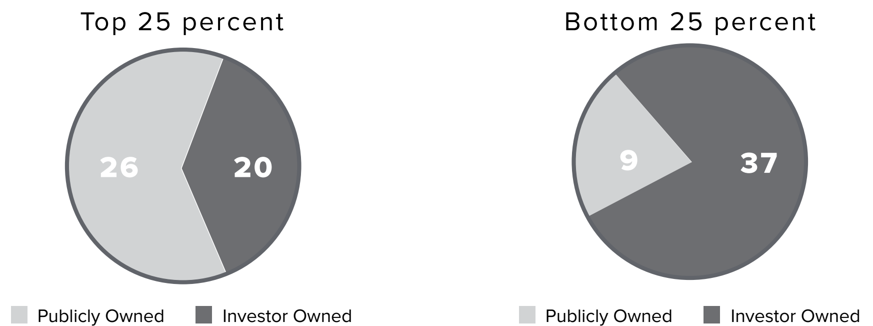
Public Sector Utilities Have High Customer Satisfaction
(# of utilities)

Source: J.D. Power Electric Utility Residential Customer Satisfaction Survey, 2019; publicly owned includes both municipal and cooperative utilities.



Publicly Owned Utilities Have High Reliability
(# of utilities)

Source: U.S. Department of Energy, Energy Information Administration; utilities with greater than 100,000 customers; publicly owned includes both municipal and cooperative utilities.



What are the Financial Implications of LIPA Management?

To test the financial and operational viability of the LIPA management option, LIPA has modeled the financial scenarios for such a transition. There are various uncertainties that need to be validated, but **the bottom-line finding is that LIPA management is financially attractive**. Long Island customers devote substantial resources to PSEG Long Island management fees and corporate service expenses annually. The PSEG Long Island management fee, which covers the costs of 18 management positions in the PSEG Long Island management company as well as PSEG company profits, averages a projected $83 million per year over the next five years. Additionally, customers incur $15 million to $20 million annually for PSEG affiliate services, New Jersey based staff and systems support within IT, Human Resources, Procurement, and other functional areas. These management and support functions can be provided at lower cost under a LIPA management model.

Under LIPA management, the utility would capture staffing cost efficiencies. Several senior management positions within the current PSEG-operated management company can be absorbed by existing functions and positions within LIPA. There is some duplication of effort inherent in the service provider model, as the owner needs to independently manage the vendor to ensure that the vendor performs to its contractually required specifications. Similarly, certain categories of New Jersey affiliate staff services can be partly or fully covered by existing capacity in LIPA and ServCo or will no longer be necessary.

Even after accounting for the necessary expenses to replace management functions and services, significant steady-state cost savings remain. **The nearly $100 million saved from eliminating management fees and affiliate expenses more than offsets the estimated $25 million in new labor and external sourcing costs that will be required within a local management structure**. Because approximately 40 percent of the management fee is capitalized annually, the resulting savings would be split between the operating budget ($40 to $45 million annual savings) and the capital budget ($30 to $35 million annual savings).

Additional savings above and beyond these estimates are possible. The rates used by PSEG Long Island to allocate service costs to Long Island include overhead allocations that exceed what we would expect to incur under a LIPA-managed structure. Further, a substantial share of affiliate services (especially for IT) is sourced through third party vendors. Stronger incentives to manage costs under LIPA management (versus the current cost pass through arrangement) can potentially deliver additional cost savings in these areas.[8]

We estimate $80 million to $90 million in one-time transition costs associated with a move to LIPA management.[9] This includes approximately $15 million to migrate PSEG IT systems to Long Island. Additional costs include expenses incurred by PSEG Long Island to support the transition, expenses incurred by LIPA incidental to the transition of ServCo staff, to recruit for new positions, to rebrand the organization, and for other miscellaneous transition activities. **With estimated annual savings of $75 million to $80 million, we expect the vast majority of these one-time costs to be recouped within the first year.**

Figure 14 summarizes the key financial metrics. **LIPA customers could save in the range of $175 million to $236 million, net of transition costs through the 2025 termination of the OSA contract.** The OSA contains an 8-year extension. If such extension were exercised, **the total savings between 2022 and 2033 would be in the range of $860 to $920 million.** The savings generated through public management can be used to reduce future rate adjustments or reinvested in new strategic initiatives driven by customer needs and priorities.

[8] A lack of full transparency from PSEG Long Island on the components of these cost categories make it difficult to quantify potential cost savings.

[9] The OSA specifies a contract termination fee of approximately $61 million. The termination fee is not owed to PSEG if it breached material obligations in the OSA, as we believe they have, so we expect actual transition costs to be closer to $30 million.

FIGURE 14:
Financial Impacts of LIPA Management vs. PSEG Long Island Management Contract

	2022	2023	2024	2025	2022-2025 Total
Estimated Change in Annual Revenue Requirements ($M)					
Forgo Management Fee and Hire New Management Team					
Eliminate Management Fee (Operating Expense)	-$24.2	-$49.4	-$50.4	-$51.4	**-$175.3**
Replace Management Positions	$2.1	$4.3	$4.4	$4.5	**$15.3**
Net Impact	-$22.1	-$45.0	-$45.9	-$46.9	**-$159.9**
Forgo Affiliate Charges and Replace Necessary Functions					
Eliminate Affiliate Charges	-$8.2	-$16.8	-$17.1	-$17.5	**-$59.7**
Replace Affiliate Functions	$7.3	$14.9	$15.2	$15.5	**$52.8**
Net Impact	-$1.0	-$1.9	-$2.0	-$2.0	**-$6.9**
Eliminate Carrying Costs on Capitalized Management Fee	-$0.6	-$1.2	-$1.3	-$1.3	**-$4.4**
Contingent Cost Increases (e.g. Medical Benefits)	$5.0	$5.1	$5.2	$5.3	**$20.6**
Total Change in Annual Revenue Requirements	**-$18.6**	**-$43.1**	**-$44.0**	**-$44.9**	**-$150.7**
Estimated Change in Annual Borrowing Requirements ($M)					
Eliminate Capitalized Management Fee	**-$15.8**	**-$32.3**	**-$32.9**	**-$33.6**	**-$114.5**
Total Estimated Savings	**-$34.5**	**-$75.4**	**-$76.9**	**-$78.4**	**-$265.2**
Estimated 2022-2025 Savings Net of Transition Costs					-$175.2
Estimated 2022-2025 Savings Net of Transition Costs (excl. termination fee*)					-$236.2

*The OSA specifies a contract termination fee of approximately $61 million. The termination fee is not owed to PSEG Long Island if it breached material obligations in the OSA, as we believe they have, so we expect actual transition costs to be closer to $30 million rather than $90 million.

What are the Key Risks of LIPA Management?

Customers are not interested in simply exchanging a "private" logo for a "public" logo on the trucks. A utility that is local in name but not in deed will offer no improvement on the status quo. Structural change alone is insufficient; other pieces also need to be in place to deliver performance.

1) Management Quality – The management team must be up to the task. A locally anchored team is more likely to prioritize customer needs, but their capabilities are equally important. **The utility should be managed by seasoned professionals whose own careers and compensation would be explicitly linked to their actual performance — with verifiable and transparent metrics.**

Day-to-day operational management requires different capabilities than oversight alone. **Under the LIPA management option, LIPA anticipates needing to add top talent in 12 new senior positions to mobilize the requisite skill sets and fill out the management structure**. Strengthening senior-level expertise in key areas such as transmission and distribution operations and customer service will be particularly important. LIPA will need to recruit seasoned managers through a rigorous, nationwide search and selection process. **The ability to offer competitive, market-based salaries to attract and retain talented managers is a critical determinant of success, and, as a public provider, LIPA may not be able to offer such salaries**.

Additionally, **a public entity may be unable to replicate a private entity's ability to incentivize efficient operation and service through compensation**. In the absence of such incentives, there is the risk that the utility falls short of its mission.

2) Customer and Stakeholder Support – Customer and stakeholder acceptance of LIPA as the management provider is a significant challenge that needs to be further explored. Between 1998 and 2013, utility service on Long Island was provided using a public-private structure under the LIPA brand name. Customer dissatisfaction was the primary motivation for the LIPA Reform Act of 2013 and for providing utility service under the PSEG Long Island brand. **A change in business model towards LIPA management, while different than what was in place between 1998 and 2013, would nevertheless require the full support of our state's elected officials, regulators, stakeholders, and most importantly customers, which is uncertain. It is possible, for example, that customers would perceive a move to LIPA management as a return to a previously failed management model that they would not support.**

3) Board Governance and Management Accountability – In the LIPA management model, the Board of Trustees is a critical component of ensuring the "purity of mission" that is so important to success. The Board, with the assistance of the DPS as independent advisors, is the entity that must hold management accountable. This involves a significant investment of time and skill to setting the long-term vision for the utility and the standards for management performance. This must include addressing evolving industry trends and standards. The state-of-the-art continues to evolve within the utility industry and the broader economy. **Under the LIPA management option, the Board of Trustees must understand their critical role in ensuring that management creates a culture of continuous improvement** – one that meets not only the needs of today but evolving customer desires. The Board will need to be rigorous in its oversight function of management, including benefitting from the expertise of the DPS, to ensure management delivers results that meet or exceed evolving industry standards and best practices.

4) Private Sector Role – A potential criticism of the public power model is that it fails to leverage the specialized expertise and scale economies and efficiencies available in the private sector. In reality, successful public utilities routinely utilize private entities in a purposeful manner. LIPA should not pursue a local management

model where all functions and services are provided in house. Rather, LIPA should selectively and flexibly assemble best-in-class expertise from the private sector, particularly to improve the cost and quality of non-core, business services currently provided by PSEG's New Jersey affiliates. Such contracts will require proactive oversight with clearly specified accountability and standards, and commensurate rewards and penalties depending on performance.

5) Transition – Much like selecting a new Service Provider in Option 3, a shift to local management introduces short-term business continuity risks and costs associated with transition. **LIPA management would need to put forth a transition plan that adequately mitigates the risks** involved in hiring a new management team, shifting 2,500 employees to a new organization, and migrating certain IT systems. The section on "Managing a Potential Transition" covers these issues in greater depth.

Summary

In this section, we have identified the potential benefits of placing the utility under the direct management of LIPA, which has a mandate driven by customer interests rather than profit maximization. The case for LIPA management is bolstered by the financial benefits. Projected savings of $75 to $80 million annually ($860 to $920 million net of transition costs through 2033) can fund important new initiatives that enhance customer welfare.

We have also identified certain risks that need to be carefully considered, including the potential difficulty of attracting and retaining qualified management, the need for customer and stakeholder buy-in, and the potential challenges associated with using compensation as an incentive for management performance.

Undertaking a significant change in business model would require the full support of our state's elected officials, regulators, stakeholders, and most importantly customers, as well as a transition plan that adequately mitigates the risks involved in hiring a new management team, shifting 2,500 employees to a new organization, and migrating certain IT systems.

Managing a Potential Transition

Both Option 3 (New Service Provider) and Option 4 (LIPA Management) involve a transition to new management. The 2013 agreement with PSEG Long Island was specifically designed to preserve these options should they be deemed more suitable in the future, and mechanisms are currently in place to facilitate an efficient and effective transition. For example, the OSA requires PSEG Long Island to cooperate with the incoming service provider and to familiarize the successor with essentially all the facilities, operations, staffing and labor agreements, emergency response plans, IT system, and property rights under the management or control of PSEG Long Island. The contract also requires an Exit Test prior to termination of the OSA to confirm that the outgoing service provider has performed all the maintenance and capital improvements that were budgeted and scheduled, and that the system is in a fit condition for assumption of responsibilities by the new service provider.

The following sections summarize key aspects of the transition process, the existing provisions in place, and potential risks and mitigation strategies.

Transmission and Distribution Assets and Employees (ServCo) Would Fully Transition to a New Service Provider

LIPA already owns or leases the T&D assets that PSEG Long Island has been managing (including the trucks, tools, call center, office space, and equipment), and the 2,500 dedicated employees can be brought under a new service provider or under LIPA's direct management with minimal disruption. These dedicated professionals, many of whom have served Long Island since the days of LILCO, through National Grid and PSEG Long Island management, are currently employed by ServCo, a company subsidiary created specifically to make transitions between service providers seamless. **The LIPA Act first adopted in 1986, requires that ServCo employees' terms of employment, their union agreements, and their employment and retirement benefits be unaffected by management transitions between service providers envisioned by LIPA's statutory business model**. This was done by LIPA during the transition from National Grid to PSEG Long Island in 2014 and can be done again.

A New Management Team Would Replace the Current PSEG Long Island Management Company

If the OSA with PSEG Long Island is terminated, a new management team would step into the position of the PSEG Long Island management company—currently comprising 18 executives—to manage ServCo. To facilitate this transition, the OSA specifies a one-year transition period during which the outgoing Service Provider would establish a transition team and provide day-to-day assistance to familiarize the new management team with existing operations.

The new service provider (Option 3) or LIPA (Option 4) would need to hire executives to fill the spots of the 18 outgoing PSEG Long Island management positions. There is a ready market for management talent, and LIPA will need to ensure that under either option a rigorous national search and selection process identifies top management talent to serve Long Island.

In either transition scenario, frontline operations and maintenance staff, their supervisors, and most Long Island based Director-level incumbents will continue in place as they transfer into the management

structure. This will minimize risks of operational disruptions and discontinuities during the transition. In core operational areas of T&D Operations, Customer Service, and Projects and Construction, for example, eight of the current 13 Director-level positions are part of ServCo and will transition to the new entity.

LIPA staff has already considered ways to manage the short-term management transition risks under the LIPA management model. First, many of the key management disciplines are already staffed by experienced professionals within LIPA. Second, LIPA will recruit key positions early in the one-year transition period, providing ample time to orient and build familiarity of the management team before the formal hand-off from PSEG Long Island. Third, LIPA has the option to engage management advisory support in various forms (e.g., recent retirees, management secondment from other large public power companies, specialized turnaround consultants) to help guide the transition. Finally, LIPA can selectively try to retain current PSEG Long Island management company leadership in areas where performance has been strong, and continuity is deemed to be important. **The ability to offer competitive, market-based executive salaries to attract and retain talented managers is a critical determinant of success for the LIPA management option.**

In the case of Option 3, LIPA expects that the selected service provider will identify similar strategies and mechanisms to mitigate management transition risks. For both scenarios, an important transition priority will be designing a management structure that coherently integrates ServCo and management team roles and functions, overcomes the current challenges posed by matrix management structures, and best positions the new entity to deliver for customers.

Key IT Systems and Data, Currently Maintained in New Jersey, Would Need to be Migrated to the New Entity

PSEG Long Island has designed and executed the IT systems that provide service to customers on a day-to-day basis. A new provider will initially need to work from this baseline before implementing a potentially different operational approach.

SAP, PSEG's current Enterprise Resource Planning system (ERP),[10] is the most significant IT transition task due to multiple interdependent SAP software modules, the breadth of utilization across ServCo, and the current reliance on New Jersey for systems support and maintenance. SAP migration will entail carving out Long Island's data, entering into new licensing agreements, and initiating new vendor support contracts. Subject to additional due diligence, we believe that the full migration process—assessment, planning, implementation, testing, and system cut-over to Long Island—can be completed during the one-year transition period.

Other PSEG enterprise IT systems will be much less complex and costly to migrate. Some systems are either already managed separately for Long Island (e.g., the customer relationship management and outage management systems) or can be relatively easily separated (e.g., email, telephone, and contact center).

Several PSEG Long Island IT systems, including ERP (SAP ECC), outage management and dispatching (CGI OMS), and customer information and billing (CAS) systems are outdated and may require upgrading or replacement. A formal IT assessment, including recommendations for longer-term systems modernization, will be conducted post transition.

The New Entity Will Need to Identify Sourcing Arrangements for Business Service Functions Currently Provided by PSEG New Jersey

PSEG affiliates in New Jersey currently provide a range of business services to Long Island. Because these

[10] ERP systems include functionality that integrates the enterprise's work management, cost tracking, financial management and asset management requirements.

services are provided outside of ServCo and are not currently contracted in LIPA's name, the provision of these services would not transfer to the new entity. These functions include:

- Information Technology – IT procurement; enterprise software support and maintenance; IT security functions.
- Human Resources – Supervisory support in the areas of employee and labor relations, talent management, workforce planning, and total rewards; HR systems administration and reporting; employee health and safety administration; and recruitment, outreach, and diversity.
- Procurement – Procurement analysis and reporting; data and systems support; audits.
- Treasury – Cash management; insurance services; trust/pension investments.

LIPA or a new service provider would need to identify how to deliver such services. Options include building capacity within ServCo or the management company or hiring best-in-class expertise from the private sector to manage these functions. LIPA or the new service provider could retain certain functions in house, while hiring third parties to manage aspects of IT, human resources, and facilities. Specialized firms exist in each of these areas, and many companies use these firms, providing access to scale benefits, private sector efficiencies, and best-in-class processes and technologies.

To mitigate transition risks, LIPA or a new service provider should, at the outset, clearly map out what functions it would carry out in-house and what will be co-sourced or outsourced to third party management, while protecting the rights and benefits enjoyed by workers under current union contracts. To ensure aligned performance, LIPA or the new service provider should ensure that robust, relevant, and verifiable performance metrics are specified for each domain that utilizes outside partners.

Clear and Consistent Communications, Internally and Externally, Will Be Critical Throughout the Transition

After seven years, PSEG Long Island has established a brand for electric service on Long Island, and LIPA has invested considerable resources in marketing and advertising that brand. **A transition to a different provider will require an extensive rebranding and customer education campaign, as was executed upon the transition from National Grid to PSEG Long Island**. Basic concerns like "who to call?" and "who to send payments to?" need to be managed. A rebranding exercise also offers an opportunity to reset the compact between the customer and the utility, ensuring that customers know the rights and services they are entitled to, and that the utility will be held accountable for its performance.

Communications requirements extend beyond customers to a range of local, regional, and state stakeholder groups, including regulators, policymakers, and labor unions. LIPA will need to clearly articulate the rationale for the management change, allay potential concerns, and provide transparent updates as the transition progresses. Particular attention will be paid to employee education and awareness about the legal statutes governing ServCo and what the transition means for employees, as well as reminding employees of their rights and offering assurances that union agreements and employee compensation and benefits will be unaffected.

FIGURE 15:
Transition Activities are Well Defined in Scope

1. Appointment of the executive management team for the new service provider(s) or LIPA and identification of the transition team of the former service provider.
2. Familiarization of the new executive team by the outgoing transition team with the existing operations and systems of record-keeping.
3. Transfer of the existing 2,500 ServCo employees from PSEG Long Island to the new provider, including the extension of all terms of employment for union and non-union employees, confirmation of existing work rules and assignments, and transfer of accrued obligations regarding pension benefits, other post-employment benefits, and tenure/seniority.
4. Migration and/or carve-out from PSEG Enterprise IT systems to dedicated Long Island IT systems.
5. Rigorous due diligence to ensure that all management, operational, and system controls are fully in place and functioning.
6. Transfer of all essential business continuity plans and responsibilities.
7. Rebranding of the utility operations.
8. Implementation of transition plans for systems and work practices to meet the expectations of the new service provider(s).
9. Transfer of access to all bank accounts, financial systems and information, and contracts for products and services to the new service provider(s).
10. Performance of the Exit Test for the outgoing service provider.

Depending on the Option Selected, the Transition Could Take One to Two Years

As summarized in Figure 15, the transition process is multifaceted, but well defined. All the transition steps are intended to result in a smooth and final transfer of all operating authority and agency responsibilities to the new provider on what is colloquially known as “Day 1.”

The steps in Figure 15 will require up to 12 months. During this period, disciplined change management will need to surface and proactively manage both known and newly emerging transition issues and risks. Accelerating this timeline could lead to higher-than-expected costs as services would be duplicated between the outgoing and incoming service provider and the potential for error and rework that result from incomplete understanding and assessment of requirements. There is also the risk that current unknowns could cause this transition period to lengthen.

A transition to LIPA management (Option 4) could be completed in this 12-month period. The upfront selection process for a new service provider in Option 3, however, would add an additional nine to 12 months to this timeline. The selection process for a new service provider involves issuing a request for information, launching an outreach and marketing campaign, issuing a request for proposal, screening qualified bidders, conducting contract negotiations, and formally selecting a new provider. Although this extends the timeframe, a thorough selection process will ensure complete consideration of prospective providers and alternative service arrangements and ultimately lead to contractual terms that are in the best interests of LIPA’s customers.

Summary

The activities associated with a management transition—mapping functions and processes, replacing IT systems, and transitioning staff to a new organizational environment—are not without costs and risks. The processes and activities involved, however, are well understood, and risks are manageable via known mitigation and change management strategies. Utility management successfully transitioned from National Grid to PSEG Long Island in 2014 and can do so again. While managing continuity risks during transition is important and takes time to do well, short-term transition concerns need not, in our view, overshadow the more consequential question of what management structure will best meet the needs of customers over the longer term.

Conclusion

A process that began with the question “What went wrong?” is now giving us the answer to “How do we make it right?”

The Isaias Task Force concluded that PSEG Long Island’s deeply embedded mismanagement was the root cause of its poor response to Tropical Storm Isaias. **The recommended solution, embraced by the Board of Trustees, is to change the way LIPA’s assets are managed to improve operations and service to customers.**

This report is the product of a comprehensive assessment of all the management options available, including the possible terms of a renegotiated agreement with PSEG Long Island (or similar terms anticipated from another service provider). As the report makes clear, there is no perfect option, and there is no option that is entirely without risk. For each option, the pros and cons have been carefully detailed to provide the Board of Trustees, elected officials, and stakeholders the facts to make an informed decision. Additionally, in keeping with the Board’s mission and mandate, this process has been conducted with unprecedented transparency so the public has the facts in real time and can see firsthand the professional, unbiased analysis which was applied to each of the options.

Our conclusion is that LIPA customers deserve better, and this Options Analysis clearly demonstrates that LIPA customers CAN do better than the current model. Options 3 and 4 demonstrate significant opportunities for improvement in critical areas such as cost-savings, reliability, community engagement, management professionalism, and local governance. We also believe that positive outcomes can be achieved with PSEG Long Island provided they rise to the occasion and commit themselves to the required reforms described in our discussion of Option 2. We will continue discussions with PSEG Long Island and report both to the Board and stakeholders if these reforms can be achieved through negotiations.

We look forward to continued discussion with the Board of Trustees, elected officials, customers, and other stakeholders as we work to introduce a substantially improved management model to deliver clean, reliable, and affordable electric service for Long Island and the Rockaways. Long Island customers deserve an excellent utility and this analysis concludes that it is eminently achievable.

How Did We Prepare this Report?

On November 18, 2020, the LIPA Board of Trustees instructed staff to develop and present options to better manage LIPA's assets. An exercise of this report's scope typically takes six to nine months; however, the issues and options are well understood, and the economics are straightforward.

To meet the Board's expectations, LIPA developed the study internally, with an "all hands on deck" approach, headed by Thomas Falcone, LIPA's Chief Executive Officer, and a team of staff and consultants. The team rose to the occasion, devoting long hours towards developing the models, analyzing the data, and brainstorming the options.

LIPA staff delivered an initial **Phase I Options Analysis Report** on December 16, 2020. This Phase II report benefits from additional study and information gained since December 2020 and confirms the initial conclusions of the Phase I analysis.

The core team of both staff and consultants are listed below.

Long Island Power Authority

Thomas Falcone
Chief Executive Officer

Mujib Lodhi
Chief Information Officer and Senior Vice President of Customer Experience

Justin Bell
Vice President of Public Policy and Regulatory Affairs

Gerard Ring
Director of Budget and Financial Oversight

John Little
Senior Advisor for Rates and Regulatory Affairs

Jen Hayen
Director of Communications

tieBridge, inc.

Osman Ahmad
Project Management

GivingWorks, Inc.

Nazir Ahmad
Subject Matter Expert and Analysis

Tim Smythe
Subject Matter Expert and Analysis

Long Island Power Authority