PRELIMINARY ANALYSIS OF GOVERNOR'S PROGRAM BILL #6
RESTRUCTURING OF THE LONG ISLAND POWER AUTHORITY (LIPA)

Amendment to the Operating Service Agreement (OSA) with PSEG

The Executive's proposal could move toward increased private control over the provision of power on Long Island. However, the memo accompanying the bill indicates the intention to preserve important cost-saving benefits derived from LIPA's public ownership status, including access to tax-exempt financing as well as to federal storm assistance when needed. Because the scope of change to the OSA is undefined, it is impossible to assess whether sufficient public control would be preserved to maintain LIPA's public ownership tax-exempt status.

As drafted, the bill would allow LIPA to renegotiate the OSA with the Public Service Electric and Gas Company (PSEG), notwithstanding any other provision of law to the contrary. There are no parameters defining what will be negotiated in such an agreement, and virtually all existing laws that relate to transparency, accountability, oversight, and best practices to ensure lowest costs and protection of ratepayers would be effectively bypassed. There are also no defined parameters as to the scope of the changes contemplated, though the Executive has expressed an intention to give "full authority" to PSEG to "manage daily operations; budgeting, operation and maintenance of the utility system; storm preparedness and response; infrastructure improvements; and energy efficiency and renewable activities."

LIPA administered a competitive procurement process for the management of its electric transmission and distribution system, which resulted in the awarding of the OSA contract to PSEG in 2012, based on LIPA's determination of the best value proposal. In fact, PSEG was the lowest cost and highest technical scoring proposal. The contract was designed to provide increased transparency, as all costs borne by ratepayers are to be segregated and visible. The contract also includes detailed performance metrics that focus on cost containment and service improvement. These provisions are intended to address two of LIPA's most significant problems – high rates and unsatisfactory customer service. It is unclear if and how these provisions will be maintained or modified as a result of a renegotiated OSA. Additional questions include:

- What will be the overall value and duration of the renegotiated OSA?
- How will the contract amendment alter protections for ratepayers, as well as disincentives and penalties for PSEG if it does not meet the relevant criteria?
- Who will be responsible for future procurements, and who will provide oversight for the procurements to ensure fair and reasonable terms for LIPA's ratepayers?
- Will the negotiated contract provide continued progress toward the delivery of LIPA's highly regarded renewable energy and energy efficiency programs?

One of the most significant cost controls in the OSA is LIPA's budget review and approval processes which are intended to be a check on PSEG's expenditures. The existing agreement gives ultimate control over the use of ratepayer dollars to the LIPA Board of Trustees, whose members are appointed by the Governor and the leaders of the Legislature. It is unclear how this control and public accountability will be preserved, if budgeting is shifted to PSEG and no regulatory entity is authorized to impose restrictions on costs. Another critical component of the current contract necessary for ensuring cost control is LIPA's supervision of and accountability for all pass-through costs. The bill does not address how that safeguard will be provided under the renegotiated contract.

Any amendment to the existing contract should be subject to the same checks and balances that govern other major procurements which impact ratepayers and should be processed transparently. Contracts and subsequent amendments should have the benefit of public review and input, as well as review and approval by the State Comptroller and the Attorney General before becoming effective. This oversight by independent entities will provide Long Island ratepayers assurance that their interests are being protected, both in the near term and the long term.

Other Procurement-Related Provisions

The bill would also eliminate Comptroller contract oversight under the State Finance Law, and, thereby, Attorney General contract oversight as well for all LIPA procurements going forward. The stated justification is that with the new LI DPS oversight role, the review and approval requirements of the Attorney General and the Comptroller are “redundant and unnecessary.” However, LI DPS’ increased oversight only authorizes the Department to review and "make recommendations" with respect to LIPA’s operations. LI DPS will not have any concrete pre-approval authority with respect to contracts. This provision essentially amounts to an audit function that does not carry with it any ability for LI DPS to ensure that the purposes of its review are actually achieved. Such purposes include, but are not limited to, ensuring that safe and adequate services are provided to Long Island residents and that rates are set as low as possible but also are sufficient to satisfy LIPA’s debt obligations and its operating and capital investment requirements.

The pre-approval function of the Comptroller provides a mechanism to ensure that Long Island ratepayers are protected fiscally and from a public safety perspective, and should be preserved. Without such pre-approval, and even with the newly proposed LI DPS oversight, LIPA and its service provider (which will now be taking on an extensive – and currently unknown – increase in responsibilities) would have the unfettered ability to enter into binding contracts with no further effective oversight.

The proposed legislation also eliminates competitive bidding requirements for LIPA contracts for services subject to State Finance Law Section 163, as well as LIPA contracts for construction and purchase of supplies, materials or equipment subject to General Municipal Law Section 103. In public procurement, competition provides the optimal means of securing the best goods or services at the most reasonable prices, and provides greater openness and transparency to the public. Consideration should be given to preserving these requirements for LIPA’s procurements.

Debt Restructuring

The proposed bill would create a new special purpose corporate municipal instrumentality of the State, the LI Power Refinancing Authority (LIPRA), with a three-member board appointed by the Governor. LIPRA would be authorized to issue restructuring bonds and pledge the “restructuring property” for repayment of such bonds, absent review and approval by the Public Authority Control Board (PACB) (which currently is required for LIPA bonds). The restructuring property would include new transition charges to be imposed by LIPA on ratepayers to pay the LIPRA bonds, apparently separate from LIPA's base rate and other charges. LIPRA, as the bond issuer, would securitize the restructuring property in order to restructure LIPA's debt portfolio, although the bill is unclear on how much of LIPA’s debt portfolio will be restructured. The bill also authorizes a new servicing fee associated with the collection of the new transition charges and other duties assigned to a servicer.

It is unclear what regulatory or statutory mechanism would protect ratepayers against the erosion of checks and balances, transparency and accountability in the constitution and operation of LIPRA, and in the shifting of debt from LIPA to the new entity. The proposal as currently structured seems to lack basic financial limitations or parameters on the issuance of restructuring bonds. For example, there is no cap in the legislation on the amount of bonds that could be issued, and it appears bonds could be refinanced without limitation. Bonds may be issued with a term of up to 30 years, which could mean that the final maturity of some LIPA bonds is extended. The bill does not set requirements on the structure or amortization of the restructuring bonds.

Further, under the proposed legislation there would be no required economic standard for the issuance of the restructuring bonds. LIPA would be authorized to prepare a restructuring cost financing order based on a finding that the issuance of restructuring bonds is expected to result in savings to the consumer of electric transmission and distribution services in the service area on a net present value basis. Actual standards for the issuance of the restructuring bonds are minimal; there is no specific refinancing plan defined other than to tie the new transition charge to debt service and debt service reserve account needs. The existence of LIPRA would continue one year and one day beyond the final redemption of outstanding bonds.

The bill's statement of findings suggests that the restructuring issuer may be more highly rated than LIPA and that this fact, in conjunction with current market conditions, could result in lower debt service and electric utility service costs. However, it is unclear how the plan will impact LIPA and LIPRA's debt service and LIPA's electricity costs in the short run or long run. The anticipated enhanced ratings and the basis for such ratings, particularly in light of the LIPRA bonds being a brand new credit, are not specifically described in the bill. It is also uncertain how this plan will impact LIPA's own ratings. LIPA's authority to issue debt remains unchanged, but it is unclear if the plan contemplates new LIPA debt issuances in the future to support capital investment. If so, preservation of LIPA's own bond rating will also be a critical factor in the overall plan. It is also important to weigh whether the creation of a new public authority is necessary, and whether it is the most cost-effective and prudent approach to accomplish the goals of the debt restructuring.

LIPA ratepayers deserve ongoing, independent scrutiny of the cost of LIPA debt, which is a substantial contributor to Long Island's high electricity rates and limits the authority's ability to make desirable long-term capital investments. In fulfillment of this goal, LIPRA bonds could be made subject to review and approval by the PACB, as are LIPA bonds. The bill could also be strengthened to include more stringent, fiscally prudent requirements for the issuance of restructuring bonds. These requirements could also be imposed on any future LIPA debt issuances. Such requirements could include:

- Setting an overall cap on the issuance of bonds;
- Prohibiting issuance of bonds for operating expenses (for example, issuance of bonds could be allowed only to finance upfront financing costs that are appropriately related to the restructuring of the LIPA debt and not for taxes, payments-in-lieu-of-taxes (PILOTS) or other ongoing operating expenses);
- Prohibiting the extension of the final maturity of the bonds and the deferral of principal payments to the future;

- Requiring that debt service be level or declining, or comply with the "50 percent rule" (which requires that no principal installment may be more than 50 percent in excess of the smallest prior installment); and
- Requiring debt service savings in each fiscal year (when the restructured debt is compared to the existing debt), and an overall net present value savings using a rate such as the effective interest cost of the restructuring bonds.

Oversight by LI DPS

The bill proposes an enhanced role for PSEG and a reduced role for LIPA. The legislation calls for LIPA staff to be "kept to a minimum," reflected by the Executive's expressed intent to reduce the number of LIPA employees from 90 to approximately 20. The bill does not identify a new entity to provide regulatory oversight of LIPA and PSEG, other than the new LI DPS, which is given power to "audit, review and make recommendations" without the power to enforce such recommendations.

The LI DPS is authorized to make recommendations to ensure safe and reliable service at rates set at the lowest level consistent with sound fiscal operating practices. The LI DPS is also authorized to review capital expenditures and emergency response plans, and to conduct audits. However, the LI DPS is explicitly prohibited from making any recommendation that would modify the compensation or fee structure in the agreement between LIPA and PSEG.

Regarding rate changes, the bill supersedes the 1997 PACB resolution requirement that any proposed rate increase greater than 2.5 percent be brought to the Public Service Commission (PSC) for approval. The bill instead requires that any rate increase greater than 2.5 percent be submitted to the LI DPS for review and recommendations, beginning in 2015 for rate changes effective January 1, 2016. However, if LIPA determines, in its discretion, that any LI DPS recommendation is inconsistent with its "sound fiscal operating practices, any existing contractual or operating obligations, or the provision of safe and adequate service," and then holds public hearings and makes a final determination, it can choose not to abide by LI DPS recommendations.

As with other oversight authority given LI DPS in the proposed legislation, the recommendations are ultimately nonbinding on LIPA and PSEG. Furthermore, it does not appear that the new transition charges authorized in the bill to support repayment of the restructuring bonds are subject to any of the provisions that apply to LIPA's rates and other charges. LIPA's ability to reduce or eliminate these charges while restructuring bonds are outstanding appears to be severely limited.

As proposed, this bill does not provide Long Island ratepayers with the same protections afforded ratepayers in the rest of the State. With regard to other utilities, the Department of Public Service has the power to: stop rate increases and other charges; order improvements related to service, capital expenditures, management, and operations; and impose penalties in response to a utility's failure to comply with certain requirements. In the absence of these protections from the Department, LIPA has been the primary "regulator" of its system operator – an arrangement which has proved to be less than ideal. Given the anticipated reduction in LIPA staff, it is unclear whether sufficient regulatory oversight and control can and will be provided. Provisions to strengthen this oversight appear necessary, and should be incorporated to ensure greater protection for ratepayers and more rigorous scrutiny of LIPA and PSEG.

Impact on Rates

LIPA customers pay electric service rates that are among the highest in the country. While LIPA was created in an attempt to control electricity costs on Long Island, ratepayers' bills have nonetheless increased significantly over time. The memo that accompanies the proposed legislation states that the total delivery charge paid by each customer would be reduced by an amount greater than the new transition charges associated with the debt restructuring. Also, the Governor's press release states that "the new utility company is seeking to freeze rates for three years." While these elements of the proposed plan have been discussed publicly and are laudable goals, they are not in the proposed legislation.

It is unclear which components of the total charges to the ratepayer would be included in the anticipated "rate freeze." Currently, the two major components of LIPA's monthly rates are: 1) the base rate or delivery charge; and 2) the fuel and purchased power cost adjustment or "power supply charge." The proposed bill introduces new charges and fees associated with the restructuring bonds. There are also potential new costs associated with the creation of staffing and administration of LIPRA. LIPA's ratepayers are responsible for payment of all of these costs, regardless of whether they are considered part of the base rate.

For more information, and a historical review of LIPA's rates, see the Office of the State Comptroller's report, *Public Authorities by the Numbers: Long Island Power Authority*, pages 5 – 8.