



# Strategic Organizational Analysis

**(New Update on August 10, 2011)**

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## Current Study Objective and Scope

- Brattle engaged in summer of 2010 to analyze organizational questions in conjunction with MSA replacement.

*The Brattle Group* provides consulting and expert testimony in economics, finance, and regulation to corporations, law firms, and governments around the world. *The Brattle Group* combines in-depth industry experience and rigorous analyses to help clients answer complex economic and financial questions in litigation and regulation, develop strategies for changing markets, and make critical business decisions.

Brattle is distinguished by:

- Thoughtful, timely, and transparent analyses of industries and issues
- Affiliations with leading international academics and highly credentialed industry specialists
- Clearly presented results that withstand critical review

- Objectives

- ▶ Develop cost and performance data for comparing options.
- ▶ Clarify and analyze organizational options for LIPA's future T&D operations.
- ▶ Estimate rate impacts associated with each organizational option.
- ▶ Recommend a preferred organizational option, with sufficient information on tradeoffs and risks to allow LIPA and its Trustees to make a reasoned decision.

- Scope

- ▶ Primarily T&D, Customer Service and Corporate functions; that is, areas outside of generation, fuel and purchased power and/or capacity.
- ▶ Also, consideration was given to possible impacts of LIPA's organizational structure on power supply costs.

## Why This Study? Why Now?

- LIPA's Management Service Agreement (MSA) with National Grid will expire on 12/31/2013.
  - ▶ The MSA must be replaced, with sufficient lead time to solicit and vet alternatives.
  - ▶ Strictly extending the current MSA would come at a considerable cost.
  - ▶ Expiring MSA has options for LIPA to transfer systems and property; must decide whether to exercise.
- This presents a unique opportunity to assess a range of organizational alternatives.

# Strategic Organizational Options

Variations on two broad sets of organizational options were analyzed.

## Municipalization Options

### **“Full Municipalization”**

Bring into LIPA:

Employees and  
resources currently  
serving LIPA

+ New resources as  
needed

### **“ServCo”**

“Partial  
Municipalization”

IT systems will be  
owned or licensed  
by LIPA

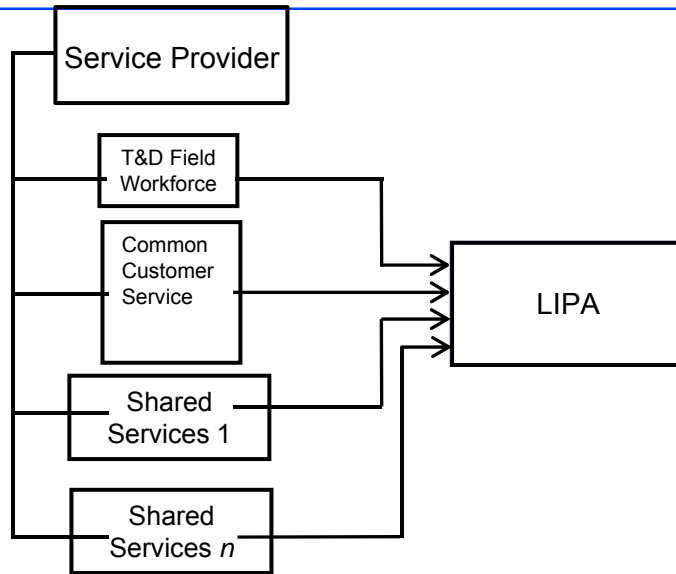
Accounting and  
costs will be more  
transparent than  
under MSA

### **Privatization**

Sell LIPA’s assets  
and obligations to a  
private company –  
such as an IOU

Put services and  
rates under NY  
PSC price  
regulation

# Management Services Agreement (MSA)



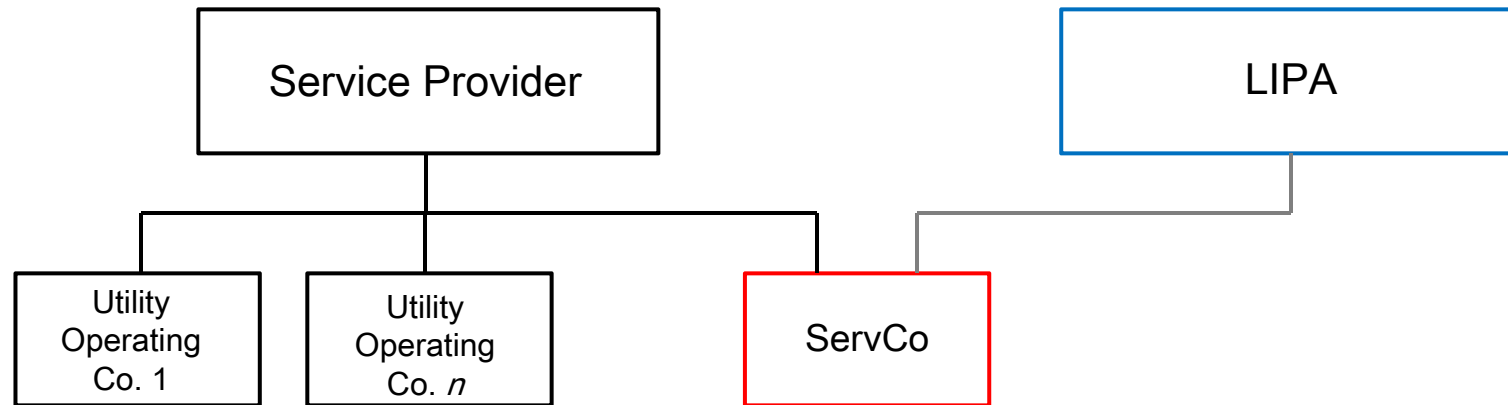
## Where is LIPA?

Many services provided under the MSA are geographically and organizationally dispersed.

Significant formula-based compensation component: incentive for Service Provider to minimize cost; may be worth taking “penalty” to avoid compliance with service levels.

- ▶ Lack of clarity and transparency re underlying costs.
- ▶ Practical consumer experience: Mixed message concerning responsibilities; “finger pointing” between LIPA and NG over service problems.

# ServCo Option



- ▶ Creates self-contained and transportable business unit, comprised of employees, systems and resources that are involved in LIPA-related activities.
- ▶ Overseen by senior management of Service Provider and Joint Operating Committee (JOC): Service Provider + LIPA.
- ▶ Compensated via actual (passed through) costs + variable (performance based incentive) compensation.
- ▶ Accounting records are transparent.

## ServCo ≠ MSA

- As envisioned: ServCo represents a reorganization from LIPA's current mode of doing business.
  - ▶ Services will be provided through dedicated subsidiary.
  - ▶ Majority of costs are “pass-through”; also includes profit component.
  - ▶ Includes incentive and penalty provisions.
  - ▶ Allows for portability of organization and assets.
- Provides LIPA with greater control over setting policy, setting goals and directing practices.

## Key Findings

# T&D Share of LIPA Costs



**LIPA Revenue Requirement  
2010 Baseline**  
~\$3,777m  
18.2¢/kWh

**T&D O&M: 15%**

\$557m

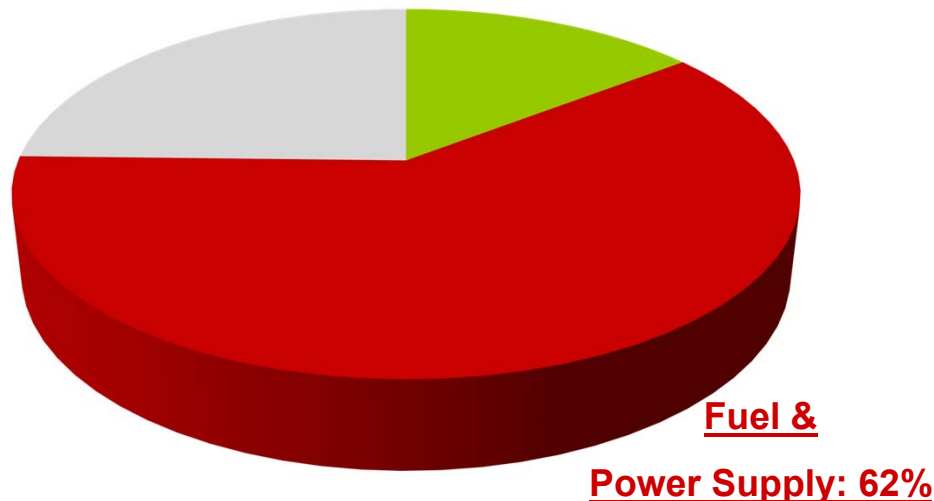
2.7¢/kWh

Financing & Tax

22% LIPA direct

Costs: 25%\*

78% NGrid



■ T&D operational expenses are only a small part of LIPA's costs.

▶ LIPA's annual T&D expenses, largely associated with the MSA, accounts for roughly 15% (\$557 million) of its total annual revenue requirement, or 2.7 cents/kWh.

▶ Even an implausibly large reduction in T&D costs would only change rates slightly.

- \$200 million cost reduction = 1 cent/kWh

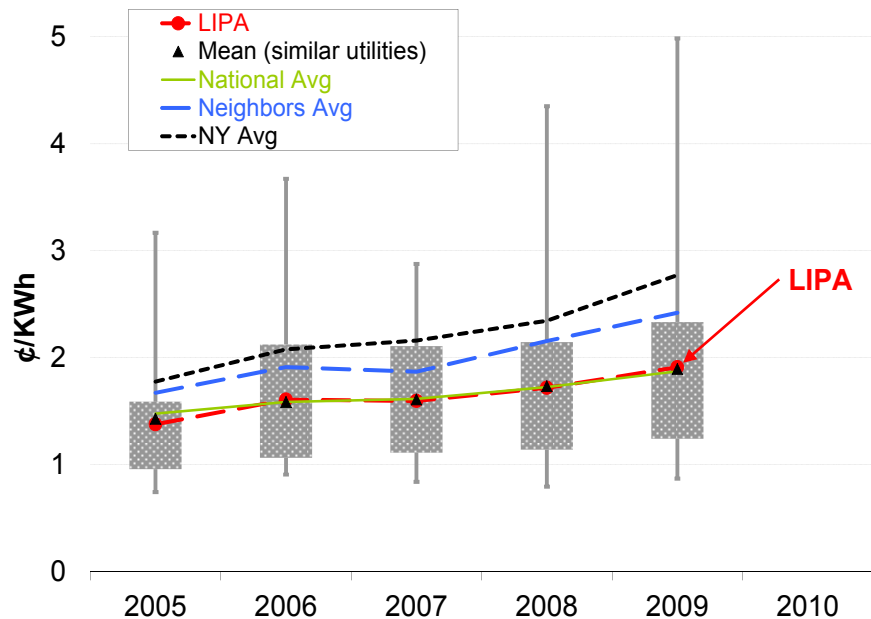
# Key Findings

## Cost Benchmarking

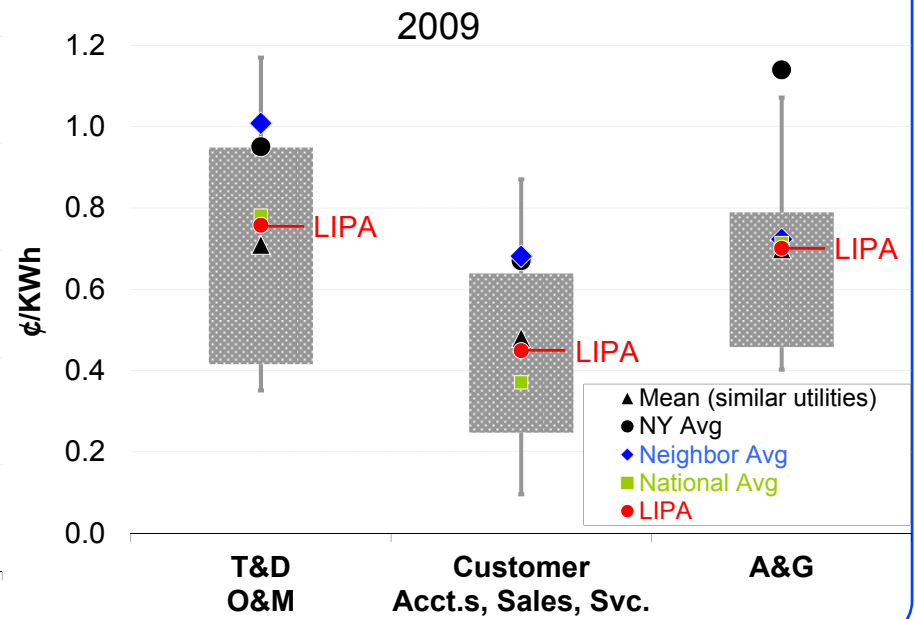


- **Brattle compiled cost data on 123 utilities for comparison to LIPA. We found that LIPA's T&D costs compare favorably to industry norms.**
  - ▶ Total LIPA NFOM cost per kWh  $\approx$  national utility average < neighbors < NY utilities.
  - ▶ Components of LIPA NFOM costs also comparable to national averages.

**Non-Gen NFOM Benchmarking  
for Similar Utility Panels**



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for Similar Utility Panels**

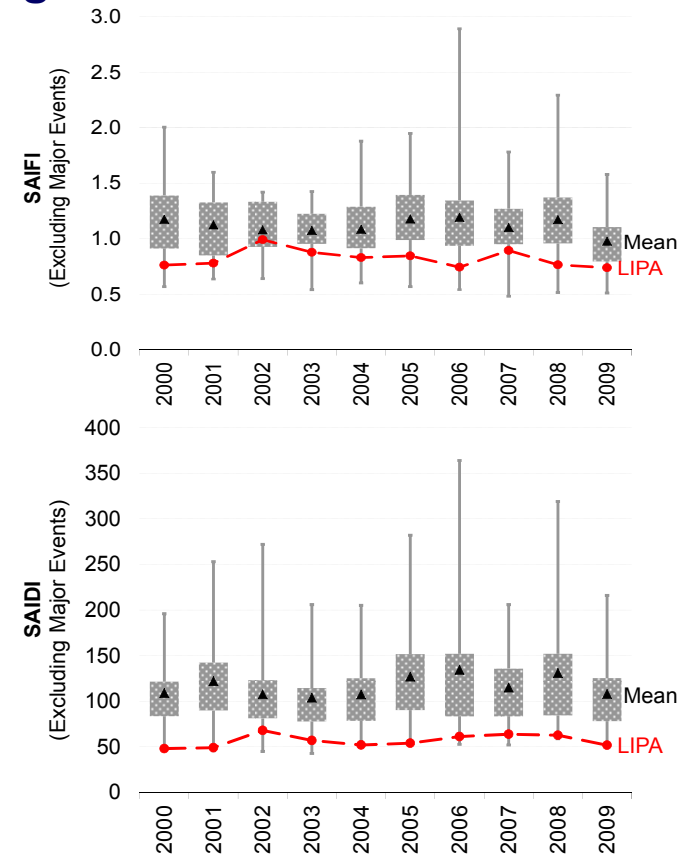
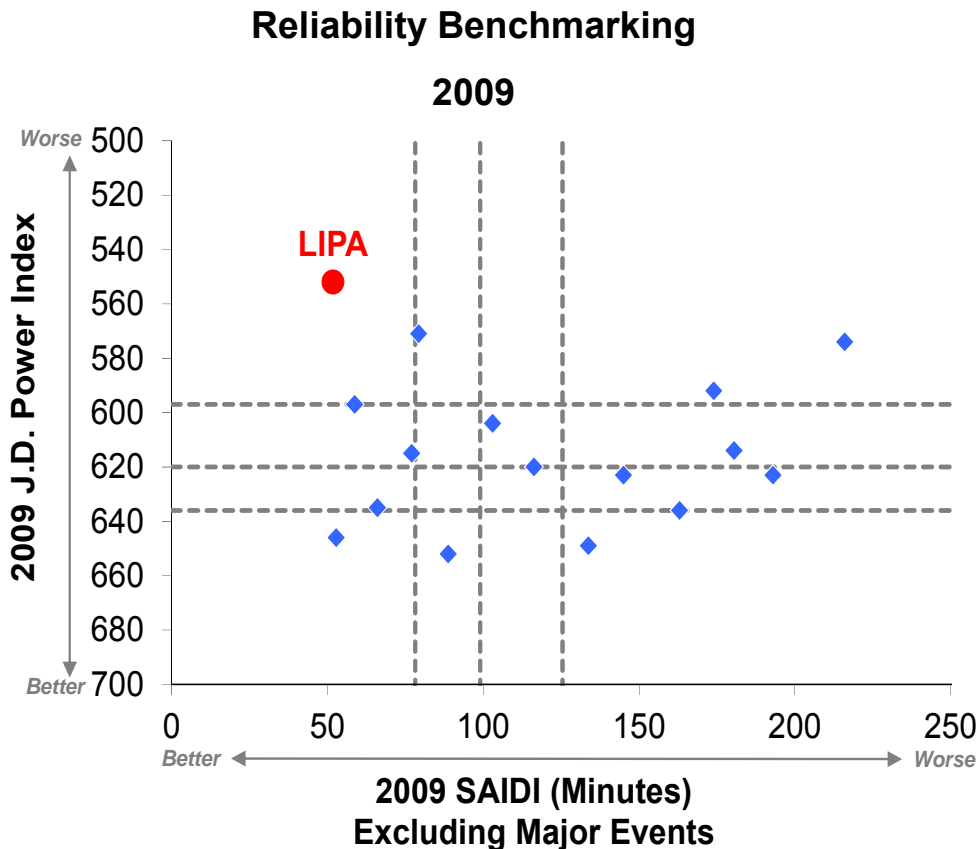


# Key Findings

## Reliability Benchmarking



**Brattle compiled data on SAIDI and SAIFI reliability statistics, as well as J. D. Powers customer satisfaction scores. LIPA's service reliability is among the highest, but its customer satisfaction is among the lowest.**



- Privatization includes a number of features that would significantly increase cost and transitional complexity
  - ▶ NYPSC rate-making process: LIPA's rates would be set by the NYPSC in a manner similar to the existing 6 IOUs in NY State.
  - ▶ Loss of tax-advantaged financing: new owner will fund with roughly 50% equity requiring around a 10% return after taxes, vs. 5% rate on LIPA's current all-debt structure.
  - ▶ Rate base: the book value of assets on which the NYPSC would allow the utility to earn a return likely to equal approximately \$7.6 Billion.
    - Non-productive \$2.6 billion Shoreham Acquisition asset doubtful – not “used and useful”
  - ▶ Debt defeasance cost: all of LIPA's debt would have to be “defeased” in order to comply with tax laws, at a total cost of ~\$961 Million.
  - ▶ Acquisition premium: Recent market observations indicate that many utilities' common stock trade at a premium to book value – could defray defeasance or rate increases.
    - Average utility stock trades at 1.5X book value per share; equivalent to 1.2X PP&E
    - In addition, utility equities usually command about a 10-20% acquisition premium in M&A transactions (based on 41 transactions from 2000 – 2010).
  - ▶ Total financing cost: Privatization would result in an increase of ~\$438+ MM in revenue requirements due to financing costs alone. This *excludes* debt defeasance costs.

# Transition Costs and Risks

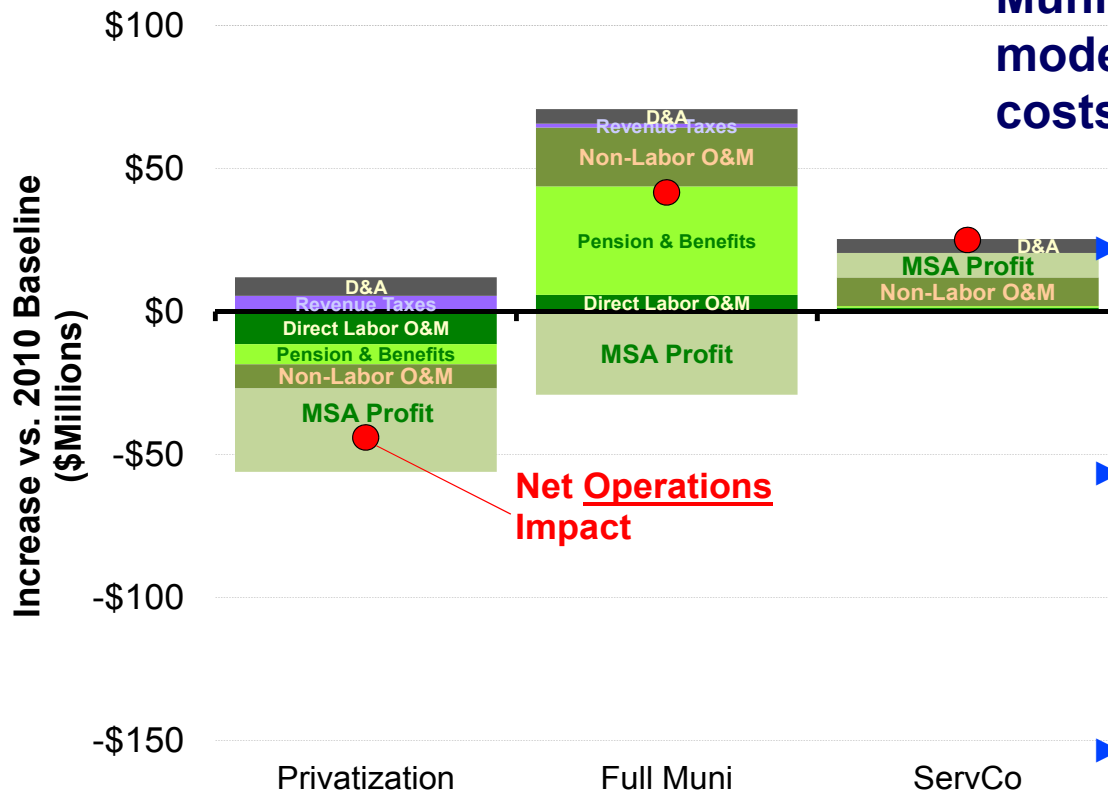
- Several kinds of transaction and transition costs, plus implementation risks attend each option:
  - ▶ **Privatization** – has transaction costs for advisory and bankers fees incurred as a part of a sale or refinancing – **\$20 – 40 million**; bond defeasance costs for providing equivalent tax exempt bonds to be exchanged for existing LIPA debt – **almost \$1 Billion**. Also a commercialization risk of being able to complete the transaction on time and terms consistent with expectations.
  - ▶ **ServCo** – has transition and integration costs involving expenses and/or capital investments to transfer systems and capabilities to the new manager – **24 months built into USM (Utility Services Management )Agreement**.
  - ▶ **Municipalization** – involves transition costs of obtaining and integrating new systems for operational and corporate management, plus management risk of ability to oversee and coordinate a much enlarged staff effectively

## Conclusions

# Changes in Operating Costs



Impacts on LIPA's Revenue Requirement Compared to 2010 Baseline (\$Millions)



Privatization will likely produce the largest reduction in operating costs, while ServCo and Full Muni are expected to have modest increases in operating costs.

Changes are plus or minus about \$50 million, or 0.25 cents per kWh.

Small improvements consistent with benchmarking findings, and with T&D costs already being under IOU management.

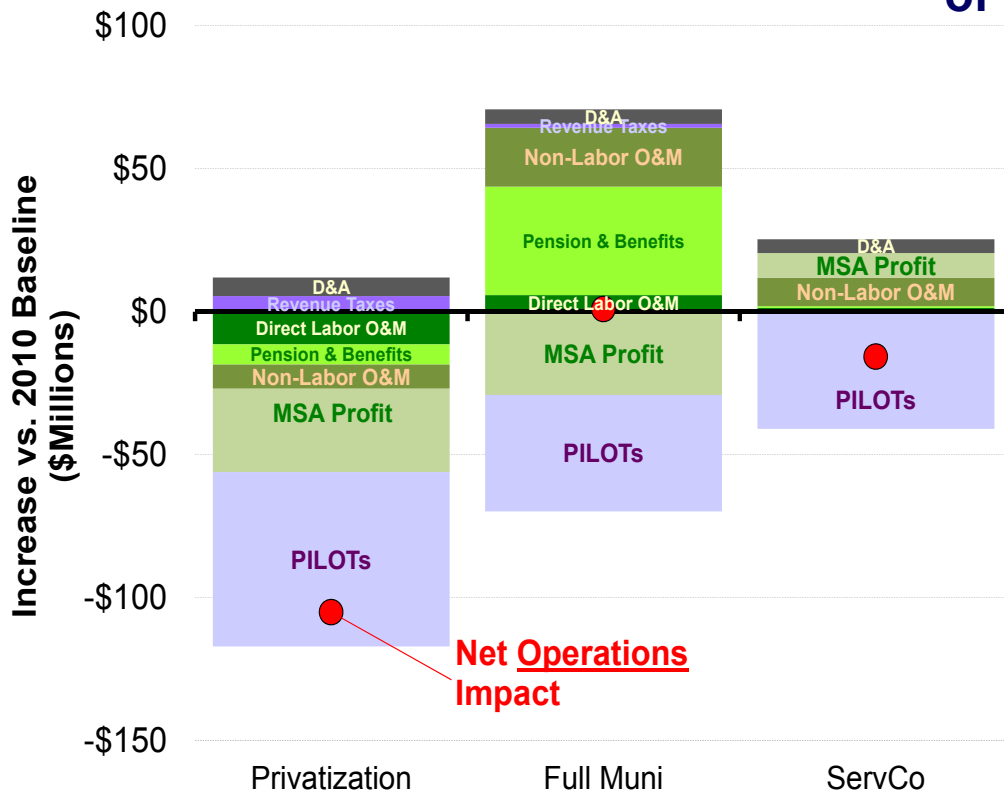
*This graph does not reflect all cost adjustments of re-organization.*

# Conclusions

## Changes in PILOTs



Impacts on LIPA's Revenue Requirement Compared to 2010 Baseline (\$Millions)



There are also opportunities to reduce LIPA's PILOT expenses – which can be pursued across each of the organizational options.

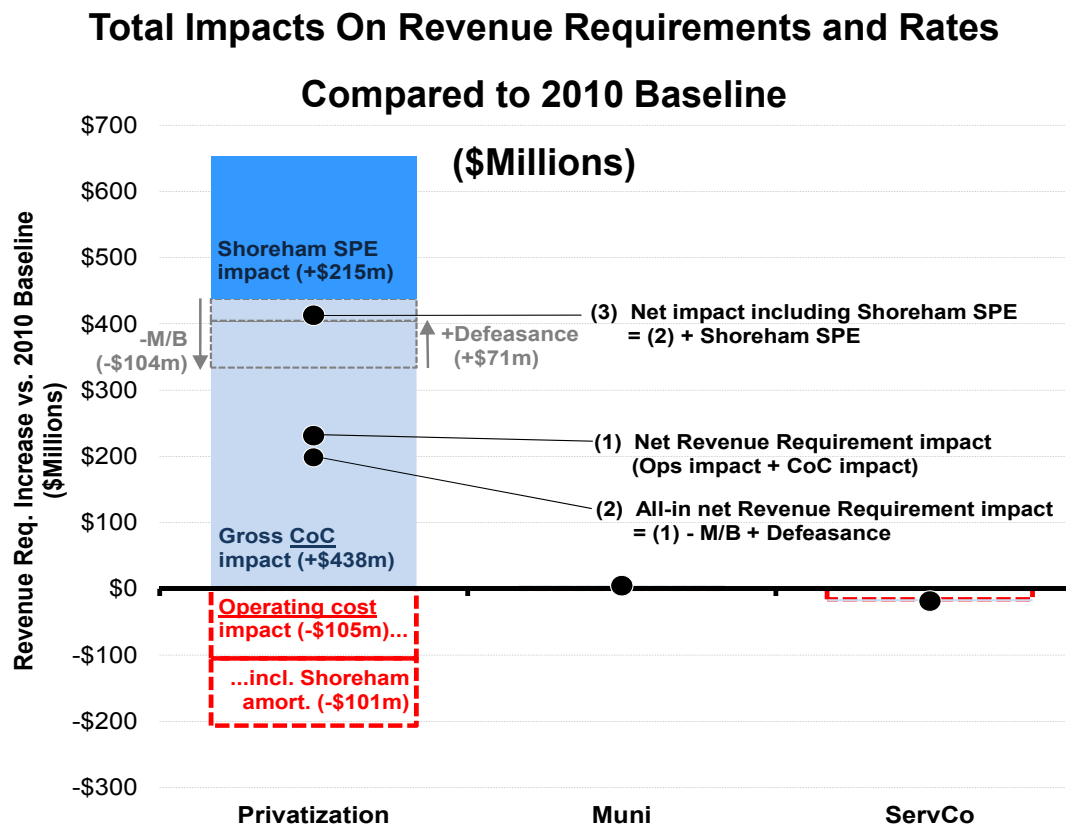
- ▶ Recent APPA survey suggests that LIPA pays higher levels of PILOTs than the panel of municipal utilities.
- ▶ We have assumed that privatization provides the strongest incentive to reduce PILOTs (property taxes).
- ▶ *This graph does not reflect all cost adjustments of re-organization.*

## Conclusions

# Overall Cost Impact Comparison



Implementing Privatization will likely include a 10% to 20% increase in electric rates: estimated \$100mm savings in operating expenses are not large enough to offset increased financing costs of over \$400mm.



# Conclusions

## Changes in Financing Costs



Even optimistic variations on privatization involve increased financing costs, creating strong tensions between substantial rate increases, unreasonably large cost reductions, implausibly low ROEs, and/or the need for other entities to cover non-productive assets.

| Acquisition Terms and Structure:               |                | As-is        | All-book     | U & U assets | U & U assets             | U & U assets                           |
|--|----------------|--------------|--------------|--------------|--------------------------|--|
|  |                |              |              | in RB + SPE  | in RB + SPE + defeasance | in RB + SPE + defeasance + M/B of 1.5x |
| Acquisition Value                              | (\$Bil)        | \$10.2       | \$10.2       | \$7.6        | \$8.4                    | \$9.7                                  |
| Rate Base (RB)                                 | (\$Bil)        | n/a          | \$10.2       | \$7.6        | \$7.6                    | \$7.6                                  |
| Rates from RB                                  | (¢/kWh)        | 18.2¢        | 21.2¢        | 19.3¢        | 19.3¢                    | 19.3¢                                  |
| Shoreham SPE                                   | (¢/kWh)        |              |              | 1.0¢         | 1.0¢                     | 1.0¢                                   |
| Amortization of defeasance                     | (¢/kWh)        |              |              |              | 0.3¢                     | 0.3¢                                   |
| Rebate from acquisition premium                | (¢/kWh)        |              |              |              |                          | -0.5¢                                  |
| <b>Total Rate</b>                              | <b>(¢/kWh)</b> | <b>18.2¢</b> | <b>21.2¢</b> | <b>20.3¢</b> | <b>20.6¢</b>             | <b>20.1¢</b>                           |
| Earned ROE                                     | (%)            | n/a          | 9.75%        | 9.75%        | 9.67%                    | 7.13%                                  |
| Required cost reductions for all-in 18.2¢ rate | (\$Mil)        | \$0          | \$622        | \$438        | \$507                    | \$406                                  |
| ROE with rates capped at 18.2¢                 | (%)            | n/a          | 2.08%        | 5.98%        | 3.96%                    | 2.74%                                  |

Require additional entities to cover non-productive assets

Substantial rate increases

Implausible cost reductions

Equity returns < bonds

## Conclusions

# Rate Impact Analysis



Rates under the Muni and ServCo options would be comparable to current levels, but **Privatization** (even assuming a Market Value / Book Value premium and greater operating cost savings) would result in a 2 to 3 cent per kWh rate increase.

|                      | Rate<br>(¢/kWh) | %<br>Change<br>from<br>Base<br>Case | Illustrative*<br>Monthly Impact on<br>Customer Bill<br>(\$/mo) |
|----------------------|-----------------|-------------------------------------|--|
| <b>Base Case</b>     | 18.2            | n/a                                 | \$141.05<br>(absolute)   |
| <b>Full Muni</b>     | ~18.2           | +0.0%                               | +\$ 0.00   |
| <b>ServCo</b>        | ~18.1           | -0.5%                               | -\$ 0.78   |
| <b>Privatization</b> | ~20.5           | +12.6%                              | +\$ 17.83  |

\* Monthly bill based on average revenue requirement impact and monthly consumption of 775 kWh.

## Conclusions

# Operating Costs



Some of the projected increases in operating costs are specific to the strategic organizational option; other costs will have to be incurred in any event.

|   | <b>Full Muni</b>  | <b>ServCo</b>   |
|---|---|---|
| <b>Staffing Levels</b>                  | Staff additions to make up for shared corporate and support resources under MSA | Staffing levels designed to account for contract management |
| <b>Pensions &amp; Benefits</b>          | Likely increase if employees are shifted to NYS Retirement System               | N/A   |
| <b>Profit to Service Provider</b>       | N/A   | OSA includes a profit component                             |
| <b>IT System Development / Upgrades</b> | LIPA = developer, owner / licensee  | SP = developer<br>LIPA = owner / licensee                   |
|   | E.g., Customer Accounting System (CAS)<br>Outage Management System (OMS)        |   |

# ServCo versus Full Muni Rates

- Rate impacts under the ServCo and Full Municipalization options are very close; modifications to cost assumptions may shift these already close rankings slightly, but not substantively.
  - ▶ Tax-advantaged financing is equivalent under both options.
  - ▶ Implementing either option will likely be accompanied by increases in (direct) T&D operating costs – but from different cost areas; at a detailed level, some cost areas are estimated to increase, others to decrease.
  - ▶ But expenses associated with PILOTs may also be reduced under both options – which would largely offset the projected increases in direct T&D expenses associated with implementing these options.
  - ▶ The close ranking of costs and rate impacts under the Full Muni and ServCo options indicates that strategic, organizational and risk considerations should primarily determine the selection process.

# ServCo versus Full Muni Transition

- ***All other things being equal* – i.e., if both options could be put into place seamlessly – the Full Municipalization option may very well be preferred over the ServCo option...**
  - ▶ ServCo provides LIPA with only indirect control over resources, and requires somewhat duplicative management; under a Full Municipalization model, LIPA directly employs resources.
  - ▶ ServCo is based on contracts and incentives – which inherently face Principal-Agent problems; these can be minimized through well designed and executed contracts, but unanticipated circumstances may present risks.
- **...But, getting from LIPA’s current state to Full Municipalization presents considerable “transition” risk – more so than the transition from the current state to ServCo.**

## Conclusions

# Full Muni Issues



- Several issues and challenges would need to be successfully addressed in order to effectuate a Full Municipal model.
  - ▶ Transition from LIPA's current organizational structure to a fully municipalized model would involve a large scale organizational transformation – which involves implementation risk.
  - ▶ Full municipalization of LIPA operations would require legislative authority.
  - ▶ Other issues:
    - Possible issues to be negotiated with collective bargaining units.
    - Loss of private sector price discipline.
    - Compensation for utility executives: NYS employee guidelines vs. private sector pay scales.

# Conclusions

## Flexibility of ServCo



- **ServCo provides several attractive features – notably option value – that address the circumstances immediately facing LIPA.**
  - ▶ The ServCo model requires that the Service Provider (with LIPA direction) build a dedicated (i.e., stand-alone) and transportable T&D electric utility.
    - This model allows LIPA to leverage the resources and expertise of the Service Provider, thereby facilitating a smoother transition to a stand alone utility, than if it had to be accomplished “from scratch.”
    - ServCo is not an “all or nothing” proposition: LIPA can keep key strategic support functions (including those that are currently provided by the Service Provider under the MSA) to LIPA.
  - ▶ ServCo governance structure allows LIPA management to actively direct improvement efforts – improving its customer satisfaction metrics.
  - ▶ The transportability component of ServCo provides *option value*; overall, the design of the ServCo model provides both an “exit” and “entrance” ramp.
    - Exit – termination provisions to end Utility Management Services contract.
    - Entrance - Optionality to convert to Full Muni, Private Utility or follow-on Service Provider, if circumstances or opportunities change.

# Overall Recommendation

- The ServCo option has the best likelihood of low transitional risks, effective performance incentives, and optionality to adjust in the future.

|                      | Full Muni  | ServCo  |
|----------------------|--|---|
| Transition Issues    | <b>Large-scale organizational deployment / transformation</b> <ul style="list-style-type: none"> <li>• Personnel</li> <li>• Systems</li> </ul>   | <b>Up-front systems and process integration</b>   |
| Control & Incentives | <b>Integrated organization, subject to public entity constraints</b> <ul style="list-style-type: none"> <li>• Salaries</li> <li>• Governance</li> <li>• Stakeholder participation</li> </ul> | <b>Potential principal-agent issues</b> <ul style="list-style-type: none"> <li>• Duplicative management</li> <li>• Cost</li> <li>• Performance</li> </ul> |
| Optionality          | <b>Largely irreversible choice</b>   | <b>Optionality to convert to Full Muni, Private Utility or follow-on Service Provider</b>   |

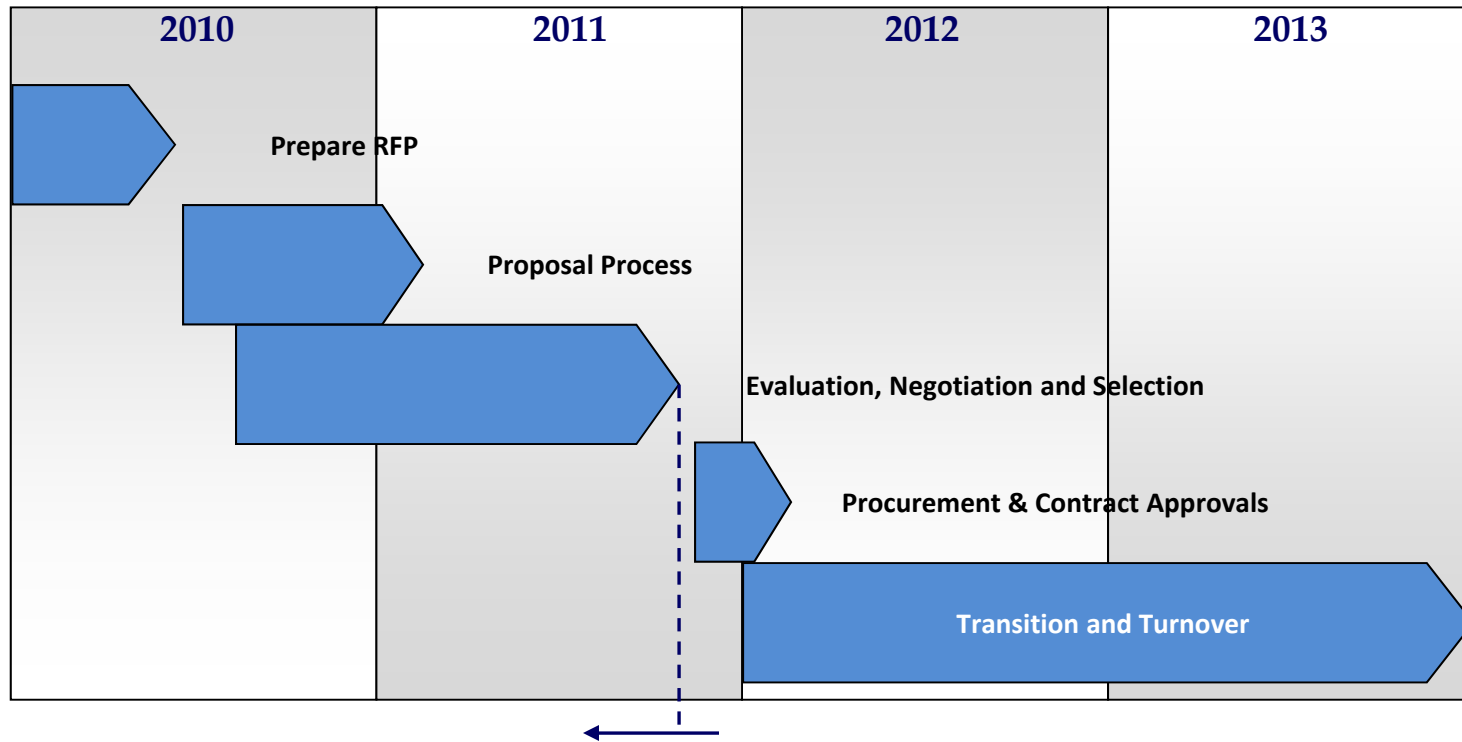
- These factors are largely qualitative and reflect overarching values and philosophies – areas within the province of the LIPA Board of Trustees

**Long Island Power Authority  
Update  
Utility Services Management Agreement**

## LIPA Management Services Agreement (MSA)

- As part of a deal brokered by New York State in 1998:
  - ▶ LIPA acquired the Long Island electric system from LILCO and
  - ▶ KeySpan (LILCO/Brooklyn Union Gas) continued to operate the system for LIPA under the Management Services Agreement (MSA)
- National Grid (NGrid) acquired KeySpan in 2007
- The current MSA terminates December 31, 2013
- This is the first time the services of the system operator have been competitively procured
- LIPA issued an Request For Proposals to competitively procure all services being performed by NGrid under the MSA including:
  - ▶ Electric system operations, maintenance, and construction,
  - ▶ Customer services (e.g., call center, meter reading, billing),
  - ▶ Energy efficiency services, and
  - ▶ Support services for LIPA's financial, planning, contract administration, environmental, and tariff administration functions to name only a few.

# USM Schedule Overview



# Utility Service Management Contenders



At the June 2011 Board of Trustees meeting, LIPA announced the three finalists contending for the new USM:

- ▶ Con Edison of New York
- ▶ National Grid
- ▶ Public Service Electric and Gas Company (PSEG)

At the September Board of Trustees meeting the Board will award the USM to one of the companies mentioned above.