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Long Island Power Authority

Year ended December 31, 2014

Assessment of the Internal Control Structure

As required under the Public Authorities Accountability Act, the Internal Control Officer is required to make an annual assessment of the effectiveness of internal controls of the Long Island Power Authority (the "Authority" or "LIPA").

As a means of providing background on the Authority and its operations, on January 1, 2014, the Authority transitioned to a new business model in response to the LIPA Reform Act, which was enacted on July 29, 2013. The LIPA Reform Act imposed a number of new obligations on PSEG Long Island (PSEG-LI), the new service provider, and effectively shifted major operational and policy-making responsibilities for the Transmission & Distribution System, including significant responsibilities relating to capital expenditures, budgets and emergency response, from LIPA to PSEG-LI. Consistent with this approach, the LIPA Reform Act requires that staffing at the Authority be kept at levels only necessary to ensure that the Authority is able to meet obligations with respect to its bonds and notes and all applicable statutes and contracts, and to oversee the activities of PSEG-LI.

It should be noted that the Authority hired a new Director of Internal Audit in late 2014, after the previous Director resigned for another position mid-2014. The Authority has also staffed a Director of Enterprise and Power Supply Risk Management position, and included in its budget funding for additional staffing for the Internal Audit Department.

The Authority also engages various consultants to examine specific areas of PSEG-LI's operations that impact LIPA. Since its creation, the Authority's Internal Audit Department has utilized independent firms to provide additional resources and expertise as needed.

In addition to the above protections, the Authority is entitled to and has direct input into certain of the activities of the PSEG-LI Internal Audit (PSEG-LI IA) department. PSEG-LI IA has not reported any significant internal control issues related to its operations on Long Island.

The italicized questions below come from the *New York State Internal Control Act Implementation Guide: Strengthening Compliance with the Act and Standards*. Below each question is the Authority's response.

Each Agency/Authority Head should provide a communication to all staff in support of its internal control program, including the importance of assessing internal controls.

Included in the forepart to the *Long Island Power Authority Management Policies and Internal Control Guidelines*, (Guidelines), is a message on internal controls which stresses the importance of strong internal controls. The message notes that employees should respect internal controls as stated in the

Guidelines and as enforced by the Internal Audit function, the Internal Control Officer (ICO) and the Finance and Audit Committee of the Board of Trustees.

Internal control programs should include a preliminary risk self-assessment by function.

Internal control programs should include an in-depth assessment of each function and should include the identification of inherent risks and internal controls for each function.

As in prior years, each process owner ("Director of...") is responsible to maintain and document a risk assessment.

As more fully set forth below, during this past two years the Authority has been fully engaged in transitioning service providers, and staff has assisted in a full process review of virtually all functions with the new service provider. As virtually all processes have been impacted by the changes in responsibilities brought about by the LIPA Reform Act, and as 2014 was a year transition activities, all of the existing internal controls will be re-evaluated over the next year as processes and responsibilities continue to evolve over the next year, including those required of LIPA to fulfill its oversight responsibilities.

The Authority views the process of risk assessment and mitigation controls as an ongoing and constant theme of good management.

Internal control programs should establish the frequency of reporting cycles for each risk assessment, internal control review, and other internal control reporting documents.

Currently, the Authority strives to prepare a risk assessment annually, and encourages staff to update the IC Guidelines when processes change, and as noted above, the Authority plans to undertake a full review of its internal controls during 2015.

Internal control programs should establish an approval or independent review process of the preliminary risk assessments and the more in-depth internal control reviews.

The risk assessments are to be reviewed by the ICO and the Director of Internal Audit.

Internal control programs should establish minimum and maximum timeframes for periodically reviewing its organizational structure and its inventory of functions.

The Operating Services Agreement with PSEG-LI required the establishment of an Internal Audit Department specifically for PSEG-LI. During this past year of transition, the PSEG-LI Internal Controls Coordinator has undertaken steps to create internal control process maps to support a Sarbanes Oxley type environment. All processes have risk based assessments prepared which drive a risk based audit approach, and all processes are fully inventoried and documented.

Internal control programs should establish a process for identifying improvement areas, corresponding corrective actions, and implementation status of all corrective actions.

If deficiencies are noted, or improvements need to be made to strengthen controls, the ICO and or the Director of Internal Audit will meet with the responsible process owners and make recommendations for change. Changes to processes are first developed with input from the process owner, and are to be incorporated into the Authority's processes. As the majority of day-to-day processes are handled through an outsourcing relationship, LIPA during the period covered by this report, relied on the PSEG-LI Internal Audit Department to identify and track corrective actions of their processes. When LIPA

engages outside independent accounting firms or other consultants who make recommendations for improvements, LIPA management takes such recommendations seriously and tasks the process owners with implementing, or overseeing the implementation of such recommendations.

Internal control programs should establish and maintain documentation standards (what needs to be kept; by whom; where; and for how long).

The Authority has reviewed and considered the applicable standards related to document retention and has adopted a Record Retention Policy that adequately complies with existing state regulations governing the Authority's documents.

Agency management should assign staff to one of three training levels: Line Staff, Middle Managers, and Executive Management.

In 2014, the vast majority of the Authority's staff was primarily engaged in the oversight of various agreements between LIPA and PSEG LI. Accordingly, each staff member was required to complete either the New York State Governor's Office of Employee Relations (GOER) – Internal Controls – Controlling Risk in the Workplace: The Manager's Role or Line Staff's Role. The courses addressed the manager's or line staff's role in ensuring that employees comply with policies and procedures, encouraging an effective control environment and maintaining high employee morale.

As such, LIPA staff needs to establish a sound oversight regimen for monitoring the new service provider. This is especially important as staffing levels have been reduced by approximately 50%.

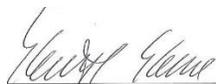
Agency management should identify training objectives and key concepts for each level.

As noted above, each staff member completed online internal control training. The objectives of the training were to help employees focus on the purpose of their jobs, be aware of and reduce risks, avoiding errors, preventing fraud and reducing waste.

Agency management should identify methods of delivery and frequency following the recommended framework of "quick hitters," instruction-based learning, and executive meetings.

As online internal control training was provided, a new and different focus was presented, yet reiterating a consistent message that internal controls are important and remain the responsibility of every employee. As LIPA enters a new stage in its corporate life cycle, many opportunities for strengthening internal controls should present themselves, which will in turn lead to more meaningful "real life" examples of mitigation activities to reinforce the importance of a strong control environment.

Based on the above, reliance on the PSEG LI internal controls processes, the support provided by independent consultants, the establishment of an Internal Audit Department within LIPA, and KPMG's "Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Governmental Auditing Standards" which did not identify any material weaknesses or significant control deficiencies, I believe that the internal controls of the Long Island Power Authority provide reasonable assurance that the organization will achieve its objectives and mission.



Kenneth Kane,
Internal Control Officer