Options Analysis for the Management of LIPA Assets (Phase I)

December 16, 2020

Long Island Power Authority

BACKGROUND

- Since 2014, LIPA has paid PSEG Long Island **$469 million in management fees** for operation of LIPA's T&D System
- Isaias Task Force's 90-Day Report found the root cause of PSEG Long Island's poor storm response was **management failures**
  - Problems experienced during the storm were **avoidable**
  - Matrix management with NJ operations delivered **absentee management** with **poor accountability**
  - Balanced Scorecard compensation resulted in **undue focus on a narrow set of metrics** that were not representative of the overall quality of management
- The Task Force recommended **changing the way LIPA's assets are managed**
- On November 18, **LIPA Board of Trustees directed PSEG Long Island to implement nearly 100 recommendations** from LIPA's Isaias Task Force
- The Board also directed LIPA staff to simultaneously pursue: 1) **terminating** or 2) **renegotiating** the Operating Services Agreement (OSA) contract with PSEG Long Island; the Board asked for analysis of these options

OVERVIEW OF OPTIONS EVALUATED

Ownership model:

Structural Options:

Private

1. Privatize LIPA Assets

- Sale of LIPA's assets to a private, investor-owned utility (IOU)
- Higher financing costs, greater tax burden, and ineligibility for federal disaster grants under private ownership would either raise customer bills by $32 per month or require unrealistic levels of synergy savings and service cuts.

Public Ownership

2. Reset the Single Partner Municipal Model

"Smarter Single Source"

- Integrate lessons learned from the PSEG experience
- Stronger contractual protections and the ability to unbundle parts of the contract away from the Service Provider
- Service Provider subject to LIPA Board policy and directives and more granular Service Level Agreements and performance metrics

3. Bring Operations under Municipal Management Model

"Integrated Services"

- ServCo becomes a direct LIPA subsidiary
- LIPA plays an active management role and acts as the integrator of services, aligning incentives and accountability

Sourcing Continuum

Reform the Contract with PSEGLI

- Reform the contract and reset the relationship with PSEG.

Terminate Contract and seek new Partner

- Reset the relationship with a different partner that is better equipped to deliver

Municipal Management with Selective Sourcing

- Core strategic functions are managed in-house
- LIPA outsources or co-sources select functions based on tradeoffs of benefits, costs, and risks

OPTION 1: PRIVATIZATION COSTS TOO MUCH

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 Federal Disaster Recovery and Storm Hardening Grant Proceeds

Year	Significant Storm(s)	Grant Proceeds (in millions)
2010	March Nor'easter	$51
2010	Winter Storm	$6
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**

- In 1998, LIPA purchased LILCO, an IOU, to **lower customer bills by 20%**; three studies since have found privatization would significantly raise customer bills
- Privatization raises financing costs by an estimated **$447 million per year** and LIPA would lose eligibility for federal disaster recovery grants that have totaled **$1.7 billion** since 2010 (avg. of **$160 million per year**)
- "Synergy" savings from privatization are not sufficient to offset these higher financing and disaster recovery costs
- Estimated cost of privatization of **$32 per month for an average residential customer** or equivalent cuts in customer satisfaction, reliability and clean energy investments

OPTION 2: REFORM AND RESET THE SINGLE-PARTNER MUNICIPAL MODEL

- **PRO:** Partnerships hold the promise of “synergy” cost savings and access to best practices
- **CON:** Principal-Agent Problems – agent/partners make key decisions but aren’t accountable for bad outcomes. “Nobody ever washed a rental car” as the saying goes
- **OSA is a “high-trust” agreement**. Mitigates principal-agent risks by:
  - PSEG Long Island’s name on the truck (but many parts of operations not visible to customers)
  - Balanced Scorecard incentive compensation to align LIPA and PSEG Long Island interests (found to be too narrow to represent the overall quality of management)
  - Audit and oversight rights but few other controls typical of outsourcing agreements
- PSEG Long Island **demonstrated systematic management failures and a lack of transparency** about problems during Tropical Storm Isaias that make such a high-trust agreement untenable

OPTION 2: PRINCIPAL-AGENT PROBLEMS ARE COMMON IN OUTSOURCING

Common Manifestations of Principal-Agent Problems[3]

- **Insufficient effort**. Shirking responsibilities, overly focusing on short-term results, or making decisions without adequate due diligence.
- **Self-dealing**. "Gold plating" without respect to cost 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, despite the fact that the responsibility and risk are ultimately the owner's and not the agent's.

- **Communications systems were not systematically tested**
- **Outage Management System (OMS) was failing *before* Isaias**
- **Distant, unaccountable NJ-based managers** for key parts of LI operations
- **PSEG management was not transparent with LIPA** about OMS failures and other issues before, during, or after the storm
- No meaningful cost synergies from the shared services provided by PSEG from NJ and **quality of such shared services range from medium to low**

OPTION 2: A REFORMED P3 AGREEMENT

- **More and better metrics of performance, reliability & readiness** (e.g. detailed service level agreements for each scope of service)
- **Abandon the matrix** – top managers on Long Island with accountability to LIPA and Long Island operations
- **Unbundle the contract** and allow independent procurement or subcontracting of scopes of service where quality of service is low
- **Strengthen contract provisions**
  - Strengthen contract termination triggers
  - Reinforce contract provisions to prevent decisions that impose high switching costs from one service provider to another
  - Larger variable compensation and penalties
  - Enhance the LIPA Board's prerogative to compel PSEG Long Island's compliance with Board Policies and directives
- **Require PSEG Long Island to be more transparent**; PSEG Long Island will need to take steps to re-establish trust with LIPA , customers, and stakeholders
- Use new contract terms to strengthen LIPA's oversight – **"trust, but verify"**

OPTION 3: OVERVIEW OF SERVICES

- Under the current P3 model, **PSEG Long Island has been hired to perform several dozen distinct scopes of services** for LIPA in a single contract
- Many of these scopes have been further outsourced to third parties, in whole or in part, by PSEG Long Island, with PSEG Long Island serving as “integrator.” For example:

Selected Scopes of Service Outsourced By LIPA

Services LIPA Has Outsourced to PSEG Long Island	Services PSEG Long Island Has In Turn Retained Other Firms, In Whole or Part, to Provide	Services LIPA Sourced to Other Providers
T&D System Operations	Engineering	Power Plant Development
Power Supply Planning	Capital Construction	Power Plant Operations
Information Technology*	Tree Trimming	
Business Services*	Energy Efficiency Programs	
Call Centers	Legal Services	
Customer Offices	Debt Collection	
Customer Billing and Payment	Advertising and Marketing	
Government Relations	Commodity Hedging Advisory	
Communications	Insurance Brokerage	
Fuel Procurement		
Energy Market Trading		
Procurement		
Facilities		
Fleet		
Records Management		
Human Resources		

* At points these services were outsourced by PSEG Long Island to other providers.

OPTION 3: MUNICIPAL MANAGEMENT

- PSEG Long Island provides **18 members of management** to manage the 2,500-employee dedicated "ServCo" workforce plus shared services from NJ
- **LIPA could hire about a dozen members of management and directly manage ServCo as a LIPA subsidiary**, while continuing to access the private sector for selected non-core services
    - OSA provides mechanism to transfer "ServCo" to LIPA as a subsidiary
- Bundling all services in one contract to PSEG Long Island is not required to access **private sector scale and efficiency benefits**
- Strategic and of core functions would be carried out by LIPA's own management and ServCo employees
- Competitive sourcing of non-core services may provide **greater value and lower cost** than sourcing all services from a single vendor (e.g. access to best-in-class firm; greater accountability; and the ability to transition to new provider if service doesn't meet expectations)

OPTION 3: FINANCIAL IMPACT

- **Savings of $65 to $75 million per year compared to PSEG Long Island contract**
  - Hire approx. a dozen LIPA management employees
  - Eliminate $80 million yearly in PSEG Long Island management fees
  - Eliminate $20 million per year in PSEG affiliate charges for shared services (mostly offset by cost of new ServCo hires to perform those services)
  - Transfer salaries and benefits of ServCo employees (requires Legislation)
  - $3 to $6 million for additional hires
  - Estimate includes $85 million to $105 million in one-time transition costs
- Savings in the range of **$155 million to $215 million** net of transition costs through the 2025 termination of the PSEG Long Island contract and **$675 to $815 million**, if that contract is extended, per its terms, through 2032
  - Will customers benefit more from PSEG Long Island management or investment of these funds into customer satisfaction, reliability, and clean energy initiatives?

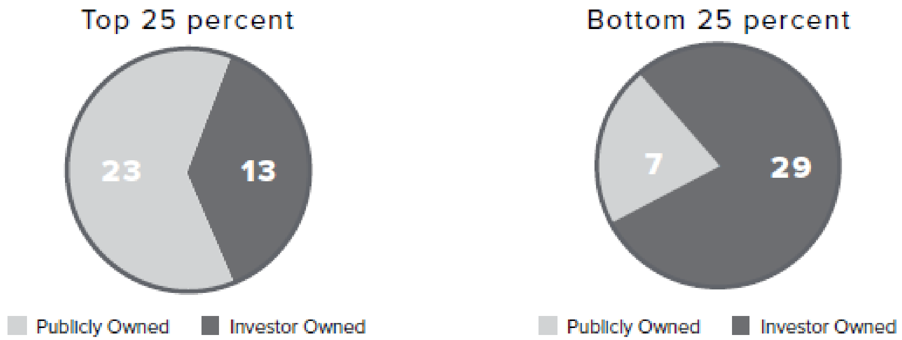
Bottom Line: Municipal Management Is Financially Feasible and an Attractive Alternative to the Single-Source Service Provider Model

OPTION 3: MUNICIPAL MANAGEMENT CAN PRODUCE STRONG RESULTS

Public Sector Utilities Have High Customer Satisfaction

(# of utilities)

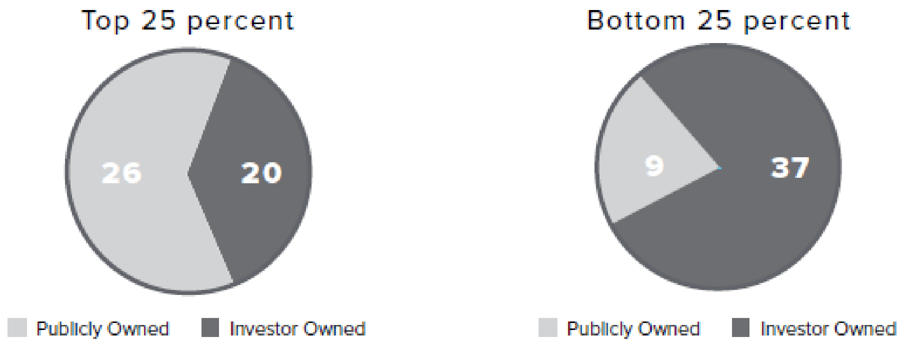
Source: J.D. Power Electric Utility Residential Customer Satisfaction Survey, 2019; publicly owned includes both municipal and cooperative utilities.



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.



- Publicly-owned utilities and co-ops nationwide fare as well or better than private sector utilities in the measures customers care about – customer satisfaction and reliability. They also tend to be leaders in clean energy

CONCLUSION

Moving forward in a 2-stage Process:

- **First Stage:** Board adopted nearly 100 recommendations to begin immediately turning around PSEG Long Island management, IT, and emergency management
- **Second Stage:** Restructure and reorganize to improve the long-term management of LIPA's assets
    - Negotiate with PSEG Long Island to obtain their **best offer for a reformed OSA**
    - Simultaneously prepare for Options 2 and 3
    - **Issue Phase II report no later than March 31** for consideration by the Board, Governor, Legislature, and stakeholders
- **Greatest Risk: Maintaining the Status Quo**

Option	Timetable
Option 2A: Reset the Current Partnership with PSEG Long Island	6 to 9 months
Option 2B: Single Partner Model with a new Partner	24 to 30 months
Option 3: Municipal Management Model	12 to 18 months

QUESTIONS?