



September 20, 2013

Wayne Brindley
New York State
Department of Public Service
Three Empire State Plaza
Albany, NY 12223

Re: Matter No. 12-00314 – Comprehensive Management and
Operations Audit of the Long Island Power Authority

Dear Mr. Brindley:

At the direction of the New York State Department of Public Service (“DPS”), NorthStar Consulting Group (“NorthStar”), completed a management and operations audit of the Long Island Power Authority (“LIPA”) and submitted a draft report to DPS for review on July 30, 2013. After receiving feedback from DPS and fact verification from LIPA, NorthStar filed its Final Audit Report (the “Report”) on September 13, 2013. In this regard, LIPA respectfully offers its comments on the Report.

Background

The Long Island Power Authority Oversight and Accountability Act (the “Oversight Act”), which was signed into Law on February 1, 2012, requires DPS to conduct periodic audits of LIPA’s internal policies and procedures to improve the transparency and efficiency of its management and operations.¹ After a competitive procurement, DPS selected NorthStar to perform the audit, which was originally expected to commence in October 2012 and run through July 2013. However, due to Super Storm Sandy (“Sandy”), the audit was delayed and field work did not fully commence until April 2013.

As required by the Oversight Act, the audit addressed: 1) LIPA’s construction and capital program planning in relation to the needs of its customers for reliable service; 2) the overall efficiency of LIPA’s operations; 3) LIPA’s Fuel and Purchased Power Cost Adjustment (“FPPCA”) clause and recovery of costs associated with such clause; and 4) LIPA’s annual budgeting procedures and process. Due to the schedule delay caused by Sandy, and the need to

¹ On July 29, 2013, the LIPA Reform Act (the “Reform Act”) was enacted, which includes, among other things, the requirements of the LIPA Oversight Act, and provides for the next management and operations audit of LIPA (and its service provider) to commence in December 2015.

complete the audit as close to the original timeline as possible, DPS directed NorthStar to delete two topics from the audit scope: 1) the manner in which LIPA meets its debt service obligations; and 2) LIPA's compliance with debt covenants.

Given the scope and timing of the audit, it is important to note that the current organizational structure of LIPA, and its relationship with its service provider, is about to transition in a material way pursuant to the Reform Act. Currently, LIPA contracts with National Grid Electric Services, LLC ("National Grid"), pursuant to the Amended and Restated Management Services Agreement ("MSA"), to perform the day-to-day operations and maintenance of the transmission and distribution system ("T&D System"), including, among other functions, transmission and distribution facility operations, customer service, billing and collection, meter reading, financial and operational reporting, and planning, engineering and construction. LIPA exercises control over the performance of the T&D System through specific standards for performance contained in the MSA. In anticipation of the MSA's expiration on December 31, 2013, and following a competitive procurement process, LIPA entered into an Operating Service Agreement ("OSA") with PSEG Long Island LLC ("PSEG-LI") (a subsidiary of Public Service Enterprise Group) on December 28, 2011. Pursuant to the OSA, PSEG-LI would perform functions substantially similar to those performed under the MSA, commencing January 1, 2014, under a different organizational structure than currently exists. LIPA is currently engaged in revising the OSA to conform to the new requirements of the Reform Act, which further restructure the arrangement between LIPA and its service provider.

Notwithstanding the new law, given the timing of the audit, NorthStar focused predominately on LIPA's operations under the MSA model, the management and oversight of those operations exercised by the existing structure, and the OSA dated December 28, 2011. NorthStar's recommendations reflect areas where improvements are needed going forward, regardless of the scope of the services in the OSA or the structure of LIPA and its governing Board. The uniqueness of the timing of this audit, while contemplated under the Oversight Act, was exacerbated by the Reform Act, and thus, LIPA appreciates the need for the audit approach taken by NorthStar and believes that it led to findings and recommendations that can be implemented over time, consistent with the impending new organizational structure at LIPA and contractual relationship between LIPA and PSEG-LI.

Audit Process

With the goals of the Oversight Act in mind, LIPA approached this audit as an opportunity to identify and assess those areas of its operations and management that need focus and improvement going forward. Throughout the course of the audit, DPS, NorthStar and LIPA (with support provided by National Grid and PSEG-LI), worked collaboratively to facilitate a comprehensive review of LIPA's operations and management. To that end, LIPA committed the necessary resources to facilitate the audit process and to ensure that LIPA was responsive to

NorthStar's requests. In total, LIPA responded to 908 data requests and 185 interview requests as part of the audit. LIPA appreciates that the Report recognizes that the audit was conducted in an open and constructive manner, including frank and meaningful discussions about NorthStar's findings, conclusions and recommendations.

Overall, LIPA believes that NorthStar's audit process was thorough and constructive. The collaborative efforts and discussions had between LIPA, DPS and NorthStar lead to a better understanding of the issues affecting LIPA and, in turn, strong and relevant recommendations aimed at improving operations going forward given LIPA's unique circumstances.

Key Findings and Conclusions

LIPA recognizes the importance of addressing the six cross-functional themes identified by NorthStar. LIPA acknowledges that these themes represent challenges that LIPA faces and is committed to more thoroughly understanding and addressing going forward. In this regard, LIPA acknowledges that addressing these areas is critical to LIPA improving overall performance, cost of service and customer service.

Notwithstanding the challenging environment in which LIPA exists, LIPA is committed to achieving excellent electric utility service for consumers. Accordingly, LIPA will refer back to the Report's six overarching themes as it is restructured pursuant to the LIPA Reform Act and as it transitions to and implements the proposed revised OSA. LIPA believes that these areas of concern can be addressed so as to allow LIPA, in conjunction with DPS, to achieve excellence in the provision of electric utility service for LIPA's customers. To that end, LIPA offers the following general comments in response to the six themes identified by NorthStar:

1. *A fully contracted utility operation such as LIPA, operating without a traditional command and control structure, is critically dependent on its "utility management IQ" to be successful.*
 - The change in structure called for in the Reform Act creates a more traditional "command and control" structure within LIPA's future service provider (PSEG-LI), which brings with it a greater "utility management IQ."
 - With respect to the LIPA Board of Trustees, the Reform Act has created minimum qualifications that the appointing authorities must consider when appointing members to the Board, namely "relevant utility, corporate board or financial experience." In this regard, the current Board has a significant amount of experience consistent with the Reform Act, including one Trustee with direct experience as an executive of similarly sized private and public utilities, and several other members with financial experience. The LIPA board has been serving during a period of significant challenges for the utility.
 - As the Report acknowledges, it is difficult for LIPA to attract and retain seasoned utility employees given various constraints identified in the Report; however,

LIPA has made significant strides in this area, including the addition of numerous, seasoned utility professionals to the management team, and will continue to build on its recent success in attracting and retaining experienced professionals in the future.

2. *As the entity ultimately responsible for electric service on Long Island, LIPA has to keep its contractors accountable for results – all the time. The service provider contract must drive performance, allowing LIPA to exercise its responsibilities as system owner and intervene as necessary to improve performance.*

- The revised OSA, as contemplated, not only contains important performance metrics that will allow LIPA to keep PSEG-LI accountable for results related to reliability and customer satisfaction, but also requires the use of the PSEG-LI brand, which is a significant tool to create accountability on the part of LIPA's service provider.
- Additionally, the new structure contemplated under the revised OSA provides for more transparency related to the provision of services in comparison to the MSA, including with respect to the cost of service. This transparency is viewed as a significant improvement that will enhance LIPA's ability to monitor and keep its future service provider, PSEG-LI, accountable.
- LIPA will provide ongoing oversight of PSEG-LI operations and OSA performance. LIPA has other significant roles bearing on utility service including meeting utility financing needs, and, at least at the start of the process, policy development and resource planning.
- DPS-Long Island will provide continuous guidance, diligent oversight and meaningful intervention as the proposed revised OSA is implemented going forward. DPS will be engaged in emergency planning and response, energy efficiency and renewables, capital budget review, OMS metrics review, rate cases, consumer complaints and other important areas.

3. *LIPA's customers deserve to be treated with maturity and respect, to receive accurate and timely information about system operations, rates and performance, and to have appropriate levels of service.*

- One of the key strengths demonstrated by PSEG-LI during the procurement process leading to selection was PSEG's superior reputation in New Jersey, where it has a proven track record of 1st quartile customer service and reliability performance. In addition to numerous process improvements contemplated under the new contract, it should be noted that LIPA is currently working with PSEG-LI to implement a new Outage Management System, which is expected to provide for enhanced communication and restoration efforts related to storm events.

4. *LIPA cannot become subordinated to the service provider's core utility operations.*

- Within the framework of the revised OSA, PSEG-LI will operate as a ServCo unit dedicated to LIPA's operations, with PSEG-LI management primarily dedicated to LIPA's operations. LIPA believes that this will address weaknesses identified in the Report under the MSA framework and will lead to ongoing improvement in services and operations. LIPA operations and customers will be the primary focus of PSEG-LI employees and management.
5. *The Authority deserves to receive outstanding performance from its providers and should only pay premiums for performance above the current norms.*
 - The revised OSA metrics seek 1st quartile performance in both reliability and customer service. Additionally, LIPA expects that assistance from and oversight by DPS Long Island with respect to service received from PSEG-LI will enhance LIPA's ability to ensure that performance metrics meet the needs of the organization.
 6. *Functional areas where LIPA is performing well should be preserved and supported through the transition to PSEG-LI and the ServCo model.*
 - LIPA expects the outcome of the new structure will result in the same high level of performance recognized in the Report, including the transfer of certain service contracts in the power markets area and the energy efficiency function to PSEG-LI and, shortly thereafter, the remainder of the power markets function.

Recommendations

In total, NorthStar offered 83 recommendations, including 43 recommendations that LIPA is able to adopt directly, and 40 recommendations that LIPA will seek to have PSEG-LI adopted and implement. While LIPA is preparing an implementation plan that would demonstrate how the 43 recommendations will be implemented, some general comments are offered as follows.

LIPA appreciates the effort and expertise that NorthStar provided during the audit process and in the development of these recommendations. In this regard, LIPA intends to work diligently to implement the recommendations with the assistance of DPS Long Island, and with the cooperation of PSEG-LI. With respect to recommendations that LIPA will seek to have PSEG-LI adopt, it should be noted that PSEG-LI has performed a preliminary review of the recommendations and has indicated to LIPA that a vast majority are already planned to be implemented in 2014.

Next Steps

LIPA believes that this audit was timely, productive and an important element of improving its operations going forward. As LIPA transitions from the MSA to the proposed revised OSA, the findings and recommendations in the Report will guide LIPA and its service providers (current and future) in improving operations now and in the future.

It is expected that NorthStar's recommendations will be presented to the LIPA Board of Trustees on October 3, 2013 for review and consideration. LIPA staff will recommend to the Board that the recommendations be accepted in full, with an implementation deadline of December 2015 (before the next management audit commences). Additionally, as the transition from National Grid to PSEG-LI continues, LIPA will work with PSEG-LI to help facilitate implementation of the recommendations in the Report applicable to them as service provider, consistent with the terms and conditions of the revised OSA.

LIPA appreciates and values NorthStar's and DPS's extraordinary efforts related to this inaugural management and operations audit of LIPA, particularly given the time and other constraints under which they were operating. The recommendations from NorthStar represent a sound framework for the types of changes contemplated by the LIPA Reform Act and the revised OSA, all of which are aimed at improving the quality of service to LIPA's customers. LIPA looks forward to continued collaboration with DPS and PSEG-LI to ensure their proper and efficient implementation.

Sincerely,

A handwritten signature in black ink, appearing to read 'Lynda Nicolino', with a long horizontal line extending to the right.

Lynda Nicolino
General Counsel and Secretary

cc: John D. McMahon, COO
LIPA Trustees