NEW YORK STATE OF OPPORTUNITY. Department of Public Service

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September 28, 2015

Honorable Ralph Suozzi
Chairman
Board of Trustees
Long Island Power Authority
333 Earle Ovington Blvd.
Uniondale, New York 11553

Re: Case Matter 15-00262 – In the Matter of a Review and Recommendation Regarding a Three-Year Rate Proposal for Electric Rates and Charges Submitted by the Long Island Power Authority and Service Provider, PSEG Long Island LLC.

Sent Electronically

Dear Chairman Suozzi:

It is my pleasure, as CEO of the New York State Department of Public Service to submit to the Long Island Public Authority Board of Trustees the Department's recommendation concerning the three-year rate proposal for electric rates and charges submitted by the Long Island Power Authority and Service Provider, PSEG Long Island LLC (PSEG LI).

This submission of the three-year rate plan represents another successful step in the improvements to utility operations and cost containment contemplated by the LIPA Reform Act. The New York Legislature enacted the Reform Act on June 20, 2013 to address the financial, structural and operational deficiencies of LIPA that became apparent in the aftermath of Superstorm Sandy. In just over two years, many of the positive changes that were contemplated in the Reform Act have been achieved, including the establishment of the DPS Long Island Office, which is now providing independent, comprehensive oversight of electric operations for the first time in LIPA's history. In addition to the rate review that is the subject of this letter, the DPS is now involved in reviewing the same key aspects of utility operations as it does for all other major electric utilities in the State, including storm preparedness and response, consumer complaint mediation, operational audits, capital plan reviews, and review of metrics and the company's performance under the metrics.

As you are aware, the Reform Act authorized the modification of the Operating Services Agreement (OSA) to shift more operational control from LIPA to PSEG LI. Following the Board of Trustees approval of the modified OSA, PSEG LI assumed operational control on January 1, 2014. The transfer of operational control from National Grid was successful and reflected months of planning and preparation by both utilities and LIPA. As a consequence, PSEG LI was able to immediately begin full operations of the system, successfully demonstrate its operating skills through several significant storms, and meet its service metrics. Importantly, the Reform Act delivered on its promise to keep delivery rates on Long Island unchanged since 2013. Moreover, the effective transition also allows PSEG LI to direct its attention over the next three years to further improvements in utility operations and customer service, including implementing the changed operations contemplated in PSEG LI's 2.0 plan as part of the State's Reforming the Energy Vision initiative.

The Department's recommendation recognizes the unprecedented investment in system hardening and resiliency initiatives. The $730 million FEMA grant to LIPA will be leveraged by a $73 million capital investment in these activities, financing of which is recognized in the attached Rate Recommendation. These activities, both FEMA and ratepayer funded, will include elevation of critical infrastructure above forecasted flood plains and construction of over 300 circuits to improved design standards, which will also incorporate some associated level of tree trimming.

Finally, by pursuing the additional securitization authorized by the Legislature earlier this year and approved by the Board in June, LIPA will significantly reduce its debt expense. Rates have been stabilized on Long Island due in large part to the tax reforms and highly effective debt restructuring authorized by the Reform Act. It is estimated that the Reform Act's securitization authorization and tax reforms will save ratepayers $720 million over the next three years, including $172 million in lower debt payments from the next securitization.

A key element of the Reform Act, as recognized in the OSA, is the requirement for PSEG LI and LIPA staff to submit to DPS their proposal for a three-year rate plan for years 2016, 2017, and 2018. That provision ensures that the delivery rates established for Long Island are considered through the rigors of an extensive and public review process. On January 30, 2015, PSEG LI and LIPA staff proposed to raise rates by a cumulative sum of $441 million over three years.

In accordance with the Reform Act, the Department's review and recommendations are designed to ensure that the Authority and the Service Provider provide safe and adequate transmission and distribution service at rates set at the lowest level consistent with sound fiscal operating practice and other criteria set forth in the Act. In developing our recommendations, certain principles were of paramount importance, such as minimizing the burden on consumers and supporting sound investment in the infrastructure, and preserving and improving the financial health of the Authority (*e.g.,* by reducing LIPA's historically high debt burden).

In setting rates for utilities, the Department's first responsibility is to ensure the utilities can provide safe and reliable service to their customers. To that end, we review the utilities' revenue requests to ensure that revenues are sufficient to meet this obligation and that they have an opportunity to earn a fair return for their investors. At the same time, because utilities are monopolies and not subject to the rigors of competition, the Department plays an important role in driving utilities towards efficiencies to ensure that ratepayers are not unduly financially burdened. This is the traditional standard for investor owned utilities in the State, but its spirit is also embodied in the Public Authorities Law requirement that LIPA maintain the lowest achievable rates. While PSEG LI as the provider of operations service and management to LIPA does not earn a rate of return, the company does have an opportunity to earn incentive compensation for achieving certain metrics that are affected in part by its operations budget. Therefore, we view the revenue requirement proposal filed by PSEG LI with a lens similar to the one we apply to the regulated utilities.

The Department has been responsible for the review of revenue requirements for investor owned utilities for over 100 years. The type and quality of the information that is required in a Department rate review, in addition to institutional knowledge of the participating parties and companies, results in a robust record to support final rate recommendations in our cases. In that tradition, the Department applied the same process of review to the PSEG LI rate case. In addition to applying its own regulatory expertise, the record benefited from the rigors of the rate review processes. Through eight months of review, including six public statement hearings, comments from thousands of ratepayers, two days of evidentiary hearings, four rounds of briefing and hundreds of pages of expert testimony from the parties in the case, DPS Administrative Law Judges, advised by a panel of the best technical experts at the Department (Senior Advisory Group), issued a draft recommendation which reduced PSEG LI's initial revenue requirement proposal by 26 percent, from a cumulative revenue requirement increase of $441 million over the three years, to $324.6 million.

The attached Rate Recommendation adopts for the most part the draft recommendation of the Senior Advisory Group, and recommends a three-year cumulative revenue requirement increase of $325.4 million, which still equates to a 26 percent reduction of PSEG LI's initial request. This recommendation reflects a balancing of competing interests and statutory and contractual requirements. Where there was insufficient support in the record to increase certain budgets as PSEG LI proposed, we recommend reducing those requested increases to a level that our experience and the record support (*e.g.*, Bulk Electric System, Distribution Tree Trimming, Outreach and Education). In other cases, where actual cost information was not available during the case, but where we know there will be a need for cost recovery (*e.g.*, interest rates on debt restructuring, labor costs that emerge from future collective bargaining agreements, etc.), the rate recommendation provides for updates for specific elements – subject to our review – to reflect actual costs before rates are set for each rate year. Overall, we have evaluated the total revenue requirement to be provided under the proposed Rate Plan and determined that, while PSEG LI did not prevail on each element of its case, it would receive sufficient revenues to operate the electric system in a prudent manner.

Equally important, as required by the Reform Act, the Rate Recommendation is consistent with ensuring that revenues are sufficient to satisfy the Authority's obligations with respect to its bonds, notes, and all other contracts. Included in these obligations is the OSA, the contract by which PSEG LI operates the electric system and by which its success is evaluated through the performance metrics included in the OSA.

As always in rate cases, there were competing expert opinions and credible and well-reasoned arguments. I commend the parties for their commitment to providing the best record basis to set rates that reflect the need to ensure ratepayers pay no more than necessary for electric service, while affording PSEG LI a reasonable opportunity to achieve contract performance metrics.

The revenue requirement for utilities falls into two categories: known costs and revenues and those that are uncertain and need to be forecasted based upon best available information and standard regulatory methodology. When looking at the forecasts of costs and revenues, the benefit of the doubt goes in favor of forecasts that do not unduly burden ratepayers, especially where the forecasted item has a mechanism to reconcile the forecast to actuals.

The Rate Recommendation addresses the budgets for operations and maintenance and capital expenditures, the forecast of revenues, and rate design matters. With respect to the first, the Rate Recommendation balances the need to provide sufficient revenues associated with outreach and education and system maintenance (*e.g.*, tree trimming and pole inspection) with the need to moderate rate increases. With respect to the second, the sales forecast represents an application of standard regulatory methodologies that comport with forecasts of economic improvement on Long Island. The Rate Recommendation notes that any under or over forecast of sales will be reconciled in the Revenue Decoupling Mechanism. Lastly, the rate design proposals were viewed with the eye towards mitigating customer impact, acknowledging the on-going evolution of rate design thinking in the Reforming the Energy Vision proceeding underway at the Public Service Commission, and the ability of customers to take responsive actions.

More importantly, the Rate Recommendation, if adopted by the Board, will ensure that critical investments are made to preserve and improve electric service and system resiliency and ratepayers realize the savings provided through debt securitization. For example, the Rate Recommendation supports the revenue requirement associated with completion of distribution tree trimming to an expanded area for the entire system by the end of the rate plan and implementation of the industry best practice of a four-year cycle thereafter. In addition, the Rate Recommendation provides revenues sufficient to complete pole inspections and necessary remediation and preventative actions within a time period consistent with industry best practices.

While nobody desires rate increases, it is important to note that a significant portion of revenues collected by rates are for items outside PSEG LI's control. For example, 25 percent of the non-fuel/purchased power revenues goes toward satisfying LIPA's property tax obligation. It is noteworthy that LIPA's property tax burden is among the highest of the State's utilities and well above the national average. Moreover, while LIPA is aggressively managing its debt obligations, 30 percent of non-fuel/purchased power revenues goes towards satisfying debt obligation and coverage requirements associated with financial metrics (*e.g.*, bond ratings). As noted, this percent would be materially higher if not for the ability of LIPA to securitize a significant portion of its existing debt authorized by the Legislature. Thus, while these non-controllable costs confirm the need to carefully scrutinize controllable expenditures, they also support the recommendation that when all factors are considered, the recommended rate adjustments are appropriate and should be adopted.

In summary, the attached Rate Recommendation will enable PSEG LI to provide reliable electric service to Long Island customers while being afforded an opportunity to earn performance based compensation and will continue the path of the Authority towards improved financial positions through lower debt costs and better debt ratings. The Department stands ready to address any questions the Board may have regarding the Rate Recommendation.

Respectfully submitted,

Audrey Zibelman
Chief Executive Officer

cc: Jon Mostel, Secretary, LIPA Board of Trustees

Encl.