



Major Decisions Facing LIPA Over Next Several Years

By [Stanley B. Klimberg](#)

Over the next several years, the Long Island Power Authority (LIPA) will be faced with major decisions regarding whether:

- to continue with its current ownership and operational structure, which has been in place since it acquired the Long Island Lighting Company (LILCO) in 1998, in which LIPA owns the electric transmission and distribution system on Long Island and is responsible for serving its approximately 1 million electric customers, and contracts with private companies to provide day-to-day operation, maintenance, construction and customer services (Operations Services);
- if it continues with its current structure, to select its current manager, National Grid, or one of the other two companies that LIPA has determined to be technically qualified, to provide Operations Services;
- to extend LIPA's current Power Supply Agreement with National Grid, which expires in May 2013, under which LIPA acquires all of the capacity, and to the extent LIPA requests, the energy from National Grid's approximately 3700 megawatts (MW) of on-Island generation currently covered by the agreement, or instead to purchase capacity and energy only from National Grid's units which provide needed or cost-effective energy; and
- to enter into agreements to purchase substantial, additional electricity from one or more of the 16 companies or groups that submitted proposals to LIPA, in response to its Request for Proposals to purchase up to 2500 MW of capacity, energy and ancillary services.



LIPA is a corporate municipal instrumentality and political subdivision of the State of New York. LIPA is governed by a 15 member Board of Trustees, nine of whom are appointed by the Governor of New York State (the Governor appoints the Chair), three are appointed by the Temporary President of the New York State Senate and three are appointed by the Speaker of the New York State Assembly. LIPA currently has a staff of approximately 100 employees.

LIPA OWNERSHIP AND OPERATIONAL STRUCTURE

In 1998, LIPA acquired LILCO, a privately-owned utility, including its electric transmission and distribution system, and became the supplier of retail electric service for most of Nassau and Suffolk Counties and the part of Queens County known as the Rockaways. As a result of the acquisition, LIPA was able to reduce immediately its customers' electric rates by approximately 20 percent, primarily as a result of its (1) lower cost of capital resulting from its issuance of 100 percent tax-exempt debt to replace LILCO's outstanding taxable debt and stock, and (2) not being subject to federal income tax.

LIPA entered into, in connection with its acquisition of LILCO, various operating agreements with separate, LILCO and Brooklyn Union Gas Company-created entities (collectively, KeySpan), under which, among other things, KeySpan (now National Grid, which acquired KeySpan in 2007) provides Operations Services to LIPA pursuant to a Management Services Agreement, which expires on December 31, 2013, and sells capacity and energy to LIPA from its on-Island generation pursuant to a Power Supply Agreement, which expires on May 28, 2013.

This arrangement, which is generally referred to as a public-private partnership, has generally worked well. Still, given LIPA's continued high electric rates, there have been suggestions over the past decade to examine alternative ownership and operational structures that might achieve lower electric rates, more effective decision making and greater operational efficiencies.



In 2004, LIPA initiated a review of the strategic organizational and governance issues facing LIPA. LIPA retained FTI Consulting, Bear Stearns & Co. Inc. and several law firms to assist LIPA in reviewing its options, which were identified as:

- continuing the current public-private partnership, under which LIPA owns the electric transmission and distribution system, establishes the policies that govern operation of the system and customer service, sets the electric rates and contracts with private companies that provide for the day-to-day operation of the system subject to LIPA's direction and oversight,
- full "municipalization," under which LIPA would assume full responsibility for the operation and maintenance of the electric transmission and distribution system, and would hire most of the National Grid employees that currently provide services to LIPA, and
- "privatization," under which LIPA would sell its transmission and distribution system and other assets to a private entity, which would own and operate the system and serve Long Island's electric customers.

FTI Consulting concluded in its December 2005 Report on the Results of the Strategic Organizational Review that the current public-private partnership was the best current alternative.

In 2009, LIPA engaged Lazard to update LIPA's 2005 Strategic Organizational Review. In its February 2010 report, Lazard concluded, among other things, that: "[t]he current public/private partnership structure continues to largely meet its statutory goals to the benefit of ratepayers, with the factors most impacting LIPA's rates (e.g., Shoreham Debt, fuel and purchased power costs, property taxes) not necessarily directly related to LIPA's current structure." Lazard recommended that given the limitations of the public-private partnership, LIPA obtain additional detailed information to properly evaluate alternatives to the public/private partnership.



In May 2010, LIPA retained The Brattle Group and M.J. Beck (Brattle Group) to continue to review its strategic options as they relate to a potential reorganization or optimization of its current operating structure. The Brattle Group is expected to complete its report in the near future.

The Brattle Group will likely conclude that the current LIPA ownership and operational structure, with important revisions, best assures low cost, reliable service to LIPA's customers compared to the alternatives of privatization and full municipalization. These revisions would likely include having substantially all of the operation and management services being provided through a separate service company or "servco" to be established by the Service Provider, with all the employees other than management providing the services to LIPA being housed in the "servco," rather than the services being provided directly by LIPA's Manager with its own employees, as is currently the case.

Most notably, the Brattle Group will almost certainly conclude that privatization would result in an increase in LIPA customers' rates over what they would otherwise be, since a private company acquirer (1) would have a substantially higher cost of capital than LIPA, since the private company's capital structure would be comprised mostly of higher cost, taxable debt and equity, compared to LIPA's 100 percent, lower cost, tax-exempt debt, and (2) would have to pay federal income taxes, which LIPA does not pay. It is difficult to see how expected private company efficiencies in the management and operation of Long Island's electric system could overcome these substantial LIPA capital structure and tax advantages.

Full municipalization could theoretically achieve some cost savings, since LIPA would no longer be paying a fee to a private company to provide day-to-day operation, maintenance, construction and customer services to LIPA. However, there are, in my view, very substantial issues and risks associated with LIPA's assuming full responsibility for operation of the system, which far outweigh and could eliminate these potential cost savings or even cause an increase in LIPA's rates.

In order to implement full municipalization, LIPA would have to, among other things, hire the several thousand workers that currently are employed by National Grid, who would then become state



employees, hire executives with extensive utility management experience to manage this workforce, and address satisfactorily the issues associated with integrating the current unionized, National Grid workforce into LIPA, including significant state pension and benefits issues. Moreover, all these activities would have to be undertaken while LIPA was providing electric services to its customers. In my view, there are simply too many complicated issues to manage and address and too many uncertainties to warrant implementing this option.

UPCOMING SELECTION OF A SERVICE PROVIDER TO PROVIDE OPERATIONS SERVICES TO LIPA

LIPA's Management Services Agreement with LIPA, under which National Grid provides for the day-to-day operation of LIPA's system, expires on December 31, 2013. LIPA issued a Request for Proposals (RFP) to select a Service Provider to provide Operations Services for a 10 year term commencing January 1, 2014. This process assumes that LIPA will decide to continue its current public-private partnership.

LIPA has announced that three companies that submitted proposals in response to the RFP were qualified technically to provide operational services: National Grid, Con Edison and Public Service Electric and Gas Company.

LIPA has stated that it expects to select a Service Provider in September 2011. In view of the very substantial role that the Service Provider has in the safe and reliable operation of Long Island's electric system and in providing for satisfactory customer services, the selection of a Service Provider is a very important decision which would have considerable consequences for the quality of electric services that LIPA's electric customers will receive over the next 10 years.



UPCOMING DECISION REGARDING POWER SUPPLY AGREEMENT WITH NATIONAL GRID

LIPA currently has a 15 year Power Supply Agreement with National Grid, which provides for the sale to LIPA of all of the capacity from National Grid's approximately 3700 MW of on-Island generation currently covered by the agreement and, to the extent LIPA requests, the electric energy from this generation.

LIPA generally purchases the lowest cost electric energy from either National Grid on-Island generation and other available supply sources, whether on and off Long Island; however, in some cases, LIPA needs to purchase electric energy from certain, more costly National Grid units which "must run" due to the units' operating characteristics or which are located in a "load pocket," that is, there isn't sufficient transmission to deliver lower cost electricity from generation located outside the load pocket to LIPA's customers located within the load pocket.

The Power Supply Agreement expires on May 28, 2013. LIPA has the right to renew the Power Supply Agreement for an additional 15 year period on substantially the same terms and conditions as the current Power Supply Agreement.

Under the terms of the Power Supply Agreement, if LIPA were to exercise its right to renew the Power Supply Agreement, LIPA would have to purchase capacity from all of National Grid's on-Island generation, even if certain of the generating units were not needed or economical. LIPA does not have the right to decide which units it wants to include in a renewed Power Supply Agreement.

Certain of National Grid's on-Island generation, particularly the Northport units (1,500 MW), are critical to meeting LIPA's electric reliability requirements. Certain of National Grid's other generation, including the Glenwood units 4 and 5 (200 MW) and Far Rockaway unit 4 (100 MW), are old and inefficient and are not be needed or economical.

Notably, LIPA recently announced an agreement with National Grid to remove the Glenwood and Far Rockaway units from the Power Supply Agreement and National Grid announced that they will be closing



and dismantling the plants. Although not stated in LIPA's Electric Resource Plan, other generation, such as Port Jefferson units 3 and 4 (350 MW), are also possible candidates for retirement.

LIPA is thus faced with the choice of either renewing the Power Supply Agreement and paying for certain unneeded and uneconomical generation, or not renewing the Power Supply Agreement and trying to negotiate an alternative agreement under which it purchases capacity and energy only from needed and economical generation. National Grid will likely resist such an arrangement, since it would be left with old and inefficient generation not under contract, which it would likely have to retire at its considerable cost.

LIPA issued a Request for Proposals for up to 2500 MW of new generation and transmission commencing operation beginning in 2016 and recently received numerous proposals. (See discussion below.) These proposals will no doubt provide LIPA with valuable information regarding the availability and costs of substantial additional generation, which it will certainly take into account in negotiating a new agreement with National Grid.

These LIPA-National Grid negotiations, together with LIPA's decisions regarding new generation and transmission, will have a lasting effect on Long Island and its energy system and the local communities where generation may be retired and added.

LIPA HAS SOLICITED FOR UP TO 2500 MW OF ADDITIONAL CAPACITY, ENERGY AND ANCILLARY SERVICES FOR OPERATION COMMENCING 2016

LIPA issued an RFP for up to 2500 MW of additional capacity, energy and ancillary services from one or more of the following eligible sources: (1) new on-Island generation, (2) repowered on-Island generation, (3) new or existing generation located outside Long Island connected to LIPA's service area via a dedicated generator lead, (4) new or existing off-Island generation offering capacity and financially firm energy to the off-Island terminus of a controllable transmission cable.



LIPA also specified 100 MW as the minimum unit sizes for items 1 -3 above and 250 MW for item 4. LIPA also specified that each proposal must propose commercial operation dates of May 1, 2016, May 1, 2017 or May 1, 2018, and include prices, terms and conditions of a LIPA option to delay the proposed project's commercial operation date for 1 and 2 years.

LIPA recently announced that 16 entities submitted proposals on March 31, 2011 for on-Island and/or off-Island projects in response to LIPA's 2010 Generation and Transmission RFP and listed the names of the proposers' parent company and/or consortium members. LIPA stated that the target schedule for proposal selection is the second quarter 2012, with contract execution targeted for the first quarter 2013.

The proposals should provide LIPA with substantial flexibility to determine how best to meet its capacity and energy needs beginning in 2016 or thereafter, including whether to extend its Power Supply Agreement with National Grid, which expires in May 2013, or to enter into an alternative contractual arrangement.

[Stanley B. Klimberg](#) is a partner and member of the firm's Energy and Construction Practice Groups. From 1995-2007, Mr. Klimberg served as General Counsel of the Long Island Power Authority. He can be reached at 516-663-6581 or sklimberg@rmfpc.com.